Our different views prove that hindsight is often myopic. Larry White's take is that Clintonian regulations perverted private incentives.

> The boom and bust happened in a system with … extensive legal restrictions on financial intermediation. Nor have we had banking and financial deregulation since … 1999.
>
> (One can't explain an unusual cluster of errors by citing greed, which is always around, just as one can't explain a cluster of airplane crashes by citing gravity. Anyway, the greedy aim at profits, not losses.) [T]o explain industry-wide errors we need to identify policy distortions capable of having industry-wide effects. The actual causes of our financial troubles were unusual monetary policy moves and novel federal regulatory interventions. Regulatory distortions intensified in the 1990s.

Perverse Compensation Systems are the Key

I disagree with Larry's theses, but have space to demonstrate only an alternative perverse incentive. What went wrong is that modern compensation systems did not "align" interests, but rather created perverse incentives to engage in accounting "control fraud," where the CEO uses an apparently legitimate firm as a "weapon" to defraud creditors and shareholders. [1] No regulation forced any lender to make a bad loan. Larry misses the key dynamic: "The greedy" do *not* "aim at profits, not losses" when compensation schemes are perverse. They maximize short-term *accounting* "profits" in order to increase their wealth. Making bad loans, growing rapidly, and extreme leverage maximize "profits." Bad borrowers agree to pay more and it is impossible to grow rapidly via high quality lending. Lending to the uncreditworthy requires the CEO to suborn controls, maximizing "adverse selection." This produced an "epidemic" of mortgage fraud, particularly in the *unregulated* nonprime sector. The FBI began warning in September 2004 about the mortgage fraud "epidemic." [2] Fraudulent loans cause huge direct losses, but the epidemic also hyper-inflated and extended the housing bubble, and eviscerated trust, causing catastrophic indirect losses. When we do not regulate or supervise financial markets we, *de facto*, decriminalize control fraud. The regulators are the cops on the beat against control fraud—and control fraud causes greater financial losses than all other forms of property crime *combined*.

The most relevant economic works for understanding these crises are by Akerlof and Romer, Galbraith, and Minsky. Akerlof and Romer explain why "looting" (control fraud) can occur and the fraudulent steps looters take to optimize short-term accounting profits (which destroy the firm). [3] Note that they are writing about a form of a "market for lemons" in which the CEO maximizes information asymmetry. The failure of economists discussing the ongoing crises to cite the work of a Nobel laureate writing in the core of his expertise demonstrates why we have failed to learn the proper lessons from prior financial crises. James Galbraith extends Akerlof and Romer's analysis to show why the state aids fellow control frauds. [4] Minsky describes the "Ponzi" phase of a crisis and why financial instability reoccurs. [5]

Modern executive compensation systems suborn internal controls. (Control frauds do not "defeat" controls—they turn them into oxymoronic allies.) The Business Roundtable's spokesman, Franklin Raines, Fannie Mae's former CEO, explained in a *Business Week* interview what caused the epidemic of accounting control fraud that became public in 2001 with Enron's failure.

> [*Businessweek:*] **We've had a terrible scandal on Wall Street. What is your view?**
>
> [Raines:] Investment banking is a business that's so denominated in dollars that the temptations are great, so you have to have very strong rules. My experience is where there is a one-to-one relation between if I do X, money will hit my pocket, you tend to see people doing X a lot. You've got to be very careful about that. 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.

Unfortunately, Raines’ insights stemmed from his implementation of just such a system. Raines knew that the unit that should have been most resistant to this “overwhelming” financial incentive, Fannie Mae’s Internal Audit department, had succumbed to it. Mr. Rajappa, its head, instructed his internal auditors in a formal address in 2000 (and provided the text to Raines, who praised it):

> By now every one of you must have 6.46 [the earnings per share target] 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 [Raines], 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%. 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 [emphasis in original].

