Prepared Testimony of

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Introduction

Chairman Leahy, Senator Grassley, distinguished members of the Senate Committee on the Judiciary, thank you for inviting me to testify on the central role that mortgage fraud, predatory lending, and foreclosure fraud have played in driving the ongoing financial crisis and the failure of all sectors to sanction the elite criminals that grew wealthy through these frauds and abuses. The Committee will deal with no more important white-collar crime issue than the subject of this hearing.

My primary appointment at the University of Missouri-Kansas City (UMKC) is in economics. I have a joint appointment in law. I have taught previously at the University of Texas at Austin and Santa Clara University. In addition to degrees in economics and law, I have a doctorate in Criminology and my primary research focus is on financial "control fraud." Control fraud is a term that criminologists use to refer to cases in which the persons controlling a seemingly legitimate entity use it as a "weapon" to defraud. In finance, accounting is the "weapon of choice." Control frauds cause greater financial losses than all other forms of property crime – combined. They drive our recurrent, intensifying financial crises. They have wrought unprecedented damage in the ongoing crisis.

Background

I am also a former senior financial regulator. At the staff level, I led the reregulation of the savings and loan (S&L) industry under Federal Home Loan Bank Board Chairman Edwin Gray that contained the S&L debacle before it could cause a recession. I played a central role in the effort to close the S&L control frauds and hold their senior officers accountable through civil suits, administrative enforcement actions, and criminal prosecutions. I was also a serial

whistleblower with a special talent for making virulent enemies in high places. Charles Keating famously issued a written order that Lincoln Savings' "HIGHEST PRIORITY" should be to "GET BLACK … KILL HIM DEAD." (Keating was an "all caps" kind of guy.) Lincoln Savings hired private detectives twice to investigate me and Keating eventually brought a *Bivens* action against me seeking $400 million in damages. One of the charges against Speaker of the House James Wright, Jr., proposed by the independent counsel of the House ethics committee after the committee's investigation, was the Speakers' repeated efforts to get me fired. The Senate ethics investigation of the "Keating Five" revealed (when the Senate ethics committee granted immunity to one of Keating's lieutenants) that, subsequent to the April 2 and 9, 1987 meetings of the five senators with us, the Speaker met with Keating and urged him to sue me (and former Chairman Gray) and to continue the effort to get me fired. I want to thank Senator Grassley for his long record of seeking to protect whistleblowers from these forms of retaliation.

My regulatory career is the focus of three works by academic experts in public administration: Chapter 2 of Professor Riccucci's book *Unsung Heroes* (Georgetown U. Press: 1995), Chapter 4 ("The Consummate Professional: Creating Leadership") of Professor Bowman, et al's book *The Professional Edge* (M.E. Sharpe 2004), and Joseph M. Tonon's article: "The Costs of Speaking Truth to Power: How Professionalism Facilitates Credible Communication" *Journal of Public Administration Research and Theory* 2008 18(2):275-295.

My book about the S&L debacle, control fraud theory, and the regulatory and prosecutorial lessons learned is entitled *The Best Way to Rob a Bank is to Own One* (2005). My work is highly multidisciplinary. George Akerlof (Nobel Laureate in Economics in 2001) and co-author with Paul Romer of the essential 1993 economics article on control fraud ("Looting: the Economic Underworld of Bankruptcy for Profit") and Paul Volcker have praised the book.

I was one of the leading trainers of FBI special agents, AUSAs, and agency personnel in the identification, investigation, and prosecution of elite white-collar criminals during the S&L debacle and I served as a (free) expert witness in the prosecution of several high priority cases. I also served as a paid expert for OFHEO in its administrative enforcement action against Mr. Raines, Fannie Mae's former CEO.

I testified many times before Congress and the California legislature during the S&L debacle. This is my fifth presentation to Congress about the ongoing financial crisis. I provided testimony to the Senate on financial derivatives and the role of control fraud in driving the crisis and I to the House on executive compensation and Lehman's failure. My congressional invitations have come at the initiative of both parties. I have had extended meetings with senior governmental officials (financial regulators and prosecutors) responding to the Irish and Icelandic financial crises at the invitation of citizens of those nations.

I have also testified before the Financial Crisis Inquiry Commission (FCIC) on the role of fraud in the ongoing crisis and presented at the invitation of the National Research Council's Committee on Law and Justice to their "Seminar on the Future of White-Collar Crime

Research." The Council asked me to discuss new quantitative methodologies relevant to measuring the incidence and impact of elite white-collar crimes, particularly those that played such a decisive role in the current crisis.

Overview of my testimony

I make seven major points.

1. We have decent data on the incidence of fraud in stated income loans. The incidence is 90 percent. We know from investigations that it was overwhelmingly the lenders and their agents that prompted these frauds. No governmental entity ever required any entity to make, or purchase, a stated income loan. Even at their most anti-regulatory extreme, U.S. regulators warned against stated income loans. We know roughly how many fraudulent stated income loans were made. Over two million fraudulent mortgage loans were made in 2006 alone. It was overwhelmingly fraudulent loans to borrowers who lacked any ability to repay their loans out of their income that caused the housing bubble to hyper-inflate.
2. Endemic accounting control fraud in the origination of mortgages led to creation of "echo" fraud epidemics in other contexts, including widespread appraisal fraud, endemic fraud in the sale of mortgages and mortgage derivatives, widespread predatory lending targeting Latinos, blacks and the elderly, and endemic foreclosure fraud. Fraudulent lenders use compensation to create perverse incentives that produce "Gresham's" dynamics in which bad ethics drives good ethics out of the marketplace. Fraud begets fraud. Or in criminology jargon, accounting control fraud involving lenders is criminogenic. The federal government, California, and dozens of financial firms have sued the largest banks for fraud, yet the Justice Department refuses to even conduct a meaningful criminal investigation of the largest banks. The FBI investigates several thousand relatively minor mortgage fraud cases annually. This is equivalent to sitting on a beach in San Diego, throwing handfuls of sand in the Pacific Ocean, and wondering how soon one will be able to walk to Hawaii. The strategy must fail. Everyone involved knows it must fail. To succeed, we must fundamentally change the strategy, not tinker with it or simply reinforce defeat. The FBI and the Justice Department have fallen for one of the greatest acts of misdirection by accepting the Mortgage Banker Associations definition of "mortgage fraud" – a definition that defines accounting control fraud out of existence. (The courts have implicitly defined accounting control fraud out existence in the context of civil suits for securities fraud. Think of how insane that is. The form of fraud that economists and criminologists have shown to be the leading cause of catastrophic financial losses purportedly does not exist because judges think such frauds would be "irrational." We are acting as if this was the first "virgin" financial crisis (conceived without sin).
3. The elite financial frauds are treating the United States of America's criminal justice system and financial markets with utter contempt. They believe they can become

wealthy – with impunity – through frauds that cost U.S. households $11 trillion dollars and cost seven million Americans their jobs. Not a single elite fraudster who was instrumental in making the millions of fraudulent loans that drove the crisis has even been indicted – over seven years after the FBI's September 2004 warnings that there was an "epidemic" of mortgage fraud that would cause a financial "crisis" if it were not stopped. Here is how bad the situation has become. The firms that specialized in making huge amounts of "stated income" loans called such loans "liar's loans." This was publicly reported – and nothing effective was done by the markets, by self-regulation, by federal regulators, or by federal prosecutors to stop frauds that were as brazen as they were massive. Akerlof and Romer's 1993 warning that accounting fraud is a "sure thing" – guaranteed to make even the most mediocre CEO wealthy – was ignored. Only fraudulent firms made large numbers of liar's loans. Making liar's loans inherently meant committing multiple frauds and making predatory loans.

4. The proposed settlement of the endemic foreclosure fraud is a profound embarrassment to the U.S. criminal justice system because it immunizes from criminal sanction endemic fraud. Had the administration gotten its preferred settlement, which was designed to block even investigations of many forms of control fraud, the result would have been the formal surrender of the U.S. to crony capitalism.
5. The newly created "working group" does not have the resources to succeed. It is more than an order of magnitude too small for the task and it has not taken the foundational steps essential to success against multiple epidemics of control fraud. Absent vigorous financial regulators that understand control fraud and make reducing and sanctioning such frauds their top priority the prosecutors cannot succeed against an epidemic of accounting control fraud. Financial regulators who make the necessary criminal referrals and provide the FBI with the expertise to identify and investigate accounting control fraud mechanisms are essential if we are to prevent or prosecute an epidemic of such frauds. Effective financial "regulatory cops on the beat" are essential to our ability to prosecute elite white-collar criminals.
6. We know how to succeed. We know how to make future crises far more unlikely and damaging. We've known for a quarter century. It is bad to forget the mistakes of the past, but one can remember a past mistake and still make a new mistake. It is tragic to forget past successes.

Formal Written Testimony

Neo-Classical Economic Policies are Criminogenic: They Cause Control Fraud Epidemics

Neo-classical economics failed to build on Akerlof's work to develop a coherent theory of fraud, bubbles, or financial crises (Black 2005). It continued to rely on a single methodological approach (econometrics) that inherently produces the worst possible policy advice during the expansion phase of a bubble.

Control frauds can cause enormous losses, while minimizing the risk that controlling officers will be sanctioned because only the CEO can (Black 2005):

- Optimize the firm's operations and structures for fraud
- Set a corrupt tone at the top, and suborn controls, employees and officers into becoming allies
- Convert firm assets to the CEO's personal benefit throught seemingly normal corporate compensation mechanisms
- Optimize the external environment for control fraud, e.g., by creating regulatory black holes.

These perverse factors were first identified in connection with the S&L debacle of the 1980s. The National Commission on Financial Institution Reform Recovery and Enforcement (NCFIRRE) (1993), report on the causes of the S&L debacle documented the patterns.

> The typical large failure was a stockholder-owned, state-chartered institution in Texas or California where regulation and supervision were most lax…. [It] had grown at an extremely rapid rate, achieving high concentrations of assets in risky ventures…. [E]very accounting trick available was used to make the institution look profitable, safe, and solvent. Evidence of fraud was invariably present as was the ability of the operators to "milk" the organization through high dividends and salaries, bonuses, perks and other means (NCFIRRE 1993: 3-4).
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> [A]busive operators of S&L[s] sought out compliant and cooperative accountants. The result was a sort of "Gresham's Law" in which the bad professionals forced out the good (NCFIRRE 1993: 76).

James Pierce, NCFIRRE's Executive Director, explained:

> Accounting abuses also provided the ultimate perverse incentive: it paid to seek out bad loans because only those who had no intention of repaying would be willing to offer the high loan fees and interest required for the best looting. It was rational for operators to drive their institutions ever deeper into insolvency as they looted them (1994: 10-11).

A lender optimizes accounting control fraud through a four-part recipe. Top economists, criminologists, and the savings and loan (S&L) regulators agreed that this recipe is a "sure thing" – producing guaranteed, record (fictional) near-term profits and catastrophic losses in the longer-term. Akerlof & Romer (1993) termed the strategy: *Looting: Bankruptcy for Profit*. The firm fails, but the officers become wealthy (Bebchuk, Cohen& Spamann 2010).

- Extremely rapid growth
- Lending at high (nominal) yield to borrowers that will frequently be unable to repay
- Extreme leverage
- Providing grossly inadequate reserves against the losses inherent in making bad loans

George Akerlof and Paul Romer published an article in 1993 about accounting control fraud. The title of their article captured their thesis – "Looting: the Economic Underworld of

Bankruptcy for Profit." They chose to end their article with this paragraph because it was the message they wished to emphasize.

> Neither the public nor economists foresaw that [S&L deregulation was] bound to produce looting. Nor, unaware of the concept, could they have known how serious it would be. Thus the regulators in the field who understood what was happening from the beginning found lukewarm support, at best, for their cause. Now we know better. If we learn from experience, history need not repeat itself.

In the S&L debacle, "the regulators in the field … understood what was happening from the beginning…." Akerlof and Romer excuse the economists, because they were "unaware of the concept," for getting the debacle wrong. They are being kind. Economists did not give "lukewarm support" to our reregulation of the S&L industry. They were our most fervid and intractable opponents. As Akerlof and Romer stressed, "now we know better." Akerlof was made a Nobel laureate in 2001. He is one of the most respected economists in the world.

The remarkable fact is that economists dominated financial policy and despite the success of the S&L regulators, which arose from understanding how accounting control frauds worked, despite the extensive scholarship by white-collar criminologists confirming the regulators' findings, despite the research of two of more prominent and well-respected economists in the world confirming the decisive role of accounting control fraud, and despite the pervasive role of accounting control fraud in the Enron-era frauds, neo-classical economists continues to ignore even the existence of accounting control fraud. They argued that such frauds could not exist because markets were "efficient."

Ironically, we proved that we did not "know better" in the same year that Akerlof & Romer published their article. The Clinton administration promptly took three actions that were far more destructive than the repeal of Glass-Steagall and the passage of the Commodities Futures Modernization Act of 2000 (the Act that created a "regulatory black hole" in which credit default swaps (CDS) operated). First, it greatly reduced the prosecution of elite bank and S&L frauds by changing the priority to health care fraud. Second, it implemented the "Reinventing Government" initiative that was hostile to regulation and enforcement. We were instructed, pursuant to that initiative, to refer to (and think of) the industry as our "clients." That is a mindset that destroys effective supervision. Third, the Office of Thrift Supervision (OTS) terminated its underwriting regulations (which essentially banned liar's loans) and replaced them with deliberately unenforceable guidelines. This change made it significantly more difficult to prosecute "accounting control frauds" by lenders. The three "de's" – deregulation, desupervison, and *de facto* decriminalization returned with a vengeance in 1993 and expanded over the next 15 years.

The result was that nonprime mortgage lenders were able to follow the same accounting fraud recipe employed 20 years earlier by the fraudulent S&Ls. Growth was extreme.

> In summary, the bank in our analysis pursued an aggressive expansion strategy relying heavily on broker originations and low-documentation loans in particular. The strategy allowed the bank to grow at an annualized rate of over 50% from 2004 to 2006. Such a business model is typical among the major players that enjoyed the fastest growth during the housing market boom and incurred the heaviest losses during the downturn (Jiang, Aiko & Vylacil 2009: 9).

A study by a Federal Reserve Bank of St. Louis economist documented that the growth of liar's loans ("Alt-a" is one of many euphemisms for liar's loans) was so extraordinary that it hyper-inflated the bubble.

> "[B]etween 2003 and 2006 … subprime and Alt-A [loans grew] 94 and 340 percent, respectively. The higher levels of originations after 2003 were largely sustained by the growth of the nonprime (both the subprime and Alt-A) segment of the mortgage market."

