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An Overview of Mortgage Fraud

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Thank you very much for the opportunity to present testimony to you today on the workings of mortgage fraud, and its effects in Florida. As a university-based criminologist, I have studied white-collar and corporate crime for three decades, beginning with the first federally-funded study of Medicaid fraud by physicians in the 1980s. Following this I was a principal investigator on the U.S. Department of Justice funded-study of the causes of the savings and loan crisis and the government response, which produced a number of published works including the award winning book, *Big Money Crime*. I have written about the role of fraud in other major financial debacles including the 1994 Orange County, California bankruptcy, the largest municipal failure in American history, the 2002 corporate and accounting meltdowns, and the current economic disaster.

My research findings indicate that fraud has played a significant role in causing the financial losses that led to major debacles occurring over the past 25 years. The only way we can effectively prevent future crises is to fully understand the nature and extent of fraud. Assigning major financial losses to “risky business” has resulted in highly destructive policymaking and ever-larger financial crises. Lax or practically non-existent government oversight created what criminologists have labeled “crime-facilitative environments” where crime could thrive.

The major losses occurring through mortgage frauds in Florida and throughout the country that brought on the current economic crisis were not due to scam artists, notwithstanding the fact that their crimes have now become collectively quite significant and warrant serious attention by authorities. Rather, the original losses were produced by large lending institutions and Wall Street companies that run afoul of the law during endemic waves of fraud typically because of decisions that are made at the top that often exploit perverse market incentives and essentially turn the organization into a weapon with which to commit crime; Lincoln Savings and Loan and Charles Keating, Enron and Jeff skilling and Ken Lay, Countrywide and Angelo Mozilo, the list goes on. All of these examples have one major factor in common. Those in charge had enriched themselves at the expense of their firms, investors, and/or the public by engaging in what is known as “control fraud.” In other words, controlling insiders had suborned both internal and external safeguards and checks, and essentially looted their own companies through various schemes that resulted in excessive compensation. Accounting is the weapon of choice of control frauds as the creation of phony profits reduces scrutiny by regulators and investors, allowing for greater sums to be stolen.

For example, the problems experienced at Countrywide Financial, the country’s largest mortgage lender, that at its height, financed one out of every five American home loans –and that has already settled a large civil case in Florida -- are illustrative of massive fraud in the industry.

Before the company was taken over by the Bank of America in 2008, its stock had risen 23,000 percent between 1982 and 2003, largely by the resale on the secondary market of subprime mortgages.[1] This meant those who bought $1,000 worth of stock in 1982 owned more than $230,000 worth in 2003. A senior vice-president of the company noted in his 2009 book that its business model of a "new system of loans and Refis (refinancing loans) awarded to anyone with a pulse, was, in retrospect, long-term madness driven by short-term profit."[2] He went on to describe Countrywide as a "profit-hungry corporate beast." Angelo Mozilo the company's CEO and chairman currently faces insider trading and securities fraud charges for failing to disclose the lax lending practices and hyping the company when he knew it was going south. Between 2001 and 2006 he took $400 million in salary, stock options and bonuses from the company. Moreover the evidence seems damning on its face. Mozilo's emails to insiders contained messages such as, "In all my years in the business I have never seen a more toxic product," and "Frankly, I consider that product line to be the poison of our time."

Criminologist Gilbert Geis[3] puts a human face on the predatory Countrywide tactics noting the case of Edward Jordan, a retired postal worker living in New York City. "Jordan was close to paying off his home when a broker told him he was paying altogether too much interest on his loan. She offered a one percent rate. Jordan refinanced his house, ending up with a fee of $20,000 for doing so. He soon found that the interest rate would quickly escalate to a high of 9.9 percent. As one commentator of the case says bluntly, "On any construction of the deal, he was robbed by Countrywide."[4]

Mortgage Origination Fraud

One recent study[5] analyzed the responses of 23 persons including those working in brokerage, lender, escrow, title, and appraisal offices documenting the rationalizations that were used to explain their involvement in mortgage-related crimes. These individuals fed the primary epidemic of control fraud which produced echo epidemics consisting of those who purchased the nonprime product.[6] The findings detail accounts of mortgage frauds in the subprime lending industry that resulted from inadequate regulation, the indiscriminate use of alternative loan products, and the lack of accountability in the industry. Perpetrators commonly perceived many acts of mortgage origination fraud as inseparable from conventional lending practices that are necessary in any "successful" *legitimate* subprime business. It came down to different manifestations of a common theme: "We are simply doing our jobs and getting our clients what they want. They are usually happy I got the loan for them."[7]

Certain types of frauds were not only perceived by loan agents as acceptable mortgage lending practice, but also were considered "good for business." Business leaders might ascribe

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[1] Bruck, Connie, "Angelo's Ashes: The Man Who Became the Face of the Financial Crisis." *The New Yorker,* June 29, 2009. pp. 46-55.

[2] Michaelson, Adam. *The Foreclosure of America: The Inside Story of the Rise and Fall of Countrywide, Home Loans, the Mortgage Crisis, and the Default of the American Dream.* New York. Berkley Books, 2009.

[3] Geis, Gilbert, "How Greed Started the Dominoes Falling: The Great American Economic Meltdown." *Fraud Magazine* 23:6 (November/December) 2009. pp. 21-46.

[4] Morris, Charles R. The *Two Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crunch.* New York: Public Affairs, 2008.

[5] Tomson Nguyen and Henry N. Pontell, "Mortgage Origination Fraud and the Global Economic Crisis: A Criminological Analysis." *Criminology & Public Policy* 9:3 (August 2010). pp. 591-612:601

[6] Black, William K. "Echo epidemics: Control Frauds Generate 'White-Collar Street Crime' Waves." *Criminology & Public Policy* 9:3 (August 2010). pp. 613-620.

[7] Nguyen and Pontell, *op. cit.,* p. 601.

to the means necessary to make a profit, even if such methods violate the law.

A common theme among respondents was the accessibility to fraud. Subjects often referred to the importance of a "willing lender," a specific loan product, or a cooperative borrower in the successful outcome of a loan originated by illegitimate means. Subjects often described actions such as overstating a borrower's income and assets, postdating documents, file stuffing, and altering employment title as a financial skill rather than as a criminal act, which requires a "creative touch" to get a loan funded. The involvement of the borrower in the fraud was described by subjects as much more commonplace and widespread than traditionally understood. Borrowers are sometimes well aware that they lack certain qualifications for a loan and depend on their loan agent to qualify them.

