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

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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
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 Criminogenensis

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
“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.