Internal audit is the “anti-canary” in the corporate “mines”; by the time it is suborned every other unit is corrupted. The CEO cannot send out a memo urging accounting fraud, but he can safely send the same message through his bonus plan. He does not have to order, or be aware of, the specific frauds—the employees will do whatever is needed to “earn” their top bonus. The CEO simply communicates—by *inaction*—that he does not care *how* they meet the target.

Fannie and Freddie were accounting control frauds that became insolvent because of their private nature. It is naïve to believe that either purchased loans or mortgage-backed securities (MBS) to help poor people. Their senior officers caused Fannie and Freddie to make purchases for the same reason their private peers did: to maximize accounting income. None of these peers had government guarantees, yet "private market discipline" *increased* their incentive to engage in accounting fraud.

Consider a CFO in 2006 who *knows* all of this: that there is a housing bubble, that non-prime loans maximize "adverse selection," that there is an epidemic of mortgage fraud, and that the (declining!) spread on non-prime loans is inadequate. If he does not purchase nonprime paper and lever up, his bank will report far lower earnings than its peers. Firm bonuses and stock appreciation will be lower — sometimes by billions of dollars. The average tenure of a CFO is less than three years. He faces intense pressures to emulate his peers—even if it dooms the firm. This environment creates a "Gresham's Law" dynamic in which perverse incentives drive good underwriting out of circulation.

The claim that Fannie and Frieddie took excessive risk *because* of an implicit governmental guarantee stands refuted. They *lost* market share because they took relatively less exposure to non-prime loans than their peers. Moreover, Fannie and Frieddie's regulator had power to bar them from purchasing non-prime MBS. The Bush administration did not do so because it *favored* the expansion of non-prime lending throughout the developing bubble. It expanded FHA's nonprime loans and opposed regulating nonprime lenders.

The Incidence and Nature of Mortgage Fraud

The defining element of fraud that distinguishes it from other forms of larceny is *deceit*. Fraud frequently goes undiscovered. Fraud reports understate incidence and are biased. The most competent frauds are least likely to be discovered. Insured depository institutions must file Suspicious Activity Reports (SARs) when they discover credible information of a crime. Many commercial banks and S&Ls, therefore, often filed SARs about mortgage fraud. Mortgage banking firms were essentially unregulated by the federal government and generally did not file SARs when they found fraud. Investment bankers, in the *four years* during the peak of the epidemic, filed only *36* SARs. [7]

Given the fact that mortgage and investment banks were (allegedly) the principal victims of mortgage fraud, why weren't they the principal SARs filers? One only spots mortgage fraud if one conducts underwriting (and accounting control frauds abhor it), and the last thing a control fraud wants is to invite the FBI's attention.

In FY 2007, there were 52,868 Suspicious Activity Reports of mortgage fraud—a 40 percent increase over fiscal year 2006. [8] Mortgage fraud has grown rapidly this decade and has overwhelmed the FBI's resources. [9] Weak regulation and perverse strategic behavior by control frauds led to pervasive underreporting of fraudulent subprime mortgages:

> In 2005, 52% of subprime mortgages were originated by companies with no federal supervision, primarily mortgage brokers and stand-alone finance companies. Another 25% were made by finance companies that are units of bank-holding companies and thus indirectly supervised by the Federal Reserve; and 23% by regulated banks and thrifts. [10]

Because insured banks and S&Ls originated only 23 percent of subprime loans in 2005, the most obvious adjustment to using SARs to estimate total subprime mortgage fraud would be to multiply the annual SAR total by five. However, unregulated mortgage lenders made a disproportionate share of the fraudulent loans. The largest mortgage control frauds cause grossly disproportionate losses and represent an enormous percentage of the total incidence of mortgage fraud. According to a Government Accounting Office report:

> Of the top 25 originators of subprime and Alt-A loans in 2006 (which accounted for over 90 percent of the dollar volume of all such originations):

- 21 were nonbank lenders, including 14 independent lenders and 7 nonbank subsidiaries of banks, thrifts, or holding companies.
- the 21 nonbank lenders accounted for 81 percent of the dollar volume (44 percent was originated by independent lenders and 37 percent by nonbank subsidiaries of banks, thrifts, or holding companies).[11]