The growth of liar's loans was actually far greater than 340 percent. The author made a common error, thinking that subprime and liar's loans were mutually exclusive categories. In fact, by 2006, roughly half of all loans called subprime were also liar's loans.

Loan standards collapsed. Cutter (2009), a managing partner of Warburg Pincus, explains:

> In fact, by 2006 and early 2007 everyone thought we were headed to a cliff, but no one knew when or what the triggering mechanism would be. The capital market experts I was listening to all thought the banks were going crazy, and that the terms of major loans being offered by the banks were nuttiness of epic proportions.

Charles Calomiris' description is even harsher and it is remarkable because Calomiris was one of the leading proponents of financial deregulation. He called the strategy "plausible deniability" and argued that the lenders, credit rating agencies, investment banks, Fannie and Freddie, and the purchasers all knew that the fraudulent mortgages and the financial derivatives based on those fraudulent mortgages were massively overvalued. It paid to pretend that they were good assets because it made everyone's bonus far bigger.

Leverage was exceptional. Unregulated nonprime lenders had no meaningful capital rules.

Honest lenders would establish record high loss reserves pursuant to generally accepted accounting principles (GAAP). "The industry's reserves-to-loan ratio has been setting new record lows for the past four years" (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). Later, "loan loss reserves are down to levels not seen since 1985" (roughly one percent) (A.M. Best 2007: 1). It noted that these inadequate loss reserves in 1985 led to banking and S&L crises. In 2009, IMF estimated losses on U.S. originated assets of $2.7 trillion (IMF 2009: 35 Table 1.3) (roughly 30 times larger than bank loss reserves).

Fraud Warnings

The claim that no one could have foreseen the crisis is false. Unlike the S&L debacle, the FBI was far ahead of the regulators in recognizing that there was an "epidemic" of mortgage fraud and that it could cause a financial crisis. The FBI warned in September 2004 (CNN) that the "epidemic" of mortgage fraud would cause a "crisis" if it were not contained. The FBI has emphasized that 80 percent of mortgage fraud losses occur when lending industry insiders are part of the fraud scheme. The FBI deserves enormous credit for sounding such a strong, accurate, and public warning. Special praise should also go to Inman News, which put out a series of reports about mortgage fraud that culminated in a compendium in 2003 entitled: "Real Estate Fraud: The Housing Industry's White-Collar Epidemic." The warnings about appraisal fraud were equally stark – "Home Insecurity: How Widespread Appraisal Fraud Puts Homeowners at Risk" (Demos 2005). The remarkable fact is that the private sector, the regulators, and the prosecutors failed to take effective action despite these warnings. The failure to act is all the more troubling because the nonprime lenders followed the distinctive four-part recipe for lenders optimizing accounting control fraud that regulators, economists, and criminologists had documented and explained in the S&L debacle, during financial privatization (e.g., tunneling), and in the Enron-era control frauds.

Fraud Markers

S&L regulators (in the 1980s) and criminologists and economists (in the 1990s) had identified fraud "markers" (a term borrowed from pathology) that only fraudulent lenders would employ. Gutting underwriting is essential for lenders engaged in accounting control fraud because they have to make massive amounts of bad loans in order to grow extremely rapidly and charge premium interest rates in order to optimize near-term accounting "profits." Banks (and economists) have known for centuries that gutting mortgage underwriting leads to "adverse selection" (lending to borrowers that will often not be able or willing repay their loans). The "expected value" of adverse selection is sharply negative, i.e., the lender will invariably lose money (once the losses become manifest).

S&L regulators looked for fraud "markers", such as deliberately lending to uncreditworthy borrowers by inflating appraisals or by ignoring a track record of defaults that no honest lender would commit (Black, Calavita & Pontell 1985; Black 2005).

S&L regulators used these markers to identify and close the accounting control frauds while they were reporting record profits and minimal losses in the 1980s before they could cause a nationwide financial bubble, a general economic crisis, or recession. The most obvious marker is when lenders do not even take prudent steps to prevent fraud, but rather cover it up.

There is no honest reason for deliberately failing to establish adequate loss reserves, yet the typical nonprime lender slashed general loss reserves while risk was surging and GAAP required reserves to increase. That constitutes accounting and securities fraud, but it is also a marker of accounting control fraud. The officers controlling nonprime lenders, by keeping loan loss reserves at trivial levels, maxmized the lenders' fictional income – and their compensation.

Similarly, appraisal fraud is not only a fraud but a "marker" of a broader fraud scheme. An honest secured lender would never inflate, or permit others to inflate, appraisal values. The

2009 FINCEN report explains why appraisal fraud adds enormously to losses from mortgage fraud.

> Lenders rely on accurate appraisals to ensure that loans are fully secured. The Appraisal Institute and the American Society of Appraisers testified that "…it is common for mortgage brokers, lenders, realty agents and others with a vested interest to seek out inflated appraisals to facilitate transactions because it pays them to do so. Higher sales prices typically generate higher fees for brokers, lenders, real estate agents, and loan settlement offices, and higher earnings for real estate investors. Appraisal fraud has a snowball effect on inflating real estate values, with fraudulent values being … used by legitimate appraisers….

The Gresham's dynamic that the accounting control frauds deliberately induced in appraisals has been established repeatedly in surveys of appraisers.

> A new survey of the national appraisal industry found that 90 percent of appraisers reported that mortgage brokers, real estate agents, lenders and even consumers have put pressure on them to raise property valuations to enable deals to go through. That percentage is up sharply from a parallel survey conducted in 2003, when 55 percent of appraisers reported attempts to influence their findings and 45 percent reported "never." Now the latter category is down to just 10 percent.
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> The survey found that 75 percent of appraisers reported "negative ramifications" if they refused to cooperate and come in with a higher valuation. Sixty-eight percent said they lost the client -- typically a mortgage broker or lender -- following their refusal to fudge the numbers, and 45 percent reported not receiving payment for their appraisal.

Control frauds, either directly or indirectly through the perverse incentives their compensations systems create for loan officers, loan brokers, and mortgage brokers, cause, encourage, and accede to endemic appraisal fraud.

The New York Attorney General's investigation of Washington Mutual (WaMu) (one of the largest nonprime mortgage lenders) and its appraisal practices supports this dynamic.

> New York Attorney General Andrew Cuomo said [that] a major real estate appraisal company colluded with the nation's largest savings and loan companies to inflate the values of homes nationwide, contributing to the subprime mortgage crisis.
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> "This is a case we believe is indicative of an industrywide problem," Cuomo said in a news conference.
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> Cuomo announced the civil lawsuit against eAppraiseIT that accuses the First American Corp. subsidiary of caving in to pressure from Washington Mutual Inc. to use a list of "proven appraisers" who he claims inflated home appraisals.

> He also released e-mails that he said show executives were aware they were violating federal regulations. The lawsuit filed in state Supreme Court in Manhattan seeks to stop the practice, recover profits and assess penalties.
>
> "These blatant actions of First American and eAppraiseIT have contributed to the growing foreclosure crisis and turmoil in the housing market," Cuomo said in a statement. "By allowing Washington Mutual to hand-pick appraisers who inflated values, First American helped set the current mortgage crisis in motion."
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> "First American and eAppraiseIT violated that independence when Washington Mutual strong-armed them into a system designed to rip off homeowners and investors alike," he said (*The Seattle Times,* November 1, 2007).

Note particularly Attorney General Cuomo's claim that WaMu "rip[ped] off … investors." That is an express claim that it operated as an accounting control fraud and inflated appraisals in order to maximize accounting "profits." A Senate investigation has found compelling evidence that WaMu acted in a manner that fits the accounting control fraud pattern.
http://levin.senate.gov/newsroom/release.cfm?id=323765

Pressure to inflate appraisals was endemic among nonprime lending specialists.

> Appraisers complained on blogs and industry message boards of being pressured by mortgage brokers, lenders and even builders to "hit a number," in industry parlance, meaning the other party wanted them to appraise the home at a certain amount regardless of what it was actually worth. Appraisers risked being blacklisted if they stuck to their guns. "We know that it went on and we know just about everybody was involved to some extent," said Marc Savitt, the National Association of Mortgage Banker's immediate past president and chief point person during the first half of 2009 (*Washington Independent,* August 5, 2009).

These markers are pervasive in the current crisis and would have allowed effective regulatory intervention. They can be used to prosecute the senior officials that caused the current crisis and they can be used to limit future crises. Current regulators and prosecutors did not recognize the markers and act effectively on the FBI warning. Current regulators and prosecutors have been so blinded by anti-regulatory ideology that they joined the private sector in failing to act effectively even against lenders that specialized in what the trade openly called "liar's loans."

Echo Epidemics of Accounting Control Fraud

The primary epidemic of accounting control fraud by nonprime lenders produced "echo" epidemics of upstream and downstream control fraud. The primary mortgage fraud epidemic created a criminogenic environment that caused the upstream mortgage fraud epidemic. The downstream epidemic consists of those that purchased the nonprime product. The downstream epidemic could not have existed without the endemic mortgage fraud the other two fraud epidemics produced, but the downstream epidemic allowed both of the mortgage fraud epidemics to grow far larger.

In order to maximize their (fictional) accounting income, the nonprime lenders needed to induce others to send them massive quantities of relatively high yield mortgage loans with supporting appraisals, without regard to credit quality. The nonprime lenders created perverse incentives that produced a series of "Gresham's" dynamics. This did not require any formal agreement (conspiracy), which made it far easier to create an upstream echo epidemic and far harder to prosecute. Traditional mortgage underwriting has shown the ability to detect fraud prior to lending. The senior managers that controlled nonprime mortgage lenders that were control frauds, therefore, had to eliminate competent underwriting and suborn "controls" to pervert them into fraud allies.

When the nonprime lenders gutted their underwriting standards and controls and paid brokers greater fees for referring nonprime loans they inherently created an intensely criminogenic environment for loan brokers and appraisers. The brokers' optimization strategy was simple – refer as many relatively high yield mortgage loans as possible, as quickly as possible, with applications and made the borrower appear to qualify for the loan. The nonprime lenders, in essence, signaled their intention not to kick the tires and weed out even fraudulent loan applications and appraisals. I call this the financial version of "don't ask; don't tell" (a justly maligned U.S. military policy about gays serving in our armed services).

The Financial Crisis Inquiry Commission (FCIC) reported on how these perverse incentives worked in the real world.

> More loan sales meant higher profits for everyone in the chain. Business boomed for Christopher Cruise, a Maryland-based corporate educator who trained loan officers for companies that were expanding mortgage originations. He crisscrossed the nation, coaching about 10,000 loan originators a year in auditoriums and classrooms.
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> His clients included many of the largest lenders—Countrywide, Ameriquest, and Ditech among them. Most of their new hires were young, with no mortgage experience, fresh out of school and with previous jobs "flipping burgers," he told the FCIC. Given the right training, however, the best of them could "easily" earn millions.
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> "I was a sales and marketing trainer in terms of helping people to know how to sell these products to, in some cases, frankly unsophisticated and unsuspecting borrowers," he said. He taught them the new playbook: "You had no incentive whatsoever to be concerned about the quality of the loan, whether it was suitable for the borrower or whether the loan performed. In fact, you were in a way encouraged not to worry about those macro issues." He added, "I knew that the risk was being shunted off. I knew that we could be writing crap. But in the end it was like a game of musical chairs. Volume might go down but we were not going to be hurt."
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> On Wall Street, where many of these loans were packaged into securities and sold to investors around the globe, a new term was coined: IBGYBG, "I'll be gone, you'll be gone." It referred to deals that brought in big fees up front while risking much larger losses in the future. And, for a long time, IBGYBG worked at every level [FCIC: 7-8]

The downstream epidemic of accounting control fraud could not be created by the nonprime lenders because they could not create a downstream Gresham's dynamic. Indeed, the argument runs the other direction. The nonprime loan purchasers, by adopting the financial version of "don't ask; don't tell" (and ignore or hide bad results), produced a criminogenic environment that helped drive the primary mortgage fraud epidemic. While press accounts have asserted that nonprime lenders had no concern about mortgage quality because they intended to sell the nonprime loans, that claim assumes away the central problem that the lender has no power to force someone to purchase the loans. The nonprime lenders were selling mortgages that were frequently fraudulent and worth dramatically less than lender's book value. They were selling in circumstances that the economic theory of "lemon" markets predicts can only be sold at a significant discount from the original book value (Akerlof 1970). Neoclassical economic theory predicts that "private market discipline" will prevent any downstream fraud (Black 2003). Fraudulent downstream investors rationally overpay for assets in order to obtain greater short-term yield (increasing accounting income) and rationally adopt a financial "don't ask; don't tell" policy with regard to asset quality and losses. Investors overpaid massively for nonprime CDOs – by 65 to 85 cents on the dollar. This created an overwhelming incentive to avoid massive loss recognition through a downstream epidemic of accounting fraud. The bankruptcy examiner's recent report on Lehman reveals that Lehman employed two common forms of accounting fraud – it did not recognize huge losses on assets and it used REPO transactions for the purpose of hiding those losses from creditors, investors, and regulators. Note that the downstream purchasers – including Fannie and Freddie – were never required to purchase fraudulent loans. Large numbers of liar's loans, for example, would not have counted towards Fannie and Freddie's regulatory requirement to purchase set percentages of below median income mortgages precisely because income was commonly grossly inflated. The CEOs that controlled the large financial players purchased over a trillion dollars in liar's loans not because they were required to or because President Clinton and Bush gave speeches favoring broader home ownership but because purchasing such loans created increased accounting income (in the near term), which maximized their bonuses.

Mortgage Fraud became Endemic

It is commonly reported that roughly 40% of U.S. mortgage lending during 2006 were nonprime, evenly split between subprime (known credit defects) and "alt-a" (purportedly high credit quality, but lacking verification of key underwriting data). "Alt-a" loans, by definition, did not conduct traditional underwriting (Bloomberg 2007; Gimein 2008). Liar's loans were sold under the bright shining lie that the borrowers had excellent credit characteristics essentially equivalent to prime borrowers. Investment banks typically called their liar's loans "prime" loans on their financial statements.

When discussing a category known in the trade as "liar's loans", however, it is well to keep in mind the likelihood of deliberate misreporting of data. Over time, "alt-a" and "subprime" loans came to increasingly common features. Lehman, for example, had a subsidiary that specialized in liar's loans (Aurora) and one (BNC) that specialized in subprime. Aurora increasingly made liar's loans to borrowers that reported substantial credit problems and BNC increasingly made liar's loans to its subprime customers. When Lehman finally shut down BNC, Aurora continued

to make liar's loans to borrowers disclosing defective credit. That is an extraordinary fact, for these were the borrowers whose incomes were typically grossly inflated. If even after the loan broker falsified much of the information on the application (Aurora purchased 95% of its liar's loans) the application showed obvious credit defects and Aurora still purchased the loans, then these actions are only rational for an accounting control fraud.