In discussing the role of fraud among loan originators and borrowers, Black[8] noted that "mortgage origination personnel, not borrowers, overwhelmingly took the lead in mortgage fraud—even when the borrowers shared culpability because they knew that the representations the lender recommended were false. It is, therefore, extremely difficult to determine not only the true incidence of frauds but also the true number of borrowers that obtain loans with the knowledge that their financial representations were false." The most common forms of financial misrepresentations that occur in loan applications are the borrower's income and assets, both of which are clearly visible on the loan application. A borrower seeking a mortgage usually finds out early in the process the potential factors (e.g., insufficient credit, income, assets, or mortgage history) that might lead to denial of the loan.

Once the loan application has been submitted to a prospective lender, it is managed by an account manager or an underwriter. These loan agents are critical to the successful outcome or funding of a loan and to the detection of fraud. They work directly with brokers, loan officers, and processors on a regular basis, and it is not uncommon for them to coach their clients on how to structure a loan or document to avoid red flags from their lender. In this stage of the loan origination process, the most common forms of fraud are directly associated with poor underwriting.

Account managers and underwriters are responsible for approving loan conditions once they have verified the information. For example, a loan approval might be predicated on verification of conditions such as an applicant's employment and assets. It is common for these loan agents to overlook questionable information or to approve a condition of a loan without verification. Funders and appraisal reviewers also commonly overlook questionable information, such as an appraisal that lacks the required comparisons to justify the value of the property in question.

Levi[9] states, "It is extraordinary difficult to distinguish white-collar crime from ordinary business transactions." In the mortgage industry, an intricate collaboration must exist among loan agents, borrowers, and lenders (account managers, reps, underwriters, and funders) to originate a loan and get it funded. Information on a loan application must undergo numerous levels of scrutiny and verification by different parties for a loan to be approved. The problem, however, was the widespread culture of maximizing profit margins and achieving financial targets in disregard of ethical and legal practices.

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[8] Black, William K. 2008. *Why Greenspan's & Bush's Regulatory Failures Allowed a "Criminogenic Environment."* Paper presented at the Levy Institute's Minsky Conference, Annandale-on-Hudson, NY. p. 6.

[9] Levi, Michael. 1984. Giving creditors the business: The criminal law in inaction. *International Journal of the Sociology of Law*, 12: 321–333. p.322.

A Brief History of the Savings and Loan Crisis: Unlearned Fraud Lessons

The history of the savings and loan crisis provides important lessons regarding fraud in financial debacles. As far as prevention, the most important one involves the need for both regulatory statutes that specifically take account of the potential for fraud, and corresponding resources for effective enforcement. The deregulation, or “de-supervision” of the savings and loan industry as a response to perverse market forces that included federally insured deposits, created a highly criminogenic environment that unleashed a massive wave of control fraud.

The devastation of the savings and loan (or "thrift") industry in the 1980s cost American taxpayers well over a hundred billion dollars. One industry consultant claimed that only 3 percent of the total bailout costs are directly due to crime.[10] Likewise, a number of economists have downplayed the role of crime in the savings and loan crisis.[11] However, there is extensive evidence that white-collar crime *was* a key ingredient in the debacle. The National Commission on Financial Institution Reform, Recovery and Enforcement speculates that losses due directly to criminal fraud "probably amount[ed] to 10 to 15 percent of total net losses."[12] Long-time thrift regulator, William Black, former Senior Deputy Chief Counsel of the Office of Thrift Supervision and chief legal officer for the western region, maintains that "fraud and insider abuse caused on a *lower* bound estimate, 25 percent of total S&L failure losses."[13] A Resolution Trust Corporation (RTC) report estimates that about 51 percent of insolvent thrifts had suspected criminal misconduct referred to the FBI.[14] Finally, a General Accounting Office study of 26 of the most costly thrift failures found that *every one* of these institutions was a victim of major insider fraud and abuse.[15] The GAO further suggested that criminal activity was a central factor in as many as 70-80 percent of thrift failures.[16]

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10 Ely, Bert. 1990. Crime Accounts for Only 3% of the Cost of the S&L Mess. Alexandria, Virginia: Ely & Company, Inc. Unpublished report, 19 July.

11 see for example, Ely, 1990; White, Lawrence J. 1991. The S&L Debacle. New York: Oxford University Press; Litan, Robert E. 1993. Deposit Insurance, Gas on S&L Fire. Wall Street Journal, July 29, 1993, p. A10.

12 National Commission on Financial Institution Reform, Recovery and Enforcement. Origins and Causes of the S&L Debacle: A Blueprint for Reform. A Report for the President and Congress of the United States. Washington D.C.: Government Printing Office, July, 1993.

13 Black, William. "The Incidence and Cost of Fraud and Insider Abuse." Staff Report No. 13, *National Commission on Financial Institution Reform, Recovery and Enforcement*, 1993, p. 75 (emphasis in the original).

14 Resolution Trust Corporation. Report on Investigations to Date . Office of Investigations, Resolutions, and Operations Division, December 31, 1990.

15 U.S. General Accounting Office. Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices: Report to Congress. GAO/AFMD-89-62. Washington DC: Government Printing Office, June, 1989.

16 U. S. General Accounting Office. Failed Thrifts. Internal Control Weaknesses Create an Environment Conducive to Fraud, Insider Abuse and Related Unsafe Practices. Statement of Frederick D. Wolf, Assistant Comptroller General, Before the Subcommittee on Criminal Justice, Committee on the Judiciary, House of Representatives. GAO/T-AFMD-89-4. Washington DC: Government Printing Office, March 22, 1989; United States Congress. House Committee on Government Operations. Combatting Fraud, Abuse, and Misconduct in the Nation's Financial Institutions: Current Federal Reports are Inadequate: 72d Report by the Committee on Government Operations. H.Rpt No. 100-1088. 100d Cong., 2d sess. Washington DC: Government Printing Office, 13 October 13, 1988.