The worst mortgage frauds operated primarily in the unregulated sector. *The New York Times* reported:

> 43 percent of the cases sampled in the study involved misrepresentation of income, assets or debts. The next-largest category was forged documents, totaling 28 percent of the sampled loans. Mortgage brokers initiated the loans on 64 percent of the reports involving misrepresentation of income, assets or debt…

The FBI erred by partnering with the Mortgage Bankers Association (MBA)—which represented the worst control frauds. The MBA's priority was blocking regulation of mortgage banking—not stopping mortgage fraud.
SARs underreport nonprime mortgage fraud at *insured* depositories. Many frauds are not spotted. Nonprime lenders ended verification to make it easy, fast, and cheap for them to approve uncreditworthy borrowers. Verification is the most effective means to deter and identify fraud, so the worst lenders had enormous undiscovered fraud. The *Times* report continued:

> Indeed, according to a report on mortgage fraud released Thursday by the Financial Crimes Enforcement Network, a unit of the Treasury Department, only 31 percent of suspected fraud was detected before loan disbursements in the 12 months ended March 31, 2007. On stated income loans, only 19 percent of the cases of suspected fraud were detected before the loans were financed, versus 33.5 percent on more fully documented loans.

The federally insured control frauds' incentive was *not* to file SARs.

> The FBI reports that, based on existing investigations, 80 percent of all reported fraud losses arise from fraud for profit schemes that involve industry insiders. [12]

A survey from Fitch Ratings also showed endemic nonprime mortgage fraud.

> Characteristics by percentage of the 45 files reviewed included (loans may appear in more than one finding):
>
> - 66% Occupancy fraud (stated owner occupied — never occupied), based on information provided by borrower or field inspector
> - 51% Property value or condition issues — Materially different from original appraisal, or original appraisal contained conflicting information or items outside of typically accepted parameters
> - 48% First Time Homebuyer — Some applications indicated no other property, but credit report showed mortgage information
> - 44% Payment Shock (defined as greater than 100% increase) — Some greater than 200%
> - 44% Questionable stated income or employment — Often in conflict with information on credit report and indicated to be outside "reasonableness" test
> - 22% Hawk Alert — Fraud alert noted on credit report
> - 18% Credit Report — Questionable ownership of accounts (name or social security numbers do not match)
> - 17% Seller Concessions (outside allowed parameters)
> - 16% Credit Report — Based on "authorized" user accounts
> - 16% Strawbuyer/Flip scheme indicated based on evidence in servicing file
> - 16% Identity theft indicated
> - 10% Signature fraud indicated
> - 6% Non-arms length transaction indicated [13]

Note that Fitch did not conduct any investigation. It identified frauds obvious from a review of the loan files.

SARs filed by federally regulated lenders seriously underreport mortgage fraud. The reported number is enormous. My belief, consistent with fraud incidence found in file reviews, is that it represents roughly 5 percent of the true incidence, which implies roughly one million fraudulent mortgage loans were made in FY 2007. [14]

The testimony of Thomas J. Miller, Attorney General of Iowa, at a 2007 Federal Reserve Board hearing shows why fraud losses are enormous:

> Over the last several years, the subprime market has created a race to the bottom in which unethical actors have been handsomely rewarded for their misdeeds and ethical actors have lost market share…. The market incentives rewarded irresponsible lending and made it more difficult for responsible lenders to compete. Strong regulations will create an even playing field in which ethical actors are no longer punished.
>
> Despite the well documented performance struggles of 2006 vintage loans, originators continued to use products with the same characteristics in 2007.
>
> [M]any originators … invent … non-existent occupations or income sources, or simply inflat[e] income totals to support loan applications. A review of 100 stated income loans by one lender found that a shocking 90% of the applications overstated income by 5% or more and almost 60% overstated income by more than 50%. Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer.