The implications of this are critical. It became the norm for liar's loans to be made on the basis of loan applications that, while fraudulent, also showed serious credit defects.

The typical presentation states that almost half of subprime loans, by 2006, did not conduct traditional underwriting. That percentage may be seriously underestimated. Lenders appear to have lied increasingly by describing liar's loan as "prime" loans. Credit Suisse reported in March 2007 that "we believe the most pressing areas of concern should be stated income (49% of originations), high CLTV/piggyback (39%), and interest only/negative amortizing loans (23%)." This is a good example of "layered risk." The sum of the three percentages exceeds 100% because it was common to make loans that had at least two, sometimes each, of these characteristics.

A small sample review of nonprime loan files by Fitch (2007), found that underwriting had to be eviscerated to permit the endemic fraud that came to characterize nonprime mortgage lending.

> Fitch's analysts conducted an independent analysis of these files with the benefit of the full origination and servicing files. The result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file.
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> [F]raud was not only present, but, in most cases, could have been identified with adequate underwriting, quality control and fraud prevention tools prior to the loan funding. Fitch believes that this targeted sampling of files was sufficient to determine that inadequate underwriting controls and, therefore, fraud is a factor in the defaults and losses on recent vintage pools.

MARI, the Mortgage Bankers Association (MBA's) experts on fraud, warned that "low doc" lending caused endemic fraud.

> Stated income and reduced documentation loans … are open invitations to fraudsters. It appears that many members of the industry have little historical appreciation for the havoc created by low-doc/no-doc products that were the rage in the early 1990s. Those loans produced hundreds of millions of dollars in losses for their users.
>
> One of MARI's customers recently reviewed a sample of 100 stated income loans upon which they had IRS Forms 4506. When the stated incomes were compared to the IRS figures, the resulting differences were dramatic. Ninety percent of the stated incomes were exaggerated by 5% or more. More disturbingly, almost 60% of the stated amounts were exaggerated by more than 50%. These results suggest that the stated income loan deserves the nickname used by many in the industry, the "liar's loan."

The same obvious question (which neither Fitch nor MARI asked) arises: why did lenders fail to use well understood underwriting systems that are highly successful in preventing fraud – even when they knew that fraud was endemic and would cause massive losses? The same obvious answer exists – it was in the interests of the controlling officers to optimize short-term accounting income. Turning a blind eye to endemic fraud helped optimize reported income and their executive compensation.

MARI's reference to the "early 1990s" refers to a number of S&Ls that originated or purchased "low doc" loans in the early 1990s. These loans caused "hundreds of millions of dollars in losses." Those losses were contained because the regulators promptly used their supervisory powers to halt the practice when they realized that it was growing and becoming material. We acted because we recognized that not underwriting maximized adverse selection and guaranteed high real losses (after near-term, fictional, profits). We ordered a halt to the practice even while many of the lenders were reporting that the lending was profitable. "Hundreds of millions of dollars in losses" is serious, but if the losses are contained at that level the number of lender failures will be minimal and there will be no risk of a crisis. Unfortunately, our regulatory successors had no "historical appreciation" for successful supervisory policies or the identification of accounting control fraud. They issued ineffective "cautions" to the industry that "low doc" loans could be risky, but refused to order an end to the practice and never considered the possibility that the lenders were control frauds.

Thomas J. Miller, Attorney General of Iowa, testimony 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.
>
> Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer.

Because these risks were "layered" – interacting to produce far greater risk (IMF 2008: 4-5 & n.6) – honest nonprime lenders would have responded by establishing record high general loss reserves in accordance with generally accepted accounting principles (GAAP). Instead, A.M. Best reported in February 2006 that: "the industry's reserves-to-loan ratio has been setting new record lows for the past four years" (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). One year later, A.M. Best reported: "loan loss reserves are down

to levels not seen since 1985" (roughly one percent) (A.M. Best 2007: 1). A.M. Best went on to point out that these grossly inadequate loss reserves in 1985 led to a decade-long crisis in banking and S&Ls. In 2009, IMF estimated losses on U.S. originated assets of $2.7 trillion (IMF 2009: 35 Table 1.3). Total U.S. bank and S&L general loss reserves in 2006 were under $100 billion, so general loss reserves would have had to be roughly 30 times larger to be adequate. If the lenders had established adequate loss reserves they would have reported that they were deeply unprofitable, which was the economic reality. The banking regulatory agencies, the SEC, and "private market discipline" all failed to require even remotely adequate reserves and minimal honesty in financial reports. The current control frauds used the same optimization techniques as did the S&Ls – but they did it on steroids. The primary epidemic directly created the upstream epidemic and was a necessary, but not sufficient, cause of the upstream epidemic.

Endemic Mortgage Origination Fraud Means Endemic Predation and Foreclosure Fraud

Liar's loans provide a superb "natural experiment" that allows us to test rival theories about what caused the U.S. crisis. As I have explained, the government did not require any entity to make or purchase a liar's loan. Liar's loans make no sense for honest lenders or purchasers. Liar's loans were overwhelmingly made for the purpose of prompt resale to the secondary market at the greatest possible price. Liar's loans were ideal for producing a "too good to be true" result that made all the controlling officers involved rich while causing massive losses to the firms. The key was the compensation system for mortgage brokers. They were paid more for producing something that would have been impossible if markets really were efficient, but was child's play to produce in the real world. The lender paid the broker a larger fee if the broker could charge a higher price (yield) to the borrower and if the broker could make the loan appear less risky. The broker also wanted to do so without creating a paper trail that would make it easy to prosecute the broker for fraud. The liar's loan was the optimal "ammunition" for such fraud purposes.

It is easier to charge borrowers a higher yield if they (i) have early stage Alzheimers, (ii) are not financially sophisticated, (iii) have fewer banking alternatives, and (iv) do not read or speak English. This is why the elderly, African-Americans, Latinos, and working class individuals with very limited income were the ideal candidates for liar's loans. Predation and liar's loans are the closest and vilest of companions.

The other key to maximizing the broker's fee was making the loan appear safer. This could easily be accomplished through fraudulently manipulating two ratios. The "loan-to-value" (LTV) ratio is the ratio of the size of the loan to the appraised (market value) of the collateral pledged as security for the loan (your house). The goal was to inflate the appraisal to make the loan appear safer.With rare exceptions, borrowers cannot inflate appraisals. Fraudulent lenders and their agents could do so easily by using their ability to hire and fire appraisers to produce a

Gresham's dynamic in which unethical appraisers drove their honest counterparts out of the work.

The other ratio was debt-to-income. By inflating the borrower's income the broker or lender could make the loan appear less risky. Inflating a borrower's income is something that only a fraudulent lender would do. It is normally a dangerous fraud to commit. We convicted hundreds of controlling officers and borrowers of loan fraud because they filed false financial statements. Honest underwriting produces a paper trail that makes prosecution far easier. If the lender or its agents forges a document or destroys the real records juries find their task simple. Liar's loans (which typically did not verify the borrower's income) are so criminogenic because they allow fraud without creating the incriminating paper trail.

We can now connect the dots to see how the lender's perverse compensation system for brokers was designed to produce endemic fraud. If the broker inflates the appraised value of the house and the borrowers income while negotiating a premium yield the lender's controlling officers fins it far easier to sell the mortgage to the secondary market and far easier to sell it at a higher price. This maximizes their executive compensation and it is a "sure thing." The most pedestrian CEOs can pull off this scam.

Now consider the matter from the broker's perspective. Your prior job (as the FCIC report explained) was often flipping burgers. If you hit the sweet spot in terms of excess yield and the most desirable ratios you can receive – for bringing one California "jumbo" ($650,000) liar's loan to the lender a fee of $20,000. Are you going to leave it to the unsophisticated borrower to randomly hit the magic ratios, particularly when you know that the borrower cannot quality for the loan at his actual income? Not all people will cheat in these circumstances, but more than enough will to be able to grow liar's loans by over 500% during 2003-2006.

This analysis also takes us most of the way to understanding why foreclosure fraud is endemic. First, foreclosures have reached unprecedented levels because so many bad loans were made pursuant to the fraud recipe and because the fraudulent loans hyper-inflated the bubble. Second, foreclosure fraud was certain to grow immensely because the originations and sales of liar's loans were pervasively fraudulent. It is necessary to gut underwriting and internal controls to allow a lender to make endemic fraudulent loans. Even in honest banks, loan officers hate paperwork. It slows them down and reduced their commissions. That is one of the reasons why honest banks have multiple levels of internal and external controls staffed by tough, anal, rigorous reviewers. Accounting control frauds must undercut these controls. The inevitable result is that lots of documents never get finalized or get lost. This tendency grew far worse once one could sell a mortgage electronically without review of the individual files and hard copy documents. MERS put this problem on steroids. A fraudulent lender could now sell a fraudulent loan without the purchaser ever checking to see whether the lender had the fully executed note. Securitization then ramped up the problem by producing large numbers of electronic assignments

and sales that removed anyone with an institutional knowledge of the loan. With MERS, no one is in charge.

The mass failure of the mortgage bankers and mortgage brokers who made the great bulk of the fraudulent loans intensified this disaster. It was common for the firms to be liquidated rather than acquired (or for the acquirer to soon fail and be liquidated). Document transfers were no longer publicly recorded if they were done through MERS. (MERS is a tax evasion scheme.) No one even knew which documents still existed and which had been thrown into the dumpsters. The overwhelming norm is that the mortgage banking firms that made the majority of the fraudulent loans failed and their record keeping was destroyed.

The final two contributions to mass foreclosure fraud were that the people hired to service the loans were often hired by the most fraudulent lenders, such as Countrywide. Many employees committed fraud as their central function when they made mortgages. They simply continued business as usual when it came to foreclosure, particularly when there work load surged due to the endemic foreclosures, which in turn were due to the endemic mortgage origination fraud. Fannie and Freddie made this even worse by documenting that foreclosure fraud was endemic by its servicers – and proceeding to do nothing effective to stop the frauds or make criminal referrals. Foreclosure fraud, we now know because of the release of a GSE report, has been widespread for over five years.

If You Don't Investigate, You Won't Find

Criminologists and financial regulators have long warned that the failure to regulate the financial sphere *de facto* decriminalizes control fraud in the industry. The FBI cannot investigate effectively more than a small number of the massive accounting control frauds. Only the regulators can have the expertise, staff, and knowledge to identify on a timely basis the markers of accounting control fraud, to prepare the detailed criminal referrals essential to serve as a roadmap for the FBI, and to "detail" (second) staff to work for the FBI and serve as their "Sherpas" during the investigation.

The agency regulating S&Ls made criminal prosecution a top priority. The result was over 1000 priority felony convictions of senior insiders and their co-conspirators. That is the most successful effort against elite white-collar criminals. The agency also brought over 1000 administrative enforcement actions and hundreds of civil lawsuits against the elite frauds. One result of this was an extensive, public record of fact that fraud was "invariably present" at the "typical large failure" (NCFIRRE 1993). The Enron-era frauds were accounting control frauds and while the effort against them was too late and weaker than the effort against the S&L frauds it involved scores of prosecutions and provided substantial public documentation.

The FBI, however, after a brilliant start in identifying the epidemic of mortgage fraud, went tragically astray and its efforts to contain the epidemic failed. The FBI suffered from a horrific systems capacity problem. It did not have the agents or expertise to deal with the concurrent

control fraud epidemics it faced this decade. Its systems capacity problems became crippling when 500 white-collar specialists were transferred to national security investigations in response to the 9/11 attacks and the administration refused to allow the FBI to hire new agents to replace the lost white-collar specialists.

The most crippling limitation on the regulators', FBI's, and DOJ's efforts to contain the epidemic of mortgage fraud and the financial crisis was not understanding of the cause of the epidemic and why it would cause a catastrophic financial crisis. The mortgage banking industry controlled the framing of the issue of mortgage fraud. That industry represents the lenders that caused the epidemic of mortgage fraud. The industry's trade association is the Mortgage Bankers Association (MBA). The MBA followed the obvious strategy of portraying its members as the victims of mortgage fraud. What it never discussed was that the officers that controlled its members were the primary beneficiaries of mortgage fraud. It is the trade association of the "perps." The MBA claimed that all mortgage fraud was divided into two categories – neither of which included accounting control fraud. The FBI, driven by acute systems incapacity, formed a "partnership" with the MBA and adopted the MBA's (facially absurd) two-part classification of mortgage fraud (FBI 2007). The result is that there has not been a single arrest, indictment, or conviction of a senior official of a nonprime lender for accounting fraud.

One of the most dramatic, and unfortunate differences between the S&L debacle and the current crisis is that the financial regulatory agencies gave the FBI no help in this crisis – even after it warned of the epidemic of mortgage fraud. The FBI does not mention the agencies in its list of sources of criminal referrals for mortgage fraud. The data on criminal referrals for mortgage fraud show that regulated financial institutions, which are required to file criminal referrals when they find "suspicious activity" indicating mortgage fraud, typically fail to do so. There is no evidence that the agencies responsible for enforcing the requirement file criminal referrals have taken any action to crack down on the widespread violations.

The crippling mischaracterization of the nature of the mortgage fraud epidemic came from the top, as the *New York Times* reported in late 2008.

> But Attorney General Michael B. Mukasey has rejected calls for the Justice Department to create the type of national task force that it did in 2002 to respond to the collapse of Enron.
>
> Mr. Mukasey said in June that the mortgage crisis was a different "type of phenomena" that was a more localized problem akin to "white-collar street crime."

The U.S. Attorney in one of epicenters of mortgage fraud has an even more crippling conceptual failure because of his inability to understand the concept of looting.

http://huffpostfund.org/stories/2010/05/too-big-jail

> Too Big to Jail?
>
> Not everyone agrees that such a case can be successful. Benjamin Wagner, a U.S. Attorney who is actively prosecuting mortgage fraud cases in Sacramento, Calif., points out that banks lose money when a loan turns out to be fraudulent. An investor in loans who documents fraud can force a bank to buy the loan back. But convincing a jury that executives intended to make fraudulent loans, and thus should be held criminally responsible, may be too difficult of a hurdle for prosecutors.
>
> "It doesn't make any sense to me that they would be deliberately defrauding themselves," Wagner said.