Thus, there appears to be ample support for the contention that material fraud played a significant role in the S&L debacle. While there may be little consensus as to the exact amount of fraud and deliberate insider abuse involved, there is substantial agreement that these swindles at the time constituted the *most costly series of white-collar crimes in American history*.[17]

Economic conditions of the late 1970s substantially undermined the health of the savings and loan industry and ultimately contributed to the dismantling of the traditional boundaries within which they operated. Perhaps most importantly, high interest rates and slow growth squeezed the industry at both ends. Locked into low-interest mortgages from previous eras and precluded from offering adjustable rate mortgages (ARMS), prohibited by Regulation Q from paying more than 5.5 percent interest on new deposits despite inflation reaching 13.3 percent by 1979, the industry suffered steep losses. Compounding the problem was the development of Money Market Mutual Funds by Wall Street, which allowed middle-income investors to buy shares in large denomination securities at high money-market rates, which triggered "disintermediation" - that is, mass withdrawals of deposits from savings and loans.

Confronted with rising defaults and foreclosures as the recession deepened, and increasing competition from new high-yield investments, savings and loans seemed doomed to extinction. The industry's net worth fell from $16.7 billion in 1972 to a *negative* net worth of $17.5 billion in 1980 with 85 percent of the country's S&Ls losing money.[18]

While policy makers had gradually loosened the restraints on savings and loans since the early 1970s, it was not until the *laissez-faire* fervor of the early Reagan Administration that this approach gained widespread political acceptance as a solution to the rapidly escalating savings and loan crisis. In a few strokes, Washington dismantled most of the regulatory infrastructure that had kept the thrift industry together for four decades.[19] These deregulators were convinced that the free enterprise system works best if left alone, unhampered by perhaps well-meaning but ultimately counterproductive government controls. Many knowledgeable onlookers disagreed passionately and pointed the finger of blame for the subsequent gush of S&L abuses directly at deregulation. One critic said of deregulation: "[It] allowed the real estate developers, with a borrower's mentality, to own banks, replacing the sober, conservative bankers. It's like giving the fattest kid on the block the keys to the candy store."[20]

Two major laws passed in the early 1980s opened the doors to the impending disaster. In 1980, the Depository Institutions Deregulation and Monetary Control Act was signed into law,[21] followed in 1982 by the Garn-St. Germain Act.[22] These laws provided for a loosening of

17 United States General Accounting Office. Bank and Thrift Fraud: Statement of Harold Valentine, Associate Director, Administration of Justice Issues. Testimony Before the Subcommittee on Consumer and Regulatory Affairs. Committee on Banking, Housing, and Urban Affairs. U. S. Senate. Washington DC: Government Printing Office, 6 February, 1992, p. 1.

18 Pizzo, Stephen, Mary Fricker, and Paul Muolo. *Inside Job: The Looting of America's Savings and Loans*. New York: McGraw-Hill, 1989.

19 Mayer, Martin. *The Greatest Bank Robbery Ever: The Collapse of the Savings and Loan Industry*. New York: Charles Scribner's Sons, 1990.

20 Quoted in Sheehy, Sandy. "Super Sleuth – White-Collar Criminals Beware: Ed Pankau is Looking for You." *Profiles*. July, 1992, p. 39.

21 DIDMCA; P.L. 92-221.

22 P.L. 97-320.

government control over the industry, which both dramatically expanded their investment powers and moved them farther away from their traditional role as providers of home mortgages for the working class. Deregulatory changes included: a phasing out of limits on deposit interest rates; permitting thrifts to make commercial real estate loans, business and consumer loans, and direct investments in their own properties; authorization to issue credit cards; and increasing federal deposit insurance from $40,000 to $100,000 per savings account. Moreover, the Garn-St Germain Act allowed thrifts to provide 100 percent financing, requiring no down-payment from the borrower, in an effort to attract new business to the desperate industry.

Industry regulators quickly jumped on the *laissez-faire* bandwagon. The elimination of the 5 percent limit on brokered deposits in 1980 gave thrifts access to unprecedented amounts of cash. "Brokered deposits" were placed by middlemen who aggregated individual investments as "jumbo" certificates of deposit (CDs). Since the maximum insured deposit was $100,000, these brokered deposits were packaged as $100,000 CDs commanding high interest rates. So attractive was this system to all concerned - brokers who made hefty commissions, individual investors who received high interest for their money, and thrift operators who now had almost unlimited access to these funds - that between 1982 and 1984, brokered deposits as a percentage of total thrift assets increased 400 percent [23]

By 1984, federally insured thrifts had access to $34 billion in brokered deposits.[24] The National Commission on Financial Institution Reform, Recovery and Enforcement points out that, even without brokered deposits, thrifts would have been able to grow rapidly through the combination of insured deposits and risky capital ventures. Nonetheless, as they observe: "Brokered deposits proved to be a convenient and low cost means of raising vast sums."[25]

Regulators also abandoned the requirement established in 1974 that thrifts have at least 400 stockholders, with no one individual owning more than 25 percent of the stock. This effectively allowed a single entrepreneur to operate a federally insured savings and loan. Furthermore, single investors could now start thrifts backed up by noncash assets, such as land or real estate. Presumably hoping that this move would attract innovative entrepreneurs who would rescue the industry, the regulators seemed oblivious to the disastrous potential of virtually unlimited charters in a vulnerable industry.

Following deregulation, losses continued to escalate. In 1982, the Federal Savings and Loan Insurance Corporation (FSLIC) spent over $2.4 billion to close or merge insolvent savings and loans, and by 1986 the federal insurance agency was itself declared insolvent.[26] With the number of insolvent thrifts climbing steadily, FSLIC, knowing that it had insufficient funds to cope with the disaster, slowed the pace of closures, allowing technically insolvent institutions to stay open. Not

23 U.S. General Accounting Office. Thrift Industry Restructuring and the Net Worth Certificate Program: Report to Congress. GAO/GGD-85-79. Washington DC: Government Printing Office, 1985. p. 7.

24 Pizzo, et al., *op. cit*.

25 National Commission on Financial Institution Reform, Recovery and Enforcement, *op. cit*., p. 47.

26 United States Congress. House. Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Committee on Banking, Finance, and Urban Affairs. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (H.R.1278): Hearings before the Subcommittee, Part 1. Serial No. 101-12. 101st Cong., 1st sess. Washington DC: Government Printing Office, March 8, 9, 14, 1989, p. 286.

surprisingly, the "Zombie" thrifts,[27] as they came to be known, continued to hemorrhage. In the first half of 1988, the thrift industry reported that it had lost an unprecedented $7.5 billion.[28] It is now known, of course, that the actual losses were much higher.

