

“It would be irresponsible to neglect mortgage fraud's impact on the U.S. housing and financial markets.” (FBI)

Levy Institute's Annual Minsky Conference

Ford Foundation HQ April 16, 2009

William K. Black

Associate Professor of Economics and Law

University of Missouri – Kansas City



Economic Analyses of the Crisis are Irresponsible

Create “criminogenic environment”

Econometrics praises the worst
practices that optimize accounting
“control fraud”

Ignores economic fraud theories
Lemons, Looting, Adverse
selection, Gresham’s, Moral
hazard. Ignores criminology.

It's easy to understand why the theoclassical are irresponsible

Control fraud falsifies their claims

Markets & contracts aren't efficient

Market discipline is perverse where
fraud gives a competitive gain

Gresham's drives honest from the mkt

Reverse Pareto optimality: both
parties lose; dishonest agents win

Financial bubbles and crises

But why are progressive economists irresponsible?

Control fraud epidemics don't falsify progressive economic views

Adding criminological input would strengthen progressive economics

White-collar criminologists study why markets become dysfunctional

That's a vital contribution to economics

Adding Control Fraud Epidemics to the Economics Canon

Incentives: the core of economics and white-collar criminology

Fraud epidemics aren't random

The factors that produce criminogenic environments are clear

The incentives are perverse, but they have predictable marginal effects

Criminologists are the Experts in Dysfunctional Markets

Four key criminology concepts:

- Criminogenic environment
- Control fraud
- Systems capacity
- Neutralization

If it's bad criminology, it's bad economics. If it's good criminology it's good econ.

Control Frauds as Superpredators

The person that controls the firm or agency uses it as a “weapon” to defraud

Financial control frauds’ “weapon of choice” is accounting

Causes greater losses than all other forms of property crime combined

Optimization is perverse

Recent epidemics

S&Ls: fraud “invariably” at the
“typical large failure”

Treadway found control fraud in
80% of SEC cases

Russian privatization; “tunneling”

Enron, WorldCom, *et al.*

Wash. Consensus – Latin Am.

Backdating options

Nonprime mortgage fraud

Mortgage Fraud “Epidemic”

FBI warned of it in *9.04*

80% of it induced by *lenders*

FY07; 08: >50K; >63K criminal referrals

Investment banks (03-07): 36 referrals

Unregulated: 80% nonprime loans

Most frauds undiscovered; referrals are
exceptionally uneven & biased

Fitch: fraud in “nearly every file”

FBI Missed Control Fraud

FBI misdiagnosed the crisis

Classified as “fraud for housing” or
“fraud for profit”

Assumed lender won't knowingly make
bad loans

Made strategic alliance with “industry
partners” Mortgage Bankers Ass'n
– the organization of “perps”

Results: a sign

But FBI Found Control Fraud

“Many of these bankrupt subprime lenders manipulated their reported loan portfolio risks and used various accounting schemes to inflate their financial reports.” FBI Report FY07

Yes, mortgage fraud inherently means accounting fraud

But no indictments of CEOs

Bubbles, Deceit & Trust

Mortgage fraud and related financial industry corporate fraud have shaken the world's confidence in the U.S. financial system. FBI 2.11.09

Accounting control fraud = bubble

Fraud = Deceit = creating, and betraying trust

Fraud destroys trusts; shuts markets

Mock this Press Release

Property crime rates in 2007 were at or near the lowest levels recorded since 1973, the first year that such data were available. Property crime rates fell during the previous 10 years (1998-2007) [12.17.08]

<http://www.ojp.usdoj.gov/bjs/pub/press/cv07pr.htm>

No, property crime is at unprecedented heights

Rating Agencies as Vectors

Any request for loan level tapes is
TOTALLY UNREASONABLE!!!
Most investors don't have it
and can't provide it. [W]e
MUST produce a credit
estimate. It is your
responsibility to provide those
credit estimates and your
responsibility to devise some
method for doing so. [S&P '01]

Why Doesn't the SEC Have a “Chief Criminologist”?

“Law enforcement agency”, but
criminologists have no role

Lawyers & economists dominate

There are economic theories that
are useful to understand fraud

But economists interpret these
theories to exclude fraud

Therefore we blunder from crisis
to crisis – things get worse

Wheeler & Rothman 1982

Three key insights:

The corporation as “weapon”

The lack of data and theory

Needed a “ballistics lab” to study

Praxis: The S&L Debacle

Regulators independently &
contemporaneously agreed:

“Autopsies” v. econometrics

Recognized that “optimization”
created patterns: triage

Control frauds were Ponzi scheme

Hit their Achilles’ heel: growth

Dealt with “systems incapacity”

Failed to Learn from Success

This crisis was much easier to prevent than the S&L debacle

Far cruder frauds: *farblondget*

Could have been stopped by a broad range of actors

Needed massive, parallel failures

“Liar’s loans” will end in disaster

Vectors as choke points

Returning Dochow to leadership

Public Health as a Metaphor

Criminogenic (pathogenic)
environments

“Hosts”, “vectors” and “triage”

Immune systems & “private
market discipline” – economics
as faith healing

Compensation: criminogenic

Even Posner agrees

Optimizing Criminogenesis

1. Deregulation & desupervision
2. Performance pay to align CEO/shareholder interests
3. Private market discipline & reputation trump incentives
4. Reduce fiduciary duties; criminal/civil liability
5. Gresham's dynamic

Deregulation & Desupervision

“a rule against fraud is not an essential or even necessarily an important ingredient of securities markets” (Easterbrook & Fischel 1991)

OTS Director Gilleran’s chainsaw
Preemption of state efforts to
restrain predatory lending

The 2001 Nonprime Non Crisis

Regulators prevented it by
cracking down on precisely the
nonprime practices that
triggered the current crisis

Ask the experts how it's done

Don't just say: "If you hit this revenue number, your bonus is going to be this." It sets up an incentive that's overwhelming. You wave enough money in front of people, and good people will do bad things.

Franklin Raines: CEO, Fannie Mae

Do as I say, not as I do

“By now every one of you must have 6.46 [EPS] branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breath and dream 6.46, you must be obsessed on 6.46.... After all, thanks to Frank, we all have a lot of money riding on it.... We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%.”

The anti-canary

“Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46. So it is our moral obligation to give well above our 100% and if we do this, we would have made tangible contributions to Frank’s goals.” (Mr. Rajappa, head of Fannie’s internal audit.)

Gresham's Grim Dynamic

“[I]t was a slippery slope. What happened in '04 and '05 with respect to subordinated tranches is ... our competition, Fitch and S&P, went nuts. Everything was investment grade. We lost 50% of our coverage [business share]....”

[Moody's 2007]

Systems Capacity

FBI agents investigating mortgage fraud: 120 FY 2007; 180 FY 2008

S&L debacle: 1000 FBI agents and forensic experts: > 1000 felony convictions

Today's financial crisis dwarves the S&L crisis

Source: FBI 2.19.09 Dep. Dir. Pistole

Self-inflicted Incapacity

Refusal to replace white-collar FBI agents transferred after 9/11

No major case against nonprime lenders for accounting/securities fraud

Deregulation = Decriminalization

Most institutions don't have to file criminal referrals

Neutralization

Mankiw (1993): “it would be irrational for operators of the savings and loans not to loot.”

Can't *govern* a control fraud: our leading business ethics and governance reforms are implicitly premised upon honest CEOs.