Wagner has confused himself with his pronouns. "They" refers to the CEO. "Themselves" refers to the bank. The CEO has a "sure thing" – he can grow wealthy very quickly by looting the bank through the accounting fraud recipe. He is not looting himself.

Wagner is far from alone in not understanding the most destructive financial fraud scheme and in making a clear error of logic. The courts routinely interpret the Private Securities Litigation Reform Act (PSLRA) to require the dismissal of complaints based on inferences the courts deem to rely on "irrational" behavior. But they mean irrational from the standpoint of the corporation. Lenders loot by making loans that are irrational from the bank's standpoint but wholly rational from the looter's standpoint. Indeed, it is the very irrationality of the action from the standpoint of an *honest* bank that allows juries to infer so strongly that the CEO caused the bank to operate in that suicidal manner because it optimized his looting. Indeed, the PSLRA case law on the most important inferences (e.g., about the criminogenic effects of particular forms of executive compensation) calls for inferences that white-collar criminologists, financial regulators, and forensic accountants (indeed, the accounting literature) all reject. The PSLRA has become a shield against even the most meritorious securities fraud actions, which has contributed to securities fraud becoming so common and severe.

The nation's top law enforcement official swallowed the MBA's mischaracterization of the mortgage fraud epidemic and economic crisis hook, line, sinker, bobber, rod, reel, and boat they rowed out into the swamp. Because Mukasey refused to investigate the elite frauds he created a self-fulfilling prophecy in which the FBI and DOJ pursued only the "white-collar street crim[inals]" (the small fry) and therefore confirmed that the problem was the small fry. The pursuit of the small fry was certain to fail.

The MBA's success in causing the FBI to ignore the control frauds reminds me of this passage in the original *Star Wars* movie where Obi-Wan uses Jedi powers to pass through an Imperial check point with two wanted droids in plain sight:

Stormtrooper: Let me see your identification.
Obi-Wan: [*with a small wave of his hand*] You don't need to see his identification.
Stormtrooper: We don't need to see his identification.
Obi-Wan: These aren't the droids you're looking for.

Stormtrooper: These aren't the droids we're looking for.
Obi-Wan: He can go about his business.
Stormtrooper: You can go about your business.
Obi-Wan: Move along.
Stormtrooper: Move along... move along.

Luke: I don't understand how we got by those troops. I thought we were dead.
Obi-Wan: The Force can have a strong influence on the weak-minded.

The FBI isn't supposed to be "weak-minded" about elite white-collar criminals. It is not supposed to be misled by "Jedi mind tricks" by the lobbyists for the "perps." It is not supposed to fail to understand the importance of endemic markers of accounting control fraud at every nonprime specialty lender where even a preliminary investigation has been made public.

The FBI, DOJ, banking regulators, SEC, and all the purported sources of "private market discipline" failed to act against (and even praised) the *perverse incentive structures* that the accounting control frauds created to cause the small fry to act fraudulently. Those incentive structures ensured that there were always far more new small fry hatched to replace the relatively few small fry that the DOJ could imprison. Accounting control frauds deliberately produce intensely criminogenic environments to recruit (typically without any need for a formal conspiracy) the fraud allies that optimize accounting fraud. They create the perverse Gresham's dynamic that means that the cheats prosper at the expense of their honest competitors. The result can be that the unethical drive the ethical from the marketplace. Had Mukasey been aware of modern white-collar criminological research he would have been forced to ask why tens of thousands of small fry were able to cause an epidemic of mortgage fraud in an industry that had historically successfully held fraud losses to well under one percent of assets. Ignoring good theory produces bad criminal justice policies.

The Size of the Mortgage Fraud Epidemic Swamps the FBI

The size of the current financial crisis and the incidence of fraud in the current crisis vastly exceed the S&L debacle. The FBI testified that it "increased the number of agents around the country who investigate mortgage fraud cases from 120 Special Agents in FY 2007 to 180 Special Agents in FY 2008…." Its testimony noted that it employed "1000 FBI agents and forensic experts" against the S&L frauds (Pistole 2009). It received over 63,000 criminal referrals for mortgage fraud in the last year for which it has full data (a figure that has risen substantially every year). The FBI, therefore, can investigate only a tiny percentage of criminal referrals for mortgage fraud. The FBI reports that 80% of mortgage fraud losses occur when "industry insiders" are involved in the fraud (FBI 2007).

Only federally insured banks and S&Ls are required to file criminal referrals. Non-insured lenders made 80% of nonprime mortgage loans (subprime and "alt-a"), and the made the worst nonprime loans that most invited fraud. These lenders can make criminal referrals and it would be in the interests of honest lenders to do so, but they rarely do. That means that the first approximation of the true annual incidence of mortgage fraud would be to multiply 63,000 by five (315,000). That extrapolation, however, would only be sound if (A) insured lenders spotted

all mortgage fraud and (B) filed criminal referrals when they spotted likely frauds. The FBI believes that insured entities identify mortgage frauds prior to lending in about 20% on "no doc" loans (known in the trade as "liar's loans") (*New York Times,* April 6, 2008). Multiplying 315,000 by five produces a product of over 1.5 million.

The data on referrals show that the typical insured lender rarely files when it finds mortgage fraud. The October 2009 FinCEN report on criminal referrals for mortgage fraud (in jargon, Suspicious Activity Reports (SARs) found:

> In the first half of 2009, approximately 735 financial institutions submitted SARs, or about 50 more filers compared to the same period in 2008. The top 50 filers submitted 93 percent of all [mortgage fraud] SARs, consistent with the same 2008 filing period. However, SARs submitted by the top 10 filers increased from 64 percent to 72 percent.

Only a small percentage of mortgage lenders, 75 in total (roughly 10% of federally-insured mortgage lenders), filed even a single criminal referral for mortgage fraud during a mortgage fraud epidemic. Of the 735 that make at least one filing, fewer than 200 file more than four referrals. A mere ten filers provide the FBI with almost three-quarters of all SARs mortgage fraud filings. We cannot form an appropriate estimate of the degree of under-filing of criminal referrals when insured banks find fraud, but we can infer that the failure to file is pervasive. The logical explanation for the widespread failure of lenders to file criminal referrals when they discover mortgage frauds is that they fear that if they file FBI would come to the lender and discover its complicity in the fraud.

To sum it up, in FY 2007 the FBI has had less than one-eighth of the resources it had to investigate the S&L frauds despite the fact that the current crisis inflicted losses on the household sector 70 times worse than the S&L debacle. It was facing well over a million mortgage frauds annually. It could investigate under 1000 cases per year. If every investigation was successful the FBI would be completely ineffective in preventing or even slowing materially the epidemic of mortgage fraud. Mukasey's and Holder's strategy of going after the small fry gave the control frauds a free pass and had to fail to deter the small fry.

What it takes to succeed against an epidemic of accounting control fraud

The Obama administration's record of prosecuting elite financial frauds is worse than the Bush administration's record, which is a very large statement. Syracuse University's TRAC issued a report on November 11, 2011 entitled "Criminal Prosecutions for Financial Institution Fraud Continue to Fall."

http://trac.syr.edu/tracreports/crim/267/

Neither administration has prosecuted any elite CEO for the epidemic of mortgage fraud that drove the ongoing crisis. This contrasts with over 1,000 elite felony convictions arising from the S&L debacle. The ongoing crisis caused losses more than 70 times greater than the S&L debacle and the amount of elite fraud driving this crisis is also vastly greater than during the S&L

debacle. Bank CEOs leading "accounting control frauds" now do so with impunity from the criminal laws. They become wealthy through fraud and even if they are sued civilly they almost invariably walk away wealthy with the proceeds of their frauds.

The Obama Administration Prefers Politics and Propaganda to Prosecutions

Elite financial institutions officers engaged in fraud face a dramatically reduced risk of prosecution compared to 20 years ago when financial fraud was far less common. TRAC reports that the number of financial institution fraud prosecutions under Obama is less than one-half the number 20 years ago. Bush (II) was slightly better than Obama in prosecuting non-elite financial institution frauds, but both were pathetically bad.

The *New York Times* reported on January 23, 2012 that the administration rushed to try to reach a settlement with the five largest banks that engaged in massive foreclosure fraud so that it could take credit for it in the State of the Union (SOTU) address. The headline for the article was "Political Push Moves a Deal on Mortgages Inches Closer." The administration did not deny the statements made in the article.

> "But a final agreement remained out of reach Monday despite political pressure from the White House, which had been trying to have a deal in hand that President Obama could highlight in his State of the Union address Tuesday night.
>
> The housing secretary, Shaun Donovan, met on Monday in Chicago with Democratic attorneys general to iron out the remaining details and to persuade holdouts to agree with any eventual deal. He later held a conference call with Republican attorneys general. But as he renewed his efforts, Democrats in Congress, advocacy groups like MoveOn.org and several crucial attorneys general said the deal might be too lenient on the banks.
>
> In a bid to win support from California officials, Mr. Donovan proposed earmarking $8 billion in aid for beleaguered California homeowners, but that left other state attorneys general incensed, according to an official familiar with the negotiations."

http://www.nytimes.com/2012/01/24/business/a-deal-on-foreclosures-inches-closer.html?_r=1&hpw

The *NYT* did not make the point, but these facts represent multiple disgraces on the administration's part that go beyond the substance of deal. First, there is the obvious impropriety of pressuring state attorney generals (AGs) who are Democrats to approve a deal so that the President can claim credit for it in the SOTU. Second, it is disgraceful that HUD Secretary Donovan met separately with Democratic AGs. Prosecutions and suits against banks must have nothing to do with political affiliation. Holding separate meetings with AGs based on their party affiliation brings the entire system into disrepute. Third, the idea of offering California a unique earmark in order to buy AG Harris' support for a deal is as stupid as it was offensive. The administration thinks that everything is about politics. As a former Department of Justice

attorney I regret the administration's bringing the department into disgrace. I can personally assure the nation that nothing like this ever occurred during the S&L debacle in our prosecutions, civil lawsuits, and agency enforcement actions.

Here is what Obama said in his SOTU address:

> "One of my proudest possessions is the flag that the SEAL Team took with them on the mission to get bin Laden. On it are each of their names. Some may be Democrats. Some may be Republicans. But that doesn't matter. Just like it didn't matter that day in the Situation Room, when I sat next to Bob Gates – a man who was George Bush's defense secretary; and Hillary Clinton, a woman who ran against me for president.
>
> All that mattered that day was the mission. No one thought about politics. No one thought about themselves."

http://www.washingtonpost.com/politics/state-of-the-union-2012-obama-speech-full-text/2012/01/24/gIQA9D3QOQ_story.html

The President was, of course, correct. The same logic applies to everything that government attorneys do. No one should think about politics or themselves. Political party "doesn't matter." Party, politics, and the pursuit of financial contributions not only matter, but are controlling for the administration in their non-pursuit of the fraudulent elite CEOs that drove the ongoing crisis.

The fact that a *NYT* story could reveal this outrage without the authors even mentioning the impropriety of the actions described, without the administration feeling any need to respond to the impropriety, and without any scandal demonstrates how badly we have fallen as a society. While the President was reviewing drafts of a major address to the nation that emphasized that politics should never have a role in government service two of his cabinet officers, Attorney General Holder and HUD Secretary Donovan, were devising a partisan lobbying strategy aimed at getting the state AGs to approve a disgraceful surrender to five of the nation's largest banks. He either did not notice the contradiction or did not feel any need to end the impropriety. Have we lost our capacity for outrage?

The failure of the article to generate a scandal reflects badly on both parties. The candidates for the Republican Party's nomination have been searching for every conceivable issue as a potential basis for attacking Obama. The administration's conduct as described by the *NYT* article provides the perfect club to the Republican candidates, yet none of them will use it. Why? The Republican candidates could not oppose a settlement that, substantively, was so exceptionally favorable to the largest banks. Finance is the largest contributor to both parties. The only criticism in the article came from liberal Democrats (Senator Brown and Representative Miller).

The administration recognized that the only threat to the disgraceful settlement came from liberal Democrats. The administration devised a sophisticated propaganda campaign to counter this opposition. It bore fruit immediately. The day after the *NYT* story ran, the Center for Responsible Lending (CRL) issued a press release entitled "AG Settlement: Not Perfect, but Significant Reform of Mortgage Servicing."

http://www.responsiblelending.org/media-center/press-releases/archives/AG-Settlement-Not-Perfect-but-Significant-Reform-of-Mortgage-Servicing.html

The press release was based on a friendly leak, presumably from the administration, of the terms of the settlement as of January 24, 2012. The settlement had two express, related substantive defects. The amount of money the banks would pay was grossly inadequate, relative to the claims being released by the federal and state governments. The third substantive defect is not contained in the written release, but it is one of the keys to the governmental surrender to the fraudulent financial CEOs who caused the crisis. The federal government does not intend to prosecute criminally the large financial firms and their senior officers who committed hundreds of billions of dollars in fraudulent mortgage originations. That figure only counts the fraudulent liar's loans the five large banks made. The total amount of mortgage origination fraud through liar's loans exceeds $1 trillion. The five banks' civil liability for mortgage origination fraud is vastly larger than their civil liability for their endemic foreclosure fraud. I have explained in detail in prior articles and testimony why only fraudulent banks made material amounts of liar's loans.

Here is how the administration successfully spun the deal to CRL.

> "•Banks remain accountable. While the state AGs would not be able to bring additional origination or servicing claims against the participating banks, the settlement would preserve the ability of homeowners to pursue claims against banks. Moreover, the settlement would not shield banks from prosecution related to criminal activities, claims based on mortgage securities violations, fair lending suits, or claims against MERS. Finally, the settlement would be enforceable in court by an independent monitor."

As of January 24, the deal the administration was desperate to conclude prior to the SOTU required the state and federal governments to release civil claims for mortgage origination fraud.

The administration's efforts to pressure the state AGs (all Democrats) to withdraw their opposition to this cynical deal to immunize expressly the largest banks from civil liability for their mortgage origination fraud and, implicitly, to immunize them from criminal liability for mortgage origination fraud failed. The administration responded to the failure through an elaborate symbolic creation of a new task force and a renewed propaganda campaign designed to neutralize liberal opposition to its proposed surrender to the largest banks. The maneuver, however, required an important substantive change in the proposed deal that reveals how bad for the public the administration's proposed deal of January 24 was.