Unfortunately, the effect of deregulation (or "unregulation" as some call it) was to attract an unsavory breed of entrepreneur to an already troubled industry. These hustlers did not see an opportunity to help rebuild the industry but a chance to plunder it through various get-rich-quick schemes. Savings and loans became "money machines" or mere shell organizations by which unscrupulous individuals could enrich themselves. After the thrift had served its purpose and was insolvent - that is, bankrupt - it could be left for dead. Government regulators then had to act as undertakers, "cleaning up" the remains by reimbursing depositors whose funds had been squandered and stolen, and attempting to sell off the remaining assets of the thrift for whatever price they could get.

"Insider" Thrift Frauds

While the list of potential frauds open to thrift operators and related outsiders is a long one, researchers have classified them into three distinct categories of white-collar crime: (1) "illegal lending" (2) "looting;" and (3) "covering up".[29] The categories often overlap in actual cases, both because one individual may commit several types of fraud and because the same business transaction may involve more than one type. Each type of offense is considered in turn.

<u>Illegal lending</u>: After lengthy hearings and testimony, the House Committee on Government Operations concluded:

> [N]ormally honest bankers (including thrift insiders) . . . resorted to fraud or unsafe practices in efforts to save a battered institution. In those cases an incentive existed to turn an unhealthy financial institution around by garnering more deposits and then making even more speculative investments, hoping to "make it big."[30]

In his testimony, former Federal Home Loan Bank Board (FHLBB) Chair M. Danny Wall described the bind of thrift operators: "[They were] on a slippery slope of a failing institution trying to save probably their institution first and trying to save themselves and their career."[31] It is this "slippery slope" of fraud that constitutes "illegal lending."

The factors that triggered this effect in the thrift industry are similar in some ways to those described in other white-collar crime studies. In an overview and synthesis of white-collar crime theory, Coleman points out that the "demand for profit is one of the most important economic influences on the opportunity structure for organizational crime."[32] Geis' famous study of the electrical equipment price-fixing conspiracy reveals the central role played by the corporate

27 Meigs A. James and John C. Goodman. "What's Wrong with our Banking System?" *Consumers' Research*, March 1991. pp. 11-17.

28 Eichler, Ned. *The Thrift Debacle*. Berkeley: University of California Press, 1989.

29 Calavita, Kitty, and Pontell, Henry N. "`Heads I Win, Tails You Lose': Deregulation, Crime and Crisis in the Savings and Loan Industry." *Crime & Delinquency* 36, 1990: 309-341.

30 House Committee on Government Operations, 1988, *op. cit*., p. 34.

31 *Ibid*., p. 46.

32 Coleman, James. Towards an Integrated Theory of White Collar Crime. *American Journal of Sociology* 93, 1987: p. 427.

emphasis on profit-maximization and the consequent corporate subculture conducive to, or at least tolerant of, illegal behavior.[33] Similarly, Farberman argues that the necessity to maximize profits within the context of intense competition produced a "criminogenic market structure" in the automobile industry.[34]

Illegal lending by thrift operators is akin to these other white-collar crimes in that it too was motivated by the profit imperative. In the case of an insolvent S&L, the profit imperative takes on special urgency as managers struggled to turn the failing institution around. But illegal lending is also distinct in a number of ways from these traditional white-collar crimes. While the corporate crime described above resulted in increased profits and long-term liquidity for the company, illegal lending in the thrift industry was a gamble with very bad odds. Unlike corporate crimes in the industrial sector, these financial crimes usually contribute further to the *bankruptcy* of the institution.

Examples include violations of loans-to-one-borrower limits, inadequate underwriting, and other unsafe and unlawful practices. While the specific type of violation may vary, what they had in common is that they are motivated by a desperate effort to save a failing enterprise. Like the gambler with dwindling funds, illegal lenders "go for broke." More often than not, they end up "broke."

Looting: While much attention has been paid in congressional testimony and elsewhere to the desperation dealing just described,[35] research has shown that self-interested fraud was the more frequent and costly form of misconduct.[36] Most S&L crimes were not committed by desperate entrepreneurs trapped by economic forces. "They were perpetrated by crooks who funneled investors' money into dummy corporations, hid assets in their wives' maiden names and performed other acts of larcenous legerdemain."[37] Such premeditated fraud for personal gain on the part of thrift management has been referred to as "looting."[38]

The Commissioner of the California Department of Savings and Loans stated in 1987: "The best way to rob a bank is to own one."[39] Looting entails the siphoning off of funds from a savings and loan institution for personal gain, at the expense of the institution itself and with the implicit or explicit sanction of its management. This "robbing of one's own bank" has been estimated to be the single most costly category of crime in the S&L debacle, having precipitated a significant number

33 Geis, Gilbert. "White Collar Crime: The Heavy Electrical Equipment Antitrust Cases of 1961." In Marshall Clinard and Quinney Richard (Eds.). *Criminal Behavior Systems: A Typology*. New York: Holt, Rinehart & Winston, 1967.

34 Farberman, Harvey A. "A Criminogenic Market Structure: The Automobile Industry." *Sociological Quarterly* 16, 1975: 438-457.

35 Lowy, Martin. High *Rollers: Inside the Savings and Loan Debacle.* New York: Praeger, 1991; Pilzer, Paul Z. and Dietz, Robert. *Other People's Money: The Inside Story of the S&L Mess.* New York: Simon and Schuster, 1989; O'Shea, James. *The Daisy Chain: How Borrowed Billions Sank a Texas S & L.* New York: Pocket Books, 1991.

36 Pontell, Henry, Calavita, Kitty, and Tillman, Robert. "Fraud in the Savings and Loan Industry: White-Collar Crime and Government Response." Final Report of Grant #90-IJ-CX-0059 submitted to the National Institute of Justice, Office of Justice Programs, U.S. Department of Justice, October, 1994.

