“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

UMKC

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.

UMKC

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

UMKC

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

UMKC

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

UMKC

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"

UMKC

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

UMKC

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

UMKC

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]

UMKC

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

UMKC

Wheeler & Rothman 1982

Three key insights:

The corporation as “weapon”

The lack of data and theory

Needed a “ballistics lab” to study

UMKC

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"

UMKC

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 Criminogenenis

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

UMKC

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

UMKC

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%."

UMKC

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.)

UMKC

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

UMKC

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.