The administration is good at spinning, and this effort had a clever twist and a substantive change that added to its credibility. To date, the spin has been largely successful with liberal commentators. The clever twist was adding the AG leading the opposition to the surrender, NY AG Eric Schneiderman, to the newly created working group. Schneiderman has great credibility with liberals because he blocked the administration's proposed grants of immunity to the five large banks (which were apparently far broader and included express terms raising crippling barriers even to criminal prosecutions). The administration needed Schneiderman on the task force to grant it any credibility. The need for credibility became even more intense after Scot

Paltrow's January 20 expose in Reuters (**Insight: Top Justice officials connected to mortgage banks).** The article revealed that U.S. Attorney General Holder and Lanny Breuer, head of DOJ's criminal division, had been partners at the law firm Covington & Burling, which represented many of the largest banks and had provided key legal opinions to the infamous MERS (Mortgage Electronic Registration System) that has contributed greatly to foreclosure fraud.

http://www.reuters.com/article/2012/01/20/us-usa-holder-mortgage-idUSTRE80J0PH20120120

Schneiderman apparently recognized the great leverage he had over the administration and insisted on the modification of the deal's release of the big banks' civil liability for their mortgage origination fraud. The administration used Schneiderman's willingness to serve on the new task force and the reduced grant of immunity for the big banks' mortgage origination fraud as the centerpiece of its effort to spin liberals. It promptly leaked a description of the new proposed deal terms to several liberals – and was immediately rewarded with praise from liberals. Given the fact that Holder and Breuer have no credibility with liberals, this was an exceptional achievement that has delighted the administration. Mike Lux, who has consistently and strongly opposed the administration's earlier proposed settlement drafts, broke the story of the substantive improvements to the deal on January 27. His story explains that two sources he trusts leaked the terms of the new deal to him. He entitled his article "Settlement Release Looks Tight." I encourage reading Lux's entire article, but here is the key excerpt.

http://www.huffingtonpost.com/mike-lux/settlement-release-looks-_b_1236602.html

> "Big breaking news about the long-fought over bank settlement: senior sources high up in the negotiations have outlined the terms of the legal release. Here's what I was told:
>
> ***
>
>> No release on the "vast majority" of origination claims.
>>
>> No release on the "vast majority" of securitization claims, including all claims of state pension funds.
>
> ***
>
> According to these (two) sources, the release is almost entirely confined to robosigning cases.
>
> Now, I haven't seen the actual language, so I can't verify all this, and I don't know what the phrase "vast majority" means. I also don't know if every player in the negotiations is 100 percent signed off on it. But I have a lot of trust in my sources that this real and that they wouldn't be trying to BS me on how narrow this is. If the language is indeed as tight as my sources are telling me, this is very big news.

> All along in this battle, there have been two things progressives working on this issue have been fighting hardest for: one was that we got a broad, deep, well-resourced, and serious investigation of the big financial fraud issues that have gone down in this country over the last decade; the other was that if there was a settlement, that the legal releases the banks got was drawn as narrowly as it could be drawn, as tight as a drum. That combination, in the view of New York Attorney General Eric Schneiderman and those of us fighting by his side, would create real potential of finally holding the Wall Street bankers who wrecked our economy and abused us all accountable for their actions, and for getting a serious amount of money for writing down underwater mortgages. While there are still legitimate questions in both areas, it is looking like we may be achieving both of these huge goals.
>
> One other big question remains in all this: with a release this narrow, will the big banks actually settle? JP Morgan Chase CEO Jamie Dimon and unnamed bank lobbyists are already threatening to walk away, and are clearly really unhappy, so that isn't clear. If they walk away, though, progressives can certainly live very well knowing that they will be prosecuted aggressively by AGs like Schneiderman, Beau Biden of Delaware, Kamala Harris of California, and hopefully others, so it's a win-win for us. My view is: anything that makes Jamie Dimon and big-bank lobbyists unhappy is good for the rest of us."

Lux obviously recognizes that there are important outstanding questions about the proposed deal. I write to add several cautions.

1. There is no reason for granting any civil immunity on mortgage origination or securitization frauds and the grant of even limited immunity for such frauds can only create future problems.
2. The state AGs do not have the resources to investigate mortgage origination fraud. It isn't even close. Collectively, the 50 state AGs could investigate Countrywide's frauds if they took every investigator with expertise in financial institutions and assigned them to the case for five years.
3. The state AGs are not investigating mortgage origination fraud by major lenders.
4. The new working group will not investigate mortgage origination fraud. Obama described the task force in these words in his SOTU address.

    > "And tonight, I am asking my Attorney General to create a special unit of federal prosecutors and leading state attorneys general to expand our investigations into the abusive lending and packaging of risky mortgages that led to the housing crisis. This new unit will hold accountable those who broke the law, speed assistance to homeowners, and help turn the page on an era of recklessness that hurt so many Americans."

    The working group will not "investigate … abusive lending" and it will not "hold accountable those who broke the law … [by defrauding] homeowners." It will not "speed assistance to homeowners." It will not "turn the page on an era of recklessness" – and fraud, not "recklessness" is what prosecutors should prosecute. The name of the working group makes its crippling limitations clear: the Residential Mortgage-Backed Securities Working Group. Attorney General Holder's memorandum about the working

group makes clear that the name is not misleading. The working group will deal only with mortgage backed securities (MBS) – not the fraudulent mortgage origination that drove the crisis (the only exception is federally insured mortgages).

http://www.justice.gov/ag/residential-mortgage-backed-securities.pdf

Fraudulent mortgage originators engaged in fraudulent sales of the mortgages, mostly to Wall Street and, eventually, Fannie and Freddie. As I stressed earlier, the administration is continuing to grant *de facto* immunity to CEOs at the large lenders whose massive mortgage origination frauds drove the crisis. The working group's mandate helps confirm the administration's continued refusal to prosecute elite mortgage origination fraud.

5. The working group is a symbolic political gesture designed to neutralize criticism of the administration's continuing failure to hold accountable the elite frauds that drove the crisis. Neither the Bush nor the Obama administration has convicted a single elite fraud that drove the crisis. This is a national disgrace and represents the triumph of crony capitalism. Remember that the FBI warned in September 2004 that there was an "epidemic" of mortgage fraud and predicted that it would cause a financial "crisis." There are no valid excuses for the Bush and Obama administrations' failures. The media have begun to pummel the Obama administration for its failure to prosecute. The administration could not answer this criticism with substance because it has nothing substantive to offer in prosecuting elite mortgage origination frauds. The ugly truth is that we are three full years into his presidency and Holder could not find a single indictment to bring that Obama could brag about in his SOTU address. Who doubts that Holder and Obama would have done so if they had anything in the prosecutorial pipeline? Why do Holder and Obama have nothing in the pipeline? There are three fundamental problems, and the working group has not even addressed, much less resolved, any of the three fundamental defects.

   One, criminal prosecutions of elite financial criminals have to come from investigations initiated by those with the expertise and resources to detect and investigate "accounting control fraud" (the form of fraud that can hyper-inflate financial bubbles and cause catastrophic losses and financial crises). Only the federal banking regulators have this capability. The absolute essential to achieving broad success is superb criminal referrals from those regulators. The central difficulty with such referrals should be that roughly 75% of the fraudulent mortgage loans were made by entities not regulated by the federal (or state) banking regulators. They were primarily made by mortgage bankers. Sadly, that did not prove to be the central difficulty with federal banking regulators' criminal referrals. The federal banking regulators essentially ceased making criminal referrals last decade.

   Banks will not file criminals against their CEOs – the people who run the accounting control frauds that produced the epidemics of mortgage fraud. Police and detectives do not investigate elite accounting control frauds. The FBI does not patrol a beat. Unless the regulatory cops on the beat (e.g., the banking regulators) make the criminal referrals

the DOJ and the FBI will never investigate or prosecute the fraud. Indeed, because accounting control fraud is inherently complex and requires specialized knowledge to recognize, the DOJ will rarely recognize accounting control fraud even when the facts are only consistent with accounting control fraud (as opposed to bad luck or optimism). Absent high quality criminal referrals from the banking regulatory agencies, DOJ may have episodic successes but it will fail utterly to prosecute any epidemic of elite accounting control fraud. Criminal referrals provide the road map that allows effective investigations and prosecutions.

Two, DOJ has not provided remotely enough resources to investigate the large accounting control frauds. Three, DOJ has adopted a self-serving definition of mortgage fraud that implicitly defines accounting control fraud out of existence. DOJ has violated the central rule of investigating elite white-collar crime – if you don't look; you don't find.

We have forgotten the successes of the past. During the S&L debacle, Congress responded to the S&L crisis, once the presidentially-ordered cover up of the scope of the crisis ended in 1989, by ordering and funding a dramatic increase in DOJ resources dedicated to prosecuting the S&L accounting control frauds that drove the second phase of the debacle. President Bush (II), President Obama, and Congress have each failed to emulate the policies that proved so successful in prosecuting elite frauds that caused prior crises. DOJ and the S&L regulators made the prosecution of the elite frauds a top priority by their deeds as well as their words. Contrast that with Holder's press release announcing the formation of the working group.

> "Over the past three years, we have been aggressively investigating the causes of the financial crisis. And we have learned that much of the conduct that led to the crisis was – as the President has said – unethical, and, in many instances, extremely reckless. We also have learned that behavior that is unethical or reckless may not necessarily be criminal. When we find evidence of criminal wrongdoing, we bring criminal prosecutions. When we don't, we endeavor to use other tools available to us – such as civil sanctions – to seek justice."

Holder was even more dismissive of criminality in his memorandum to the financial fraud task force officially informing it of the creation of the working group: "To the extent there was any fraud or misconduct in the RMBS market, we remain committed to discovering it…." This phrase indicates his doubt that there was any fraud – he is saying that they have not "discover[ed]" any fraud. That is a remarkable statement on three grounds. It is a statement made without any credible DOJ investigation. It is a statement contrary to all recent experience with financial crises. Accounting control frauds caused the largest losses in the Enron-era frauds and the S&L debacle. It is also extraordinary because other federal agencies have documented endemic fraud and charged many of the world's largest financial institutions with intentionally selling loans they knew to be fraudulent through false reps and warranties.

Holder consistently emphasizes the lack of criminality. Indeed, since he has prosecuted no elite CEO involved in causing this crisis, he is actually saying that he believes this is our first Virgin Crisis. Countrywide and its ilk made millions of fraudulent mortgage loans – yet Holder thinks that Countrywide's CEO was a victim of the fraud.

I have concluded that the entire working group gambit upsets me so much because it rests on such crude propaganda. Holder decided to embellish the gambit with the illusion of concrete action. Reuters reported Holder's claims at his press conference on the working group.

> "The Justice Department issued civil subpoenas to 11 financial institutions as part of a new effort to investigate misconduct in the packaging and sale of home loans to investors, Attorney General Eric Holder said on Friday.
>
> Holder declined to provide specifics, including the names of the firms.
>
> "We are wasting no time in aggressively pursuing any and all leads," Holder said at a news conference announcing details of a new working group to investigate misconduct in the residential mortgage-backed securities (RMBS) market, "you can expect more to follow.""

http://www.reuters.com/article/2012/01/27/us-mortgages-subpoenas-idUSTRE80Q27U20120127

One assumes that reporters were so stunned by Holder's audacity that they failed to challenge his claim that "we are wasting no time in aggressively pursuing any and all leads." Let us review only the most obvious reasons why this statement is preposterous. The subpoenas are civil subpoenas, not grand jury subpoenas. There is no indication that Holder is serious even now about conducting any criminal investigation of elite banks or bankers.

The question is not whether the Working Group wasted a day or two in issuing civil subpoenas. The Obama administration has wasted three years before issuing these subpoenas. (The Bush administration wasted eight years. The total waste is cumulative.) Civil subpoenas are the most preliminary form of investigation. DOJ should have been issuing grand jury subpoenas to every lender making liar's loans and every entity packaging liar's loans no later than September 2004 when the FBI warned that there was an "epidemic" of mortgage fraud and predicted that it would cause a financial "crisis."

The Obama and Bush administrations have consistently failed to "pursu[e] any and all leads." Let us count the ways DOJ has *typically* failed to pursue leads against the *elite officers whose* frauds drove this crisis: they have not used grand juries, they have not issued civil subpoenas, they have not used electronic surveillance, they have not used undercover investigators, they have not "wired" cooperating witnesses who they have "flipped", they have not appealed for whistleblowers to come forward, they have not called elite witnesses before grand juries, they have not convened grand juries, they have not sent FBI agents to their homes or offices to conduct formal interviews, they have not

retained expert witnesses or consultants with expertise in accounting control fraud, they have not demanded that the banking regulatory agencies produce high quality criminal referrals, they have not asked those agencies to "detail" examiners and other skilled staff to the FBI to serve as internal experts, they have not trained AUSAs, special agents, and banking regulators in how to detect, investigate and prosecute accounting control frauds, they have not prosecuted where other federal agencies, after investigation, have charged that financial elites committed fraud, and they have not flipped intermediate officers and gone up the chain of command, they have not assigned remotely adequate staff to investigate and prosecute frauds, they have not assigned any meaningful number of their staff to investigate the elite frauds, and they have not made strong, consistent demands that Congress fund adequate staff to end the ability of financial elites to commit fraud with impunity. Conversely, DOJ has assigned its inadequate staff almost exclusively to non-elite mortgage fraud, has formed a "partnership" with the Mortgage Bankers Association (MBA) – the trade association of the "perps", and has adopted the MBA's absurd "definition" of mortgage fraud that implicitly defines accounting control fraud out of existence. How does Holder expect to get "leads" against elite frauds when he gets no criminal referrals from the banking regulatory agencies, "defines" the leading fraud perpetrators of mortgage fraud as the "victim" of mortgage fraud, conducts no credible investigation of elite frauds, takes no proactive steps to investigate (e.g., using undercover FBI investigations), makes no plea for whistleblowers to come forward with evidence on the elite frauds, and provides training for regulators, FBI agents, and AUSAs that implicitly denies the existence of accounting control fraud? I understand that he inherited a disaster and a disgrace from his predecessor, but he has made it worse.

Collectively, the Bush and Obama administration have provided *de facto* impunity from the criminal laws for our largest financial firms and their elite officers who drove our crisis. DOJ has had episodic successes against financial elites not involved in creating the crisis (e.g., Madoff and a prominent insider trader). These "successes" were bittersweet. Madoff conducted a Ponzi scheme that last for decades. DOJ only learned about the scheme because Madoff confessed to his family. He only confessed because the Ponzi scheme was about to collapse. The government learned of the insider trading through a whistleblower and found key facts through electronic surveillance and "wiring" "flipped" participants in the insider trading. The insider trading fraud went on for many years and likely would have gone on for many more years without the government learning of it but for the whistleblower. Both of these frauds were elite financial control frauds, so it is bizarre that Holder simultaneously takes credit for their successful prosecution while implicitly denying that control fraud could exist in elite financial institutions in the mortgage fraud context.