37 Sheehy, *op. cit.*, p. 39.

38 Calavita and Pontell, 1990, *op. cit*.

39 Quoted in U.S. Congress. House Committee on Government Operations 1988, *op. cit.*, p. 34 (emphasis in the original).

of the largest insolvencies to date.[40] The GAO concluded that, of the S&Ls it studied, "almost all of the 26 failed thrifts made transactions that were not in the thrift's best interest. Rather, the transactions often personally benefitted directors, officers, and other related parties."[41]

Embezzlement is by no means an isolated or uncommon form of white-collar crime. The advent of computers and their proliferation in business makes access to "other people's money" easier than ever. Not surprisingly, the toll from such crime is considerable. Conklin notes that between 1950-1971, at least 100 banks were made insolvent as a result of embezzlement.[42] Moreover, in the mid-1970s commercial banks lost almost five times as much money to embezzlers as they did to armed robbers.[43]

The traditional embezzler is usually seen as a lower-level employee working alone to steal from a large organization. Sutherland noted: "[T]he ordinary case of embezzlement is a crime by a single individual in a subordinate position against a strong corporation."[44] Similarly, Cressey, in his landmark study, *Other People's Money*, examined the motivations of the lone embezzler.[45] The *looting*, however, differs in important ways from this traditional model.[46]

Looting constitutes not only deviance *in* an organization,[47] but deviance *by* the organization. Not only are the perpetrators themselves in management positions, but the very goals of the institution are to provide a money machine for owners and other insiders. The formal goals of the organization thus comprise a "front" for the real goals of management, who not infrequently purchased the institution in order to loot it, and then discard it after it served its purpose. It is a prime example of what Wheeler and Rothman have called "the organization as weapon": "[T]he organization . . . is for white-collar criminals what the gun or knife is for the common criminal - a tool to obtain money from victims."[48] The principal difference between Wheeler and Rothman's profile of the organization as weapon and the case of looting in the S&L industry is that the latter is an organizational crime *against* the organization's own best interests. That is, the organization is both weapon *and* victim. This form of financial crime is referred to repeatedly in government documents[49] and was highlighted by informants in a major research study as the most egregious form of thrift fraud.[50]

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40 U.S. Congress. House Committee on Government Operations 1988, op. cit., p. 41; U.S. General Accounting Office, Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices: Report to Congress. 1989, *op. cit*., p. 19.

41 U.S. General Accounting Office, Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices: Report to Congress. 1989, op cit., p. 19.

42 Conklin, John E. Illegal*, But Not Criminal: Business Crime in America*. New York: Spectrum Books, 1977.

43 *Ibid*, p. 7

44 Sutherland, Edwin. *White Collar Crime: The Uncut Version*. New Haven: Yale University Press, 1983; p. 231.

45 Cressey, Donald R. *Other People's Money: A Study of the Social Psychology of Embezzlement*. Glencoe, IL: Free Press, 1953.

46 Calavita and Pontell, 1990, op. cit.

47 Sherman, Lawrence. *Scandal and Reform*. Berkeley: University of California Press, 1978.

48 Wheeler, Stanton, and Rothman, Mitchell L. "The Organization as Weapon in White Collar Crime." *Michigan Law Review* 80, 1982: p. 1406.

49 U.S. Congress. House Committee on Government Operations 1988, *op. cit.*; U.S. General Accounting Office, Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices: Report to Congress. 1989, *op. cit*.

50 Pontell, et al., 1994, *op. cit*.

Covering Up. A considerable proportion of the criminal charges leveled against savings and loan institutions involved attempts to cover up or hide both the thrift's insolvency and the fraud that contributed to that insolvency.[51] "Covering up" was usually accomplished through a manipulation of company books and records. This form of fraud may have been the most pervasive criminal activity of thrift operators. Of the alleged 179 violations of criminal law reported in the 26 failed thrifts studied by the GAO, 42 were for covering up, constituting the single largest category.[52] The same study found that *every one* of those thrifts had been cited by regulatory examiners for "deficiencies in accounting."[53]

Covering up was employed to a variety of ends by S&L operators. First, it produced a misleading picture of the institution's state of health, or more specifically, misrepresented the thrift's amount of capital reserves, as well as its capital-to-assets ratio. Second, deals could be arranged that included covering up as part of the scheme itself. For example, in cases of risky insider loans, a reserve account may be created to pay off the first few months (or years) of a development loan to make it look current, whether or not the project had failed or was phony in the first place. Third, covering up was used after the fact to disguise illegal investment activity. Previously honest bankers, responding to the competitive pressures of the 1980s and the deregulated thrift environment stepped over the line into illegal lending or other illicit attempts to save their ailing institutions and their own reputations. In such cases, covering up became an essential part of the fraud.[54]

While savings and loan frauds occurred nationwide, California and Texas accounted for a preponderance of the worst thrift failures and frauds. Southern California, which federal authorities have long dubbed the "fraud capital of the United States," was home to numerous insolvencies in which financial crimes played a significant role. The notorious case of Charles Keating's Lincoln Savings and Loan of Irvine is perhaps the best known illustration.

"Outsider" Thrift Frauds

Savings and loan fraud was not confined to insiders. Thrift officers were often joined in the largest scams by "outsiders" from various occupations and professional groups. Industry regulators and FBI investigators have reported that appraisers, lawyers, and accountants were among the most frequent co-conspirators; indeed, their compromised services made many of the S&L scams possible. Perhaps foremost in this regard were accountants, whose audits allowed many fraudulent transactions to go unnoticed. Professional accounting firms were highly paid for their services, and thus could easily turn a blind eye when evidence of wrongdoing surfaced. One study conducted by the General Accounting Office reports that, of eleven failed thrifts in Texas, six involved such laxity

51 *Ibid*.

52 U.S. General Accounting Office, Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices: Report to Congress. 1989, *op. cit*.

53 *Ibid*., p. 40.

54 Pontell et al., 1994, *op. cit*.

on the part of auditors that investigators referred them to professional and regulatory agencies for formal action.[55]

Appraisers were central players in the epidemic of fraud as well. As assessors of property values, appraisers are essential to the real estate and banking systems. In some states where the thrift industry was particularly hard hit, such as Texas, the appraisal business is entirely unregulated. Like many other professionals involved in the thrift crisis, appraisers were susceptible to designing their results to meet clients' wishes, as they are particularly dependent on repeat business and referrals. Thrift regulators have reported that inaccurate and inflated appraisals were found in the wreckage of failed thrifts throughout the country.[56]

Accountants, lawyers, and appraisers interested in retaining lucrative contracts with S&Ls in the 1980s were confronted with the tension between safe banking procedures, legal statutes and fiduciary regulations, and professional standards on one hand, and the demands of their clients on the other. Periodically the line was crossed, or even erased, as these "outsiders" violated not only professional codes of conduct but, in some cases, the law. Much as the criminogenic environment of the S&Ls triggered insider abuse and fraud, the very structure of the relationship between insiders and professionals on the outside assured that some segment of those outsiders would become accomplices to fraud.