It is no answer to say, "they did not underwrite because they sold their loans." That model can only work if an ultra-sophisticated entity buys. Investors must stop accounting control fraud if markets are to be efficient. But they do not. Elite investors' Potemkin models created illusory sophistication. Their only skill was in the intricate footwork required in the *Totentanz* with their partners at the rating agencies in which they structured toxic nonprime paper into risk-free "AAA."

As Paul Volcker has concluded, "modern finance" has failed the market test. Its policies optimize the environment for control fraud and create perverse dynamics that create recurrent financial crises.

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Notes

[1] Black, William K., 2005. *The Best Way to Rob a Bank is to Own One*, (Austin, TX: U. Tex. Press).

[2] "FBI warns of mortgage fraud 'epidemic': Seeks to head off 'next S&L crisis'" CNN, Sept. 17, 2004.

[3] Akerlof, George, and Paul M. Romer, 1993. "Looting: The Economic Underworld of Bankruptcy for Profit." *Brookings Papers on Economic Activity* 2: 1-73.

[4] Galbraith, James, 2008. *The Predator State* (NY: Simon & Schuster).

[5] Minsky, Hyman, 1982. "The Financial-Instability Hypothesis: Capitalist processes and the behavior of the economy", in Kindleberger and Laffargue, editors, *Financial Crises*. See also recent works by Wray, R. and Kregel, J. extending and applying Minsky's theories to the ongoing crises.

[6] Raines' observation about the perverse impact of such compensation systems has been confirmed. Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004): at 183-85. "Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage." Lucian A. Bebchuk and Jesse M. Fried. *Journal of Corporation Law*, 2005, Vol. 30, pp. 807-822 (at p. 811).

Even Michael Jensen now warns that they caused endemic accounting and securities fraud. Jensen, Michael. "Putting Integrity Into Finance Theory and Practice: A Positive Approach" (June 9, 2007) (available on SSRN). The Shadow Financial Regulatory Committee has decried rating agencies' perverse

compensation systems. Statement No. 257: “Reliance on Third-Party Credit Ratings” (February 11, 2008).

[7] Gretchen Morgenson, “Fair Game: A Road Not Taken by Lenders” (April 6, 2008).
http://www.nytimes.com/2008/04/06/business/06gret.html?scp=2&sq=mortgage+fraud&st=nyt

[8] “Mortgage Loan Fraud: An Update of Trends Based upon an Analysis of Suspicious Activities Reports,” [pdf] Financial Crimes Enforcement Network, 2008.

[9] “’Mortgage fraud is the fastest-growing white-collar crime affecting the United States today,’ says Karen Spangenberg, chief of the financial crimes section of the FBI’s criminal investigative division.” “Mortgage Shakedown,” *Mortgage Banking*, August 1, 2006.

[10] Greg Ip & Damiam Paletta. “Regulators Scrutinized In Mortgage Meltdown.” (March 22, 2007). *The Wall Street Journal Online*

[11] GAO briefing of the Committee on Financial Services House of Representatives. Subject: Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments (October 16, 2007: 54).

[12] “Mortgage Fraud: Strengthening Federal and State Mortgage Fraud Prevention Efforts” (2007). Tenth Periodic Case Report to the Mortgage Bankers Association, produced by MARI.

[13]
http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=356624.

[14] Note that this discussion also refutes two of Larry’s regulatory claims: (1) that the Community Reinvestment Act (CRA) was a material contributor to the crisis and (2) that inadequate regulation did not contribute to the crisis. The principal nonprime lenders were not even subject to the CRA. The principal buyers of nonprime paper were not subject to the Act. The CRA had been in place for decades, yet caused a crisis during a decade when the Bush

administration gutted CRA supervision. The regulated lenders that were nonprime specialists (and made the great bulk of nonprime loans in that sector) did not have to do so to comply with the CRA. Lenders made nonprime loans to maximize accounting income. The CRA never requires a lender to make a bad loan.

Larry also misses the entire concept of desupervision. When the OTS Director brings a chainsaw to a press conference to destroy the rules and when he and the head of the FDIC gut the agency staff effective supervision ends. When the guardians don't guard, rules fail.