The Reuters story records Holder's effort to claim that DOJ is vigorously prosecuting elite corporate frauds.

> "[Holder] responded to criticism that federal enforcers have brought few marquee cases in the aftermath of the financial crisis. Holder said the department has brought around 2,100 mortgage-related cases.

> "The notion that there has been inactivity over the course of the last three years is belied by a troublesome little thing called facts," Holder said."

It is Holder whose claims are "belied by a troublesome little thing called facts." He was responding to the factual critique that he has not indicted or prosecuted any elite banking officers of the large fraudulent lenders that drove the financial crisis. That critique is true. Holder, however, implied that it was an untrue critique by deliberately making a non-responsive response. His answer was that he has indicted 2,100 defendants in mortgage-related cases (roughly 700 annually). By 2006, lenders made roughly *two million* fraudulent liar's loans. In 2005, they made over one million fraudulent liar's loans. Prosecuting roughly 700 (or 7,000) smaller mortgage fraud cases annually is, at best, a symbolic act that cannot possibly have any material effect in slowing an epidemic of mortgage fraud, bringing to justice the elite frauds that caused the ongoing crisis, or deterring future crises. If Holder had led any elite prosecutions of the senior officers of the huge, fraudulent lenders and investment bankers that drove the crisis he would have used them to refute the criticism. Instead, he tried misdirection.

In January 1993, the GAO released a report entitled: Bank and Thrift criminal Fraud" prepared at the request of Senate Judiciary Committee Chairman Biden, who is now Obama's Vice-President. Here are key excerpts from that report that demonstrate how real investigations and prosecutions occur.

> "In 1984, Justice, along with the federal financial regulatory agencies, formed the Interagency Bank Fraud Enforcement Working Group in an effort to facilitate interagency communication and coordination between Justice and each of the regulatory agencies.
>
> [WKB note: the key deregulatory law that created the criminogenic environment that led to the epidemic of accounting control fraud by roughly 300 S&Ls was the Garn-St Germain Act of 1982. By 1984, DOJ and the banking regulatory agencies realized (with the aid of a vigorous kick to their rears from the House of Representatives administered by Chairman Doug Barnard (D. Georgia)) that there was a fraud crisis and had formed the working group to investigate and prosecute bank frauds.]
>
> Renamed the National Bank Fraud Enforcement Working Group, the group included officials from Justice (including the Criminal Division's Fraud Section, the Attorney General's Advisory Committee of Attorneys, and FBI), OTS, FDIC, occ, the Fed, NCUA, the Farm Credit Administration, the Secret Service, the Department of the Treasury, and the Securities and Exchange Commission.
>
> [WKB note: Contrast this membership with Holder's announcement of the members of his working group:
>
> > "The mission of the group — to hold accountable those who violated the law and provide relief for homeowners struggling from the collapse of the

housing market — will be furthered through the active participation of the following members:

• Executive Office for United States Attorneys
• Federal Bureau of Investigation
• Financial Crimes Enforcement Network
• Internal Revenue Service - Criminal Investigation
• Consumer Financial Protection Bureau
• Federal Housing Finance Agency's Office of Inspector General
• United States Department of Housing and Urban Development
• United States Department of Housing and Urban Developments Office of Inspector General”]

[WKB note: Notice the conspicuous (except that no one I have read mentions it) failure to include any of the banking regulatory agencies – the entities that should have the expertise and should be making the vital criminal referrals. The administration will eventually be forced to add the banking regulatory agencies to the working group to quell criticism. The administration’s failure to name them originally is revealing. Any serious effort would start with the banking regulatory agencies. The more fundamental problem is, that unlike the S&L debacle, when the banking regulatory agencies led the demand for criminal prosecution of the elite frauds, the current crop of regulatory leaders under Bush and Obama have been notoriously silent and have failed to take even the most basic, essential step – reestablishing a superb criminal referral process and vigorous regulatory investigations of the largest frauds. There is no excuse for this continuing failure.]

In 1990, in testimony before the House Committee on the Judiciary, the Assistant Attorney General of the Criminal Division noted that the group had a number of accomplishments. Among other things, he noted that it produced a uniform criminal referral form….

[WKB note: this may seem a small, bureaucratic step if you have never created a system that resulted in the most successful prosecution of elite white-collar criminals. It is in fact the absolute essential place to start. The bank working groups engaged in what we would now call “continuous improvement.” The banking regulators responsible for making criminal referrals got feedback from the FBI on what aspects of our referrals were most useful and what aspects failed to meet the FBI’s needs. Our criminal referral specialists took that knowledge back to our staff and, through training and editing of draft referrals, continuously improved the quality of our referrals.]

The criminal financial institution fraud investigative workload in FBI has continued to grow. As of July 31, 1992, FBI had 9,669 investigations pending, an increase of about 46 percent from 1987. More than half of those investigations were classified as “major” fraud cases….

Table 2.1: [Number of criminal referrals filed by the banking regulatory agencies]
Federal Home Loan Bank Board/OTS [WKB note: the Office of Thrift Supervision (OTS) was the successor agency to the FHLBB.]

1987: 6,100
1988: 5,114
1989: 5,014
1990: 6,393
1991: 7,861

[WKB note: these figures do not include criminal referrals made by OTS after 1991, criminal referrals by the RTC (which resolved failed S&Ls' bad assets), and criminal referrals by S&Ls placed into receiverships by OTS). Collectively, the federal agencies regulating S&Ls and dealing with S&L failures filed well over 30,000 criminal referrals during the S&L debacle.]

[WKB note: number of criminal referrals filed by OTS in the ongoing crisis: 0.]

Following enactment of FIRREA, the Attorney General designated criminal fraud in financial institutions a top enforcement priority. He announced but did not implement plans to address this "enormous and unprecedented challenge" by establishing task forces in 26 cities around the country modeled after the Dallas Bank Fraud Task Force. The Crime Control Act of 1990 authorized more than a doubling of available Justice resources and focused responsibility for the overall effort in Justice's new Office of Special Counsel for Financial Institutions Fraud.

[WKB note: the Dallas Bank Fraud Task Force was staffed with over 100 professionals plus support staff. See the 1993 GAO report for the breakdown.]

FBI has relied on the cooperation of staff from the regulatory agencies to provide information and expertise needed for investigations.

Between October 1, 1988, and June 30, 1992, Justice charged 3,270 defendants through indictments and informations [in "major cases"] and convicted 2,603 defendants (110 defendants were acquitted, establishing a conviction rate near 96 percent). The courts sentenced 1,706 of 2,205 offenders to jail (77.4 percent).

The major difference between working groups and task forces is that task forces investigate and prosecute cases, while working groups do not.

As of July 31, 1992, FBI had 9,669 financial institution fraud cases pending, an increase of 11.3 percent over the 8,678 pending at the end of fiscal year 1991 and 45.3 percent over the 6,649 pending at the end of fiscal year 1987.

In 1989 and 1990, Congress passed two major pieces of legislation that shaped the government's approach. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRRRA) of 1989 and the Crime Control Act of 1990 (Crime Control Act) provided Justice with additional powers and resources to investigate and prosecute financial institution fraud.

The House report accompanying FIRREA reflects the belief that Title IX of FIRREA was "absolutely essential to respond to a serious epidemic of financial institution insider abuse and criminal misconduct and to prevent its recurrence in the future."

Title XXV of the Crime Control Act [was] entitled the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990….

Appropriations following FIRREA and the Crime Control Act nearly tripled the investigative and prosecutive resources that had previously been available to Justice to address the mounting volume of criminal bank and thrift fraud. The Crime Control Act also authorized additional appropriations to support more IRS resources important to fraud investigations. In addition, the act appropriating funds for the Department of the Treasury in fiscal year 1991 also authorized the Secret Service to participate in financial institution fraud investigations.

Appendix III: FBI and U.S. Attorney Resource Allocations Under FIRREA [Additional staffing resources made available to aid the prosecution of S&L and bank frauds pursuant to the Financial Institution Reform, Recovery and Enforcement Act of 1989]

FBI: Special Agents: 219; Accounting technicians: 100
U.S. Attorney office: AUSAs: 121; Auditors: 22; Support: 120

Appendix IV: FBI and U.S. Attorney Resource Allocations Under the Crime Control Act [of 1990]
FBI: Special Agents: 289
U.S. Attorney Office: AUSAs: 228; Support: 198 [WKB note: this category included paralegals and auditors]

Table 2.4: Increased Justice Authorized Staff Positions
Fiscal years 1990 to 1992 (special agent, attorney, and other support positions)

FBI (total positions):	1621
U.S. Attorneys (total positions):	772
Criminal Division (total positions):	116
Tax Division (total positions):	65
Civil Division (total positions):	46
Total [DOJ] positions	2,620

[WKB note: these figures do not include IRS, Secret Service, Postal Service, and banking regulators working on the S&L and bank fraud task cases.]

[WKB (very long) note: in FY 2007 the FBI had 120 agents assigned to mortgage fraud cases. By FY 2009 that number rose to 300.

http://www.fbi.gov/stats-services/publications/financial-crimes-report-2009

The ongoing crisis caused losses over 70 times greater than the S&L debacle and the number of frauds in this crisis is vastly greater than during the S&L debacle. The best estimate is that there were roughly two million new cases of mortgage fraud in 2006. (The estimate arises from two facts explained at length in my prior work. Roughly one-third of all mortgage loans originated in 2006 were liar's loans and the incidence of fraud in liar's loans is roughly 90 percent.) Worse, DOJ formed a "partnership" with the Mortgage Bankers Association (the MBA) – the trade association of the "perps" and adopted the MBA's contrary-to-fact definition of "mortgage fraud" in which the lender originating the fraudulent mortgages is always the victim of the fraud. Accounting control fraud is, implicitly, defined out of existence. The DOJ repeats this self-serving definition of mortgage fraud repeatedly, without any critical consideration. After the dominant role of accounting control fraud in the second phase of the S&L debacle and the Enron-era frauds we are faced with the conclusive assumption (unsullied by any real investigation or analytics) that the current crisis is the Virgin Crisis. Because they know that the lender is the victim, virtually every FBI agent has been assigned to investigating relatively minor mortgage frauds in which the lender is the purported victim. There has been no meaningful criminal investigation of any of the large fraudulent lenders. Given the pathetically low number of FBI agents assigned to mortgage frauds and their assignment to review staggering numbers of relatively small mortgage fraud cases there were never, remotely, adequate numbers of FBI agents to conduct a real investigation of Countrywide or Washington Mutual (WaMu). Each of these S&Ls made hundreds of thousands of fraudulent mortgage loans. Each of these S&Ls is substantially larger and more complex to investigate than Enron. Each of the S&L originated their hundreds of thousands of fraudulent mortgages by crafting perverse incentives for a vast network of mortgage brokers that induced them to commit endemic mortgage fraud. It took roughly 100 DOJ professionals several years to investigate Enron, so a comparable competent investigation of Countrywide or WaMu would require well over 100 DOJ professionals for several years. Any credible investigation of Countrywide or WaMu would have also required a group of OTS examiners to be "detailed" to work with the FBI investigation and serve as their internal experts. There is no evidence that either of these events ever occurred. Any purported FBI investigation of those massive shops was a sham.

The Working Group continues the sham and political symbolism at the expense of substance. Holder's press release explained its staffing levels.

> "Attorney General Holder announced that the new Working Group will consist of at least 55 Department of Justice attorneys, analysts, agents and investigators from around the country. Currently, 15 civil and criminal attorneys are part of the Working Group, along with 10 FBI agents and analysts who will be assigned to the Working Group efforts. An additional 30 attorneys, investigators and other staff around the country will join the Working Group efforts in the coming weeks. This team will join existing state and federal resources investigating similar misconduct under those authorities."

http://www.justice.gov/opa/pr/2012/January/12-ag-120.html

Compare that staffing with the staffing levels we know from experience are required to be successful against elite accounting control frauds. The Working Group does not pass even the most generous laugh test. No one who has ever been involved in a successful, complex criminal investigation of a large organization could take this Working Group seriously. It lacks the capacity to conduct a competent investigation of any of the largest financial frauds – and there are scores of huge institutions engaged in MBS frauds and hundreds of large mortgage banks engaged in MBS frauds.]

The Settlement is too good, or too bad to be true

Lux notes that Jamie Dimon (JP Morgan Chase's CEO) has expressed skepticism about whether the five large banks will continue to support the settlement now that its substance has been changed (assuming the accuracy of the leaks) to remove the "great majority" of the grants of immunity from civil liability and all grants of criminal immunity. The banks considered the earlier drafts of the deal that offered substantial immunity for mortgage origination fraud to be worth far more than the $25 billion they would pay in return to secure the immunity. Their civil liability exposure for mortgage origination fraud is in the hundreds of billions of dollars, so being released from both mortgage origination and foreclosure fraud for $25 billion would have been a spectacular win for the banks. Even if they received no express immunity from criminal prosecutions, it was clear that the administration was implicitly signaling that it would prosecute their mortgage origination frauds. By eliminating civil liability for mortgage origination fraud, the banks also would have made civil suits far less likely or even impossible and that would greatly reduce the risk that civil investigations would disclose criminal conduct that DOJ could not avoid prosecuting, particularly in an election year.

If the administration's characterization of the revised settlement as having virtually no releases from civil liability for mortgage origination fraud and none for criminal actions is accurate, then it should have been a no brainer that the deal no longer made any sense for the banks. Their civil liability for their foreclosure fraud should be far less than $25 billion. The banks, however, are eagerly seeking to finalize the revised settlement that Dimon criticized. We can infer from their decision that the big banks realize that they have such rotten skeletons in their foreclosure fraud closets that it is imperative that they settle the suits and prevent the civil suits from going forward and bringing the skeletons to light.

Could this crisis have been prevented?

Yes. Indeed, in many ways this was an easier crisis to contain successfully than many prior financial crises. The United States had extensive experience with nonprime mortgage lending – and it always ended badly. This is the third nonprime failure in twenty years. Nonprime lending, on its face, is inherently imprudent. I quoted MARI about the nonprime losses of the early 1990s and explained how we used supervisory powers to end those losses. No expensive failures resulted and there was, of course, no crisis. Those were primarily "low doc" and (marginally) subprime loans.

Nonprime lenders suffered considerably worse losses (and many failures) in the late 1990s. These nonprime lenders were also known for their predatory lending practices, which led to serious (but not criminal) sanctions by the Federal Trade Commission. The most disturbing aspect of this series of nonprime failures was that elite commercial banks rushed to acquire the predatory lenders even as they were failing and sued by the FTC. President Bush even appointed the most infamous predatory subprime lender (and his largest political contributor), as our ambassador to the Netherlands.