<u>Criminal Networks</u>: Another consistent theme in the S&L debacle is the degree to which the financial resources of the thrift industry and individual thrift executives enabled troubled savings and loans to secure the support of influential policymakers.[57] Regarding the collapse of thrifts in Texas, a staff member of the Senate Banking Committee predicted: "What you're going to find in these thrifts is a sort of mafia behind them. I don't mean Italians, but I'm using it in a generic sense: a fraudulent mutual support." [58]

The nature of many of the crimes permeating the thrift industry depended on this "mutual support." A Senate Banking Committee memo delineates the four most common forms of fraudulent transactions: land flips, nominee loans, reciprocal lending arrangements, and linked financing.

<u>Land Flips</u>: In a land flip, a piece of property, usually commercial real estate, is sold back and forth between two or more partners, inflating the sales price each time and refinancing the property with each sale until the value had increased several times over. In one of the most infamous cases, a Dallas developer and his partner purchased a parcel of land outside of Dallas. They then sold it to each other inflating the price from $5 million to $47 million in less than a month.[59] The final loan

55 U.S. General Accounting Office. CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems: Report to the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives. GAO/AFMD-89-45 Washington DC: Government Printing Office, February, 1989.

56 Pontell, et al., 1994, *op. cit.*

57 Pizzo, et al., op cit.; Adams, James R. The *Big Fix: Inside the Savings and Loan Scandal*. New York: John Wiley and Sons, Inc., 1990; United States Congress. House. Committee on Standards of Official Conduct. Report of the Special Outside Counsel in the Matter of Speaker James C.Wright, Jr. Richard J. Phelan, Special Outside Counsel. 101st Cong., 1st sess. Washington DC: Government Printing Office, February 21, 1989.

58 Quoted in Calavita, Kitty, and Pontell, Henry N. "Savings and Loan Fraud as Organized Crime: Toward A Conceptual Typology of Corporate Illegality." *Criminology* 31, 1993: p. 534.

59 *New York Times*. "4 Convicted of Defrauding Texas Savings And Loan," November 7, 1991, p. C16.; Pizzo, et al., *op. cit.*

was defaulted on, leaving the partners with hefty profits and the lending institutions with short-term points and fees. A flip scam requires an organized network of participants - at a minimum, two corrupt borrowers (who are often affiliated with the lending thrift) and a corrupt appraiser.

Nominee Loans: Nominee loan schemes involve loans to a "straw borrower" outside the thrift who is indirectly connected to the thrift. Nominee loans are used to circumvent regulations limiting the permissible level of unsecured commercial loans made to thrift insiders. Don Dixon, the owner and operator of the infamous Vernon Savings and Loan in Texas, provides an extreme example of how nominee loans can be used in a fraudulent manner. Dixon established a network of over thirty subsidiary companies for the sole purpose of making loans to himself and other insiders.

Reciprocal Lending: Reciprocal lending arrangements are similarly designed to evade restrictions on insider loans. These arrangements were used extensively in the mid-1980s by thrift officers and directors, who, instead of making loans directly to themselves - which would have sounded an alarm among regulators - agreed to make loans to each other, with each loan contingent on receiving a comparable loan in return. One investigation in Wyoming in 1987 revealed a "daisy chain" of reciprocal loans among four thrifts which resulted in a $26 million loss to taxpayers.[60]

Linked Financing: Finally, linked financing is "the practice of depositing money into a financial institution with the understanding that the financial institution will make a loan conditioned upon receipt of the deposits."[61] These transactions usually involved brokered deposits in packages of $100,000, the limit on FSLIC insurance. Deposit brokers often received a generous non-recourse loan, which was frequently defaulted on, in return for these deposits.

Investigators and regulators report finding variations of these four basic "mutual support" scams over and over in their autopsies of insolvent savings and loans. In each of these schemes a network of participants is absolutely essential. Arthur Leiser, an examiner with the Texas Savings and Loan Department for 35 years, kept a diary and noted the relationships among savings and loan operators, developers, brokers, and a variety of borrowers. One network recorded by Leiser included seventy-four participants. According to Leiser's calculations, practically all the insolvent thrifts in Texas were involved in such networks.[62]

The conspiratorial quality of thrift frauds was not confined to Texas or the southwest. In a speech to the American Bar Association in 1987, William Weld, Assistant Attorney General and Chief of the Criminal Division at the Justice Department (later Governor of Massachusetts), declared: "We now have evidence to suggest a nationwide scheme linking numerous failures of banks and savings and loan institutions throughout the country."[63] That same year, the GAO reported that 85 criminal referrals had been made to the Department of Justice relating to the twenty-six insolvent thrifts in its study, involving 182 suspects and 179 violations of criminal law.[64]

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60 United States Congress. House Subcommittee on Commerce, Consumer, and Monetary Affairs. Committee on Government Operations. Adequacy of Federal Efforts to Combat Fraud, Abuse, and Misconduct in Federally Insured Financial Institutions: Hearing Before the Subcommittee. 100st Cong., 1st sess. Washington DC: Government Printing Office, November 19, 1987: pp. 79-80, 129-130.

61 U.S. Congress. House Committee on Government Operations 1988, op cit., p. 42.

62 United States Congress. House Committee on Banking, Finance, and Urban Affairs. Effectiveness of Law Enforcement Against Financial Crime (Part I): Field Hearing before the Committee, Dallas, Texas. Serial No. 101-111. 101st Cong., 2d sess. Washington DC: Government Printing Office, April 11, 1990: pp. 804-872.

63 Quoted in Pizzo, et al., *op. cit*., p. 279.

64 U.S. General Accounting Office, 1989, Thrift Failures, *op. cit*.

These crimes were sometimes facilitated by connections between perpetrators and those in a position to shield them from prosecution. At the lowest level of field inspectors and examiners, evidence has surfaced of collusion with fraudulent thrift operators. One strategy of thrift executives was to woo examiners and regulators with job offers at salaries several times higher than their modest government wages. When "Erv" Hansen, owner of Centennial Savings and Loan in Santa Rosa, California, was questioned by examiners about his extravagant parties, excessive compensation schemes, and frequent land flips, he hired the Deputy Commissioner of the California Department of Savings and Loans, making him an executive vice-president and doubling his $40,000 a year state salary. According to an interview with Hansen's partner, the new employee's chief assignment was to "calm the regulators down."[65] Similarly, Don Dixon at Vernon Savings hired two senior officials from the Texas Savings and Loan Department, and according to one official, "provided prostitutes along the way."[66]