The nonprime loans of the current crisis were an order of magnitude worse than in the early 1990s. They were subprime loans with severe credit defects and "no doc" ("liar's loans"). I've explained why that produces severe adverse selection. Adverse selection is criminogenic. It can produce fraud epidemics.

I noted the how the "layered" nature of the risk of nonprime loans surged during the crisis. These risks interact, the whole is far riskier than the sum of the parts – and the sum of the parts would have been terrifying to any honest lender. By 2006 and 2007, it was common for nonprime loans to include each of these characteristics:

- A trivial, or even no, downpayment
- The minimal downpayment was funded by another loan
- The purported loan-to-value (LTV) ratio was substantial
- The actual LTV was far higher, often >100%, because the appraisal was inflated
- The loan was occurring during the worst financial bubble in history, so the LTV once the bubble burst would greatly exceed 100%
- The loans were increasingly secured by junior liens
- The loan was "no doc" and the representations were not verified
- The information on the loan application was false
- The lender "qualified" the borrower for the loan on the basis of whether he could pay the initial, far lower ("teaser") interest rate rather than the fully indexed rate
- The borrower could not afford to pay the fully indexed interest rate (even if the borrowers "stated income" was accurate – it was typically inflated)
- The loan payments were less than the interest due (negative amortization)

- The home was not being purchased by someone who would occupy the home (despite a contrary representation on the application)
- While it was never typical, it became common for the mortgage term to be 40 years

Any experienced lender, investment banker, accountant, regulator, or rating agency official would recognize that this was a formula for disaster. They would also understand that packaging a thousand of these toxic mortgages together in a collateralized debt obligation (CDO) in which 80 percent of the derivative was structured as top "tranche" and was supposedly worthy of a "AAA" rating was too good to be true. CDOs are no better than the underlying mortgages (the various "credit enhancements" proved ephemeral). I learned by reading here in Reykjavik a recently released governmental report on Iceland's banking crisis, that large amounts of worthless debt instruments of Iceland's "Big 3" banks were put into CDOs because their debt carried relatively high credit ratings. It should not be necessary to add that the ratings for the (deeply insolvent and massively fraudulent Icelandic banks) bore no relationship to reality and that this debt did not adequately "enhance" CDO credit quality.

I've discussed the warnings of an "epidemic" of mortgage fraud, which began in 2003, were embraced by the FBI in 2004, and were supplemented by warnings of endemic appraisal fraud in 2005. "Stated income" loans became known throughout the industry as "liar's loans" and grew to roughly 30% of total new mortgages by early 2007. Many lenders made liar's loans their primary product. How difficult was it for a regulator (or purchaser of nonprime mortgages or CDOs) to figure out that a business strategy of making "liar's loans" was imprudent?

The nonprime market also made no sense on other dimensions. As I've just explained, the risk of loss rose spectacularly during the decade as loan quality collapsed, fraud became endemic in nonprime loans, and the bubble hyper-inflated. Logically, this should have caused a dramatic increase in loss reserves and should have caused nonprime "spreads" to widen substantially. Instead, the officers controlling the lenders reduced loan loss reserves to ridiculous levels – and spreads narrowed. The first dimension demonstrates endemic accounting and securities fraud. The second dimension demonstrates that markets were not only "inefficient", but also became increasingly inefficient throughout the growing crisis.

While Greenspan and other failed regulators have claimed that no one warned of the coming crisis; that was truer of the S&L debacle than the current crisis. I've shown that there were strong, early warnings of endemic fraud and predictions that it would cause a crisis. Nonprime loans, as I've explained, had a consistently bad track record and their problems were sufficiently recent that they should have been well known to both private and public sector leaders. The Enron-era control frauds and New York Attorney General Spitzer's investigations were fresh in Americans' minds. Those frauds made clear that:

- The most elite corporations engaged in fraud
- Those frauds were led from the top
- Accounting fraud produced exceptional deception – firms such as Enron that were grossly insolvent and unprofitable purported to be immensely profitable

- The large frauds were able to get “clear opinions from top tier audit firms
- Executive compensation was a major driver of the frauds
- Banks funded the accounting control frauds rather than exerting effective “private market discipline” against them
- Effective regulation was essential to limit such frauds

During the S&L debacle, by contrast, only one economist (Ed Kane) warned publicly of a coming crisis arising from bad assets – and he did not warn about the wave of control fraud. Economists virtually unanimously opposed our reregulation of the industry (Paul Volcker was the leading exception). Economists, including Alan Greenspan, were leading allies of the worst S&L accounting control frauds.

The most difficult aspect of the current crisis to contain was that roughly 80% of nonprime loans were made by entities not subject to direct federal regulation (primarily mortgage bankers). (Note that this also meant they were not subject to the Community Reinvestment Act (CRA) and to requirements to file criminal referrals.) The Federal Reserve (Fed), however, had unique statutory authority to regulate all mortgage lenders under the Home Ownership and Equity Protection Act of 1994 (HOEPA), but Greenspan and Bernanke refused to use it. Finally, over a year after the secondary market in nonprime loans (CDOs) collapsed, and after Congressional pressure to act, the Fed used its HOEPA authority to order an end to some of the most abusive nonprime lending practices. Prior to that time, the federal regulatory agencies acted aggressively throughout the decade to assert federal “pre-emption” of state regulation as a means of attempting to prevent the states from protecting their citizens from predatory nonprime lenders.

All the regulators needed to do to prevent the crisis was ban lending practices that were rational only for control frauds engaged in looting. The regulators consistently refused to do so because of their anti-regulatory ideology. Traditional mortgage underwriting practices are highly effective against fraud. The regulators knew what reforms would work, but refused to mandate the reforms.

By the time this crisis began economists (Akerlof & Romer 1993), regulators (Black 1993); and criminologists (Calavita, Pontell & Tillman 1997; Black 2003; Black 2005) had developed effective theories explaining why combining financial nonregulation and modern executive and professional compensation produced criminogenic environments that led to epidemics of accounting control fraud. We also explained why these were near perfect frauds and explained how control frauds used their compensation and hiring and firing powers to create a “Gresham’s” dynamic that allowed them to suborn the “independent” professionals that were supposed to serve as “controls” and transform them into allies. (This is similar to HIV’s ability to infect the immune system.)

One of the important practical aspects of control fraud research findings is the existence of fraud “markers.” These can be used to identify the frauds even while they are reporting record profits

and minimal losses. The fraud markers also make it possible to prosecute successfully complex frauds because jurors can understand that it makes no sense for honest firms to engage in such practices but makes perfect sense for frauds.

Equally importantly, our research showed how to contain a spreading epidemic of accounting control fraud. These policies were exceptionally effective in containing the S&L debacle. The existence of these research findings and our regulatory record of successful efforts against the accounting control fraud should have made it far easier for our regulatory successors (and any honest bankers) to identify the frauds at an early date and take effective action against them.

What if We Had Looked?

Within the last month, facts have been revealed about three massive nonprime players that show the strong evidence of elite criminality that would have been revealed – in some cases, five years ago – had there been real investigations.

WaMu

Readers interested in reading the Senate Permanent Subcommittee on Investigations' report and the underlying documents can find them through this link:
http://levin.senate.gov/newsroom/release.cfm?id=323765

WaMu was an obvious disaster. Its advertising campaign mocked prudent bankers and made it clear that WaMu's answer to potential borrowers would be "yes." Here are the high points picked up by the *New York Times* and the *Huffington Post* in two recent columns:

http://www.nytimes.com/2010/04/13/business/13wamu.html?hpw

April 12, 2010

Memos Show Risky Lending at WaMu

By SEWELL CHAN

WASHINGTON — New documents released by a Senate panel show how entrenched Washington Mutual was in fraudulent and risky lending, and highlighted how its top executives received rewards as their institution was hurtling toward disaster.

The problems at WaMu, whose collapse was the largest in American banking history, were well known to company executives, excerpts of e-mail messages and other internal documents show.

The documents were released on Monday by the Senate Permanent Subcommittee on Investigations, which began an inquiry into the financial crisis in November 2008. The

> panel has summoned seven former WaMu executives to testify at a hearing on Tuesday, including the former chief executive Kerry K. Killinger.
>
> The panel called WaMu illustrative of problems in the origination, sale and securitization of high-risk mortgages by any number of financial institutions from 2004 to 2008.
>
> "Using a toxic mix of high-risk lending, lax controls and compensation policies which rewarded quantity over quality, Washington Mutual flooded the market with shoddy loans that went bad," the panel's chairman, Senator Carl Levin, Democrat of Michigan, said.
>
> Mr. Killinger was paid $103.2 million from 2003 to 2008. In WaMu's final year of existence, he received $25.1 million, including a $15.3 million severance payment.

In fairness to the reporter, I note that reporters rarely write their headlines. The headline, however, exemplifies the weak analysis and lack of candor that dominates coverage of this crisis. WaMu's failure was caused by fraudulent lending practices, not "risky lending." "Risk", as we conventionally use that word in economics and finance, had nothing to do with any of the three epidemics of accounting control fraud. WaMu's senior managers deliberately put in place incentive structures that produce massive fraud – then gutted the protections (underwriting and controls) that honest lenders use (successfully) to limit fraud. In combination with providing trivial loss reserves and an executive compensation system based largely on short-term accounting "income", this produced a "sure thing." It was certain that the strategy would produce record (albeit fictional) short-term profits. If other lenders followed similar practices (as was extremely likely), it was also certain hyper-inflate the bubble. That meant WaMu's bad loans could be masked for years through refinancings (WaMu also delayed the recognition of losses by making primarily option ARM loans that allowed extremely low mortgage payments for up to a decade – payments so low that they produced serious negative amortization.) By masking the inevitable defaults for many years the senior executives were able to be become exceptionally wealthy. It was also certain that this would lead to disaster for the firm. But the failure of the firm does not represent a failure of the fraud scheme.

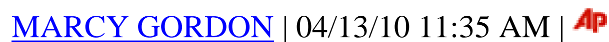
Criminologists view WaMu as a "vector" spreading the fraud epidemic through the financial system. But one should have limited sympathy for the purchasers of WaMu's fraudulent loans for the reasons the Fitch study demonstrated. The fraudulent mortgages were typically obvious on the face of the document. Had the purchasers of WaMu's mortgages, typically (allegedly) sophisticated parties, engaged in due diligence they would have found widespread fraud. Indeed, that is one of the weaknesses of endemic mortgage fraud – it is relatively easy to spot. The purchasers, however, engaged in "don't ask; don't tell" because their senior officers knew that

purchasing relatively high yield nonprime loans would produce record short-term accounting income (and extraordinary compensation).

Killinger was made rich by the lending policies that destroyed WaMu. The fact that he is complaining in his Congressional testimony that it was "unfair" that the taxpayers didn't bail out WaMu after he trashed it epitomizes the demise of elite accountability and its replacement with a sickening sense of absolute entitlement of the group that Simon Johnson and Peter Kwak aptly refer to as the financial "oligarchs" (2010).

http://www.huffingtonpost.com/2010/04/13/kerry-killinger-exwamu-ce_n_535749.html

Kerry Killinger, Ex-WaMu CEO, It's 'Unfair' Bank Didn't Get Bailed-Out


MARCY GORDON | 04/13/10 11:35 AM |

> WaMu was one of the biggest makers of so-called "option ARM" mortgages. They allowed borrowers to make payments so low that loan debt actually increased every month.
>
> The Senate subcommittee investigated the Washington Mutual failure for a year and a half. It focused on the thrift as a case study on the financial crisis.
>
> Senior executives of the bank were aware of the prevalence of fraud, the Senate investigators found.
>
> The investors who bought the mortgage securities from Washington Mutual weren't informed of the fraudulent practices, the Senate investigators found. WaMu "dumped the polluted water" of toxic mortgage securities into the stream of the U.S. financial system, Levin said.
>
> In some cases, sales associates in WaMu offices in California fabricated loan documents, cutting and pasting false names on borrowers' bank statements. The company's own probe in 2005, three years before the bank collapsed, found that two top producing offices – in Downey and Montebello, Calif. – had levels of fraud exceeding 58 percent and 83 percent of the loans. Employees violated the bank's policies on verifying borrowers' qualifications and reviewing loans.

Citicorp

The full prepared statement of Mr. Richard Bowen, Former Senior Vice President and Business Chief Underwriter of CitiMortgage Inc. before the Financial Crisis Inquiry Commission on April 7, 2010 can be found here:

http://www.fcic.gov/hearings/04-07-2010.php

Mr. Bowen's testimony received far less attention because he testified on the same day as Alan Greenspan and Citi's former top officials. This is unfortunate because he was far more candid about Citi's operations than were its former senior officials. Mr. Bowen disclosed that Citi was also a massive vector, selling roughly $50 billion annually in mostly bad mortgages (primarily to Fannie and Freddie).

> The delegated flow channel purchased approximately $50 billion of prime mortgages annually. These mortgages were not underwriten by us before they were purchased. My Quality Assurance area was responsible for underwriting a small sample of the files post-purchase to ensure credit quality was maintained.
>
> These mortgages were sold to Fannie Mae, Freddie Mac and other investors. Although we did not underwrite these mortgages, Citi did rep and warrant to the investors that the mortgages were underwritten to Citi credit guidelines.
>
> In mid-2006 I discovered that over 60% of these mortgages purchased and sold were defective. Because Citi had given reps and warrants to the investors that the mortgages were not defective, the investors could force Citi to repurchase many billions of dollars of these defective assets. This situation represented a large potential risk to the shareholders of Citigroup.
>
> I started issuing warnings in June of 2006 and attempted to get management to address these critical risk issues. These warnings continued through 2007 and went to all levels of the Consumer Lending Group.
>
> We continued to purchase and sell to investors even larger volumes of mortgages through 2007. And defective mortgages increased during 2007 to over 80% of production.

Lehman Brothers

The bankruptcy examiner conducted an investigation of Lehman Brothers. The report reveals that Lehman Brothers was engaged in large scale accounting and securities fraud by failing to recognize losses so large that it had failed as an enterprise. Lehman's senior executives sought to cover up its failure with a series of very large ($50 billion) quarter end REPO transactions. Curiously, the report puts no emphasis on the underlying fraud that drove the fraud concentrates on the second-stage REPO cover up.