Even more important than these relatively infrequent forms of explicit collusion, were connections between thrift industry executives and elected officials. Not only was the powerful U.S. League of Savings and Loans, with its generous campaign contributions and lobbying efforts, a significant force behind the deregulation that provided the opportunities for fraud in the first place, but financial pressure was brought to bear by the operators of fraudulent institutions in order to avoid regulatory scrutiny. While the "Keating Five" case is by far the most well-publicized instance of political influence-peddling to stave off official actions in response to thrift violations, it was only one quilt in a sinister blanket. The repercussions of bribery and political corruption in the S&L tragedy go far beyond one or two institutions. The connections between former House Speaker Jim Wright, Congressman Tony Coelho, and thrift executives illustrate this pattern.[67] Such ties were replicated throughout the country, most notably in California, Texas, Arkansas, and Florida, where failures proliferated and losses soared. One senior official in Florida reported that to his knowledge, *all* the Florida thrifts that managed to stay open after insolvency did so with the help of their owners' and operators' well-placed political connections.[68]

Representative Henry Gonzalez, Chair of the House Committee on Banking, warned FBI Director William Sessions of the urgency of dealing with thrift crime:

> The issue is very, very serious. We cannot allow . . . a loss of faith in the deposit insurance system. . . Confidence is at the root of everything because if we lose the confidence of the people, no system will stand up to that.[69]

GAO Director Harold Valentine called thrift fraud and the financial collapse to which it contributed, "perhaps the most significant financial crisis in this nation's history."[70] The Department of Justice referred to it as "the unconscionable plundering of America's financial institutions."[71] A

65 Quoted in Pizzo, et al., *op. cit*., p. 47.

66 Personal interview.

67. Jackson, Brooks. *Honest Graft: Big Money and the American Political Process*. New York: Alfred A. Knopf, 1988; United States Congress. House Committee on Standards of Official Conduct, 1989. op cit.

68 Pontell, et al., 1994., *op. cit*.

69. U.S. Congress. House Committee on Banking, Finance and Urban Affairs, 1990, *op. cit*., p. 15.

70 U.S. General Accounting Office, 1992, *op. cit*., p. 19.

71 United States Department of Justice. Attacking Savings and Loan Institution Fraud: Department of Justice Report to the President. Washington DC: Government Printing Office, 1990.

senior staff member of the Senate Banking Committee explained the attention being given to thrift fraud:

> This industry is very close to the heart of the American economy! We teetered on the edge of a major, major problem here. Well... we got a major problem, but we teetered on the edge of a major collapse. ... You know, all these [financial] industries could bring down the whole economy.[72]

In summary, the major federally-funded study on S&L fraud and the response of the government to the ensuing debacle concluded the following:[73]

***** Crime and deliberate fraud were extensive in the thrift industry during the 1980s, contributing to the collapse of hundreds of institutions and increasing the cost of the taxpayer bailout.

***** Deregulation of the thrift industry in the early 1980s, combined with continued deposit insurance, were key elements of a criminogenic industry environment. In particular, these policy changes increased the opportunities for fraud while decreasing the risks associated with fraud.

***** While there were numerous variations of fraudulent thrift deals, four basic types of transactions provided the vehicle for the most egregious frauds. These are land flips, nominee loan schemes, linked financing, and reciprocal lending. Further, frauds consisted generally of three types of misconduct: "desperation dealing," "looting," and "covering-up."

***** Thrift crimes typically involved networks of insiders, often in association with affiliated outsiders.

***** Fraud was correlated with specific organizational characteristics at failed S&L's. Institutions that were stock-owned, were less involved in the home mortgage market, and undertook strategies that led to dramatic growth in assets, were the sites and vehicles for the most frequent, most costly and most complex white-collar crime.

***** The government response to thrift fraud focused on containing the financial crisis, rather than punishing wrongdoing *per se*.

***** Despite the urgency of this response and its unprecedented scale, its effectiveness is limited by the complex nature of these frauds, resource constraints, inter-agency coordination difficulties, and inherent structural dilemmas related to financial regulation.

***** A relatively high proportion of those formally charged in major thrift cases were convicted (91 percent), and of those, a significant proportion (78 percent) received prison sentences.

***** Thrift offenders received relatively short prison sentences compared to those convicted of other federal offenses.

***** Significant amounts of fraud will go undetected, and a large proportion of individuals suspected of major thrift offenses will never be prosecuted.

One high official put the S&L crisis in particularly graphic terms when he compared the damage to a major environmental disaster, too enormous to be cleaned up effectively:

> I feel like it's the Alaskan oil spill. I feel like I'm out there with a roll of paper towels. The task is so huge, and what I'm worrying about is

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72 Personal interview with Henry Pontell, Kitty Calavita and Robert Tillman.

73 Pontell, Henry N., Calavita, Kitty and Tillman, Robert. "Fraud in the Savings and Loan Industry: White-Collar Crime and Government Response." Executive Summary of Grant #90-IJ-CX-0059, National Institute of Justice, Office of Justice Programs, U.S. Department of Justice, October, 1994: pp. 42-45.

where can I get some more paper towels? I stand out there with my roll and I look at the sea of oil coming at me, and it's so colossal![74]

Given the best available evidence, at least one thing is certain from this sad chapter in American history - which makes it all the sadder: ***The incredible financial losses directly attributable to white-collar crimes that were discovered and recorded in official statistics on the savings and loan crisis represent only "the tip of the iceberg."***[75]

Studies of the savings and loan debacle in the United States empirically demonstrated that law enforcement and criminal justice agencies were not able to investigate and assuredly not prosecute offenses that they were aware of because of a shortage of personnel and resource capacity.[76] Today, offenses associated with the current subprime lending frauds are featured obliquely in political debates but the focus is almost exclusively on the consequent problems for the banking industry and for homeowners undergoing or contemplating foreclosure. The word “speculation” sometimes surfaces and we hear of high-pressure and misleading sales pitches that induced persons to buy a house they could not truly afford. But the word “crime” is not prominent in the discussion, although it permeated the behaviors.

How and why such crimes are omitted in practice is no mystery. The importance of status and power in influencing the trivialization of white-collar crime is powerfully illustrated in a study of arson cases in Boston[77] that demonstrated how resource constraints and class bias provided a “structural cloak” that covers white-collar criminality. The fires were intentionally arranged by landlords in order to collect insurance. But for years, officials blamed them on lower-class occupants of the buildings. By keeping arson-for-profit a “non-issue” a significant form of white-collar crime was trivialized.