Here is a link to the full series of the bankruptcy examiner's reports:

http://lehmanreport.jenner.com/

My oral and written testimony before House Financial Services on April 20, 2010 provides a detailed description of the evidence indicating accounting control fraud at Lehman. Lehman was one of the principal vectors of liar's loans in the world. The links are:

http://c-spanvideo.org/program/id/222787

http://www.house.gov/apps/list/hearing/financialsvcs_dem/black_4.20.10.pdf

Goldman Sachs

Now, we learn that the SEC charges that Goldman Sachs should be added to the list of elite financial frauds. It is a tale of two (unrelated) Paulsons. Hank Paulson, while Goldman's CEO, had Goldman buy large amounts of collateralized debt obligations (CDOs) backed by largely fraudulent "liar's loans." He then became U.S. Treasury Secretary and launched a successful war against securities and banking regulation. His successors at Goldman realized the disaster and began to "short" CDOs. Mr. Blankfein, Goldman's CEO, recently said Goldman was doing "God's work." If true, then we know that God wanted Goldman to blow up its customers.

Goldman designed a rigged trifecta: (1) it secured additional shorting pressure from John Paulson (CEO of a hedge fund that Goldman would love to have as an ally) that aided Goldman's overall strategy of using "the big short" to turned a massive loss caused by Hank Paulson's investment decisions into a material profit, (2) helped make John Paulson a massive profit – in a "profession" where reciprocal favors are key, and (3) blew up its customers that purchased the CDOs. Paulson and Goldman were shorting because they believed that the liar's loans were greatly overrated by the rating agencies. Goldman let John Paulson design a CDO in which he was able to help pick the nonprime packages that were most badly overrated (and, therefore, overpriced). Paulson created a CDO "most likely to fail." Goldman constructed, at John Paulson's request, a "synthetic" CDO that had a credit default component (CDS). The CDS allowed John Paulson to bet that the CDO he had constructed (with Goldman) to be "most likely to fail" would in fact fail – in which case John Paulson would be become even wealthier because of the profit he would make on the CDS.

Now, any purchaser of the "most likely to fail" CDO would obviously consider it "material information" that the investment was structured for the sole purpose of increasing the risk of failure (and helping Goldman "big short" strategy designed to offset losses on Hank Paulson's worst investments). The SEC complaint says that Goldman therefore defrauded its own customers by representing to them that the CDO was "selected by ACA Management." ACA was supposed to be an independent group of experts that would "select" nonprime loans "most likely to succeed" rather than "most likely to fail." The SEC complaint alleges that the representations about ACA were false.

The obvious question is: did John Paulson and ACA know that Goldman was making these false disclosures to the CDO purchasers? Did they "aid and abet" what the SEC alleges was Goldman's fraud? Why have there been no criminal charges? Why did the SEC only name a relatively low-level Goldman officer in its complaint? Where are the prosecutors?

The Rating Agencies

The Senate has released documents from the rating agencies that demonstrate that they were willingly manipulated by perverse compensation arrangements to give grotesquely inflated ratings to liar's loans. At the barest minimum, the rating agencies were leading enablers of the downstream epidemic of accounting control frauds.

Fannie and Freddie

The SEC found accounting control fraud at Fannie and Freddie and forced large restatements of their financial statements. If they won their bet on interest rates they gained. When Fannie lost on its interest rate risk gambles it used fraudulent "hedge" accounting to avoid recognizing its losses. When Freddie won on its interest rate gambles it used fraudulent "hedge" accounting to defer recognizing the gain until it had a bad quarter that would lead the executives to fail to obtain their maximum bonus. Freddie's managers could then make the gain magically appear so that they would receive their maximum bonus. (This is a variant on "cookie jar reserves.")

When the SEC found that Fannie and Freddie had engaged in accounting fraud their financial regulator, which was then OFHEO, forced CEO changes. OFHEO also (finally) limited what had been the rapid growth of their portfolio (which they used primarily to take interest rate risk prior to the SEC action.)

Because Fannie and Freddie were privatized, their officers designed their compensation system in the same perverse manner as most firms (Bebchuk & Fried 2004), they stood to gain enormous compensation if they inflated short-term accounting income. As Mr. Raines explained in response to a media question as to what was causing the repeated scandals at elite financial institutions:

> **We've had a terrible scandal on Wall Street. What is your view?**
> 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.

http://msnbci.businessweek.com/magazine/content/03_20/b3833125_mz020.htm[1]

Raines learned that the unit that should have been most resistant to this "overwhelming" financial incentive, Internal Audit; had succumbed to the perverse incentive. Mr. Rajappa,

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[1] Raines' observation about the perverse impact of such compensation systems has been confirmed by statistical tests. As Bebchuk & Fried, the leading experts on compensation systems, observed in their study of Fannie Mae's compensation system:

> As we noted at the outset, we do not know whether Raines and Howard were in any way influenced by the incentives to inflate earnings created by their compensation packages. There is a growing body of evidence, however, that in the aggregate, the structure of executive pay affects the incentive to inflate earnings.[10] For example, pay arrangements that enable executives to time the unwinding of equity incentives have been correlated with attempts to increase short-term stock prices by inflating earnings. Thus, the problem of rewards for short-term results is of general concern.
>
> n. 10 *See, e.g.*, Scott L. Summers & John T. Sweeney, **Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis**, 73 *Acct. Rev.* 131 (1998). For further discussion of this problem, see [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 scholars opposed to many aspects of financial regulation have noted the endemic nature of these perverse incentives and their close ties to accounting and securities fraud. Markham, Jerry W. **Regulating Excessive Executive Compensation – Why Bother?** (available on SSRN: See, e.g., pp. 20- 21). The depth of consensus on this issue is shown by the strong concurrence of the intellectual father of executive bonus systems, Michael Jensen, who has concluded that (as implemented) they have caused pervasive perverse incentives and led to endemic accounting and securities fraud. Jensen concludes:

- When managers make any decisions other than those that maximize value in order to affect reporting to the capital markets they are lying
- And for too long we in finance have implicitly condoned or even collaborated in this lying. Specifically I am referring to "managing earnings", "income smoothing", etc.

- When we use terms other than lying to describe earnings management behavior we inadvertently encourage the sacrifice of integrity in corporations and in board rooms and elsewhere

Recent Evidence from Survey of 401 CFO's Reveals Fundamental Lack of Integrity

- Graham, Harvey & Rajgopal survey ("Economic Implications of Corp. Fin. Reporting" http://ssrn.com/abstract=491627) of 401 CFOs find:
- 78% of surveyed executives willing to knowingly sacrifice value to smooth earnings
- Recent scandals have made CFOs less willing to use accounting manipulations to manage earnings, but
- Perfectly willing to change the real operating decisions of the firm to destroy long run value to support short run earnings targets

Jensen, Michael. **Putting Integrity Into Finance Theory and Practice: A Positive Approach (June 9, 2007)** (available on SSRN).

Senior Vice President for Operations Risk and Internal Audit instructed his internal auditors in a formal address in 2000 (and provided the text of the speech to Raines). ($6.46 refers to the earnings per share (EPS) number that will trigger maximum bonuses.)

> By now every one of you must have 6.46 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 <u>just</u> our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46. So it is our <u>moral obligation</u> to give well above our 100% and if we do this, we would have made tangible contributions to Frank's goals (emphasis in original).

In addition to allowing the CEO to convert firm assets to his personal benefit through seemingly normal corporate means, executive compensation has two additional advantages to accounting control frauds. The CEO of a large corporation cannot send a memorandum to 5000 employees instructing them to commit accounting fraud – but he can send the same message with near impunity through the compensation system. The CEO ensures that the compensation system creates a criminogenic environment that produces powerful incentives for subordinated to engage in accounting fraud in order to maximize their bonuses (which will maximize the CEO's bonus and the value of his stock) – all with complete deniability from the CEO. Generous bonuses for even lower level managers also provide a powerful social pressure against whistle blowers coming forward and leading all their peers to lose their bonuses.

Fannie and Freddie CEOs caused them to purchase huge amounts of nonprime assets because, with their growth restricted the way to create fictional accounting income and maximize their bonuses was to purchase for their portfolio the highest yield assets. This is the same strategy that most of the investment banker CEOs followed. OFHEO had ample regulatory power to order that an end to this strategy. It failed to do so because it did not believe that regulating assets purchases was an appropriate regulatory policy prior to those assets causing serious losses. The bubble masked those losses by allowing refinancing. The CEOs of Fannie, Freddie, Bear Stearns, Citi, Wachovia, Merrill Lynch, and Lehman followed similar strategies for the same perverse reasons (and that list is not exhaustive).

Other Nations Suffering from Control Fraud during this Crisis

Very recent reports by governmental authorities in Ireland, Afghanistan, and Iceland provide strong support for concerns that control fraud played a role in their bank failures.

Specific Proposals to Reduce and Deter Accounting Control Fraud

1. Eliot Spitzer, Frank Partnoy and I proposed in our December 19, 2009 op ed in the *New York Times* – that AIG's emails and key deal documents be made public so that we can

investigate the elite control frauds. (I have called for the same disclosures of Fannie and Freddie's key documents.) Goldman used AIG to provide the CDS on these synthetic CDO deals and Hank Paulson used our money to bail out Goldman when AIG's CDS deals drove it to failure. Treasury also used AIG to secretly bail out UBS – a massive Swiss bank engaged in a conspiracy with wealthy Americans to commit tax evasion/fraud. In essence, Americans paid UBS' fine – and gave it over $4 billion is walking away money. AIG was not federally insured. The U.S. had no responsibility to bear its losses. AIG's managers, directors, and trustees have failed to make any response to our requests that they assist these vital investigations by releasing the documents. (I have received no response to my similar open requests to Fannie and Freddie.)

2. Clarify that investors and creditors may pursue a private right of action against those that "aid and abet" relevant frauds under the securities laws.

3. Enact Representative Kaptur's bill to authorize, fund and direct the FBI to hire 1000 additional white-collar crime specialists as FBI agents to replace those transferred to national security and add resources necessary to take on the backlog of control frauds.

4. The regulators, FBI, and DOJ should follow a successful strategy used during the S&L debacle and create a "Top 100" priority list of the most significant criminal cases arising from the Great Recession.

5. All home lenders should be required to file criminal referrals (SARs) when they discover a reasonable suspicion of a federal crime.

6. The regulatory agencies should revitalize their criminal referral processes (which effectively ceased to exist with regard to control frauds).

7. The regulatory agencies should "detail" experienced examiners and supervisors to the FBI and DOJ so that they can serve as "Sherpas" to aid the investigations and prosecutions and have access to "6e" grand jury materials.

8. DOJ/FBI should create a national task force to investigate the systemically dangerous institutions (SDIs) and other major originators, sellers, and purchasers of nonprime paper and financial derivatives.

9. Where appropriate, the FBI should use undercover investigators and electronic surveillance in investigating control frauds.

10. The FBI should terminate immediately its "partnership" with the MBA.

11. The regulatory agencies should reinstate requirements for full underwriting of income, assets, liabilities, credit ratings, and appraised values for all mortgage lenders. They should, by rule, require that this underwriting be evidenced contemporaneously in writing

and be maintained on site for at least five years (and off site for ten years from the date of the loan being made). While violating such rules is not a crime, this requirement is one of the most effective means of establishing the necessary intent of those that seek to evade the requirement.

12. The agencies should immediately review every significant nonprime lender under their jurisdiction to determine whether they have made roughly the number of criminal referrals that would be expected given the epidemic of mortgage fraud. Where lenders have filed far too few referrals they should be priorities for special purpose examinations to determine whether their failure to file referrals is an indicator that they are a control fraud.

13. The regulatory agencies, including the CFTC, SEC, FBI, and DOJ, should create a position of the "Chief Criminologist" staffed by someone tasked with remaining current with white-collar criminological findings and ensuring that such findings, where relevant, be provided as input to senior decision-makers.

14. Create minimum federal requirements for fiduciary duties, which have been badly eroded by state "competition in laxity." Delaware corporations, for example, have generally eliminated the duty of care.

15. Take conflicts of interest exceptionally seriously. Forbid financial institutions to make any loans to their employees, officers, boards, and professionals (e.g., senior personnel of their outside auditors and rating agencies).

16. Remove the perverse incentive caused by compensation not tied to demonstrated, long-term performance. This is one of the leading criminogenic environments globally.

17. Reform professional compensation to remove the perverse incentives and "Gresham's dynamic" now common.

Biography of William K. Black

Bill Black is an Associate Professor of Economics and Law at the University of Missouri – Kansas City (UMKC). He is a white-collar criminologist. He was the Executive Director of the Institute for Fraud Prevention from 2005-2007. He has taught previously at the LBJ School of Public Affairs at the University of Texas at Austin and at Santa Clara University, where he was also the distinguished scholar in residence for insurance law and a visiting scholar at the Markkula Center for Applied Ethics.

He was litigation director of the Federal Home Loan Bank Board, deputy director of the FSLIC, SVP and General Counsel of the Federal Home Loan Bank of San Francisco, and Senior Deputy Chief Counsel, Office of Thrift Supervision. He was deputy director of the National Commission on Financial Institution Reform, Recovery and Enforcement. His regulatory career is profiled in Chapter 2 of Professor Riccucci's book *Unsung Heroes* (Georgetown U. Press: 1995),

Chapter 4 (“The Consummate Professional: Creating Leadership”) of Professor Bowman, et al’s book *The Professional Edge* (M.E. Sharpe 2004), and Joseph M. Tonon’s article: “The Costs of Speaking Truth to Power: How Professionalism Facilitates Credible Communication” *Journal of Public Administration Research and Theory* 2008 18(2):275-295.

George Akerlof called his book, *The Best Way to Rob a Bank is to Own One* (University of Texas Press 2005), “a classic.” Paul Volcker praised its analysis of the critical role of Bank Board Chairman Gray’s leadership in reregulating and resupervising the industry:

> Bill Black has detailed an alarming story about financial - and political - corruption. The specifics go back twenty years, but the lessons are as fresh as the morning newspaper. One of those lessons really sticks out: one brave man with a conscience could stand up for us all.

Robert Kuttner, in his *Business Week* column, proclaimed:

> Black's book is partly the definitive history of the savings-and-loan industry scandals of the early 1980s. More important, it is a general theory of how dishonest CEOs, crony directors, and corrupt middlemen can systematically defeat market discipline and conceal deliberate fraud for a long time -- enough to create massive damage.

Black developed the concept of “control fraud” – frauds in which the CEO or head of state uses the entity as a “weapon.” Control frauds cause greater financial losses than all other forms of property crime combined and kill and maim thousands. He helped the World Bank develop anti-corruption initiatives and served as an expert for OFHEO in its enforcement action against Fannie Mae’s former senior management.

He teaches White-Collar Crime, Public Finance, Antitrust, Law & Economics (all joint, multidisciplinary classes for economics and law students), and Latin American Development (co-taught with Professor Grieco, UMKC – History).

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