One need only consider the enormous wave of control fraud[78] in the savings and loan crisis, the corporate and accounting scandals of 2002 which included the fraud-induced bankruptcies of Enron, Arthur Andersen, Worldcom and others, and the most recent subprime mortgage crisis to see the massive damage caused by white-collar and corporate crimes.

The Current Meltdown

The global meltdown of 2008 and 2009 was influenced by a number of factors including flawed financial policies, law-breaking, greed, irresponsibility, and not an inconsiderable amount of concerted ignorance and outright stupidity. To date, the greatest attention regarding that criminality has focused on the $65 billion Ponzi scheme perpetrated by Bernard Madoff, a scam

74 Quoted in Pontell, Henry N., Calavita, Kitty and Tillman, Robert. "Corporate Crime and Criminal Justice System Capacity: Government Response to Financial Institution Fraud." *Justice Quarterly* 11, September, 1994: p. 400.

75 *Ibid,* p. 395.

76 Ibid., Calavita, Kitty, Henry N. Pontell and Robert Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan *Crisis.* Berkeley: University of California Press, 1997; Robert Tillman, Henry N. Pontell, and Kitty Calavita, "Criminalizing White-Collar Misconduct: Determinants of Prosecution in Savings and Loan Fraud Cases." *Crime, Law and Social Change* 26:1 (1997) pp. 53-76.

77 Goetz, Barry. 1997. Organization as class bias in local law enforcement: Arson-for-profit as a "nonissue." *Law & Society Review*, 31(3):557-588.

78 Black, William K. The Best Way to Rob a Bank is to Own One: How Corporate Executives and Politicians Looted the S&L Industry. Austin: University of Texas Press; Calavita, Pontell and Tillman, 1997, op. cit.

that resembled tactics of con men, not big time corporate financiers.[79] Prototypical corporate frauds such as those perpetrated by Wall Street behemoths American International Group (AIG), Countrywide, Lehman Brothers, and Bear Sterns received much less attention.[80] These companies, whose balance sheets were saturated with securities containing subprime mortgages, collapsed, were bought by competitors, or were bailed out by the federal government with huge infusions of taxpayer money. For most onlookers, including criminologists and the public in general, their actions represented intricate and arcane business practices that were difficult to fully understand and to portray in sound bytes – and therefore they tended to become trivialized in regard to their criminal components.

The current worldwide financial problems have their roots in home mortgage lending practices. Many are part of the subprime loans that, at best, are less than prudent, and, at worst, criminally fraudulent. The bursting of the real estate bubble, which had grown quickly to massive proportions, resulted in an unprecedented number of foreclosures, a striking collapse in the market value of homes, and heavy losses for those holding investments involving the bundling of loans and debt. Moreover, some of the most sophisticated financial institutions had allowed—and encouraged—practices that were highly imprudent, despite their reputation for expertise in risk management. Well before the bubble burst, one commentator noted the danger signs and diagnosed the risks that these companies faced:

> [T]heir CEOs, acting on the perverse incentives crucial to today's outrageous compensation systems, engaged in practices that vastly increased their corporations' risks in order to drive up corporate income and thereby secure enormous increases in their own individual incomes. And these perverse incomes follow them out the door…Pay and productivity (and integrity) have become unhinged in U.S. financial institutions.[81]

This viewpoint is perhaps over-generous in portraying a need to show a particularly healthy balance sheet in order to justify outrageous pay packages for executives.[82]

"Control fraud" or fraud committed by controlling insiders of large organizations, can extend, and hyper-inflate, financial bubbles that eventually result in systemic crises.[83] The economist whose academic work focused on such matters, Hyman Minsky, used the term "Ponzi phase" to characterize this growth in financial bubbles.[84] It is a descriptive phrase, and not simply metaphorical. The "weapon of choice" in bubbles is accounting and the principal intended victims are the firm, its shareholders, creditors, and customers. Such waves of fraud are neither random nor irrational; they occur when a "criminogenic environment" creates perverse incentives to act unlawfully. The lack of effective financial regulation and enforcement during the Bush administration and the policies fostered by former U.S. Federal Reserve Chairman Alan Greenspan allowed such criminogenic environments to flourish in industries related to the

[79] Sander, Peter, Madoff: Corruption, Deceit, and the Making of the World's Most Notorious Ponzi Scheme. Guilford, CT: Lyons Press, 2009; Strober, Deborah Hart and Gerald Strober. Catastrophe: The Story of Bernard Madoff, the Man who Swindled the World. Beverly Hills, CA: Phoenix Books, 2009.

[80] Bamber, Bill A. and Andrew Spencer. Bear Trap: The Fall of Bear Stearns and the Panic of 2008. New York: Black Tower Press, 2009; Kelly, Kitty. Street Fighters: The last 72 Hours of Bear Stearns, the Toughest Firm on Wall Street. New York: Portfolio, 2009; McDonald, Larry G. and Patrick Robinson. A Colossal Failure of Common Sense: The Insider Story of the Collapse of Lehman Brothers. New York: Crown, 2009; Michaelson, 2009, op. cit.

[81] Black, William K. "(Mis)understanding a banking industry in transition." *Dollars and Sense*, 273 (Nov/Dec 2007):14-27.

[82] Friedrichs, David. "Exorbitant CEO compensation or grand theft?" *Crime, Law & Social Change,* 51(February 2009):45-72.

[83] Black, 2008, *op. cit.*

[84] Minsky, Hyman P. *Can "It" Happen Again? Essays on Instability and Finance.* Armonk, NY: M.E. Sharpe, Inc., 1982.

origination, sale, and securitization of home loans.[85] Financial instruments based on these "toxic assets" were sold throughout the world.

Nobel Prize-winning economist Paul Krugman[86] asks rhetorically, "How did economists get it so wrong?" The short answer he gives is that "economists, as a group mistook beauty, clad in impressive mathematics, for truth….[T]he central cause of the profession's failure was the desire for an all-encompassing, intellectually elegant approach that also gave economists a chance to show off their mathematical prowess."[87] As with much mathematical modeling of human relationships, their version of economic reality conveniently ignored elements that could cause things to go wrong as they ultimately did. As Krugman puts it, "They turned a blind eye to the limitations of human rationality that often leads to bubbles and busts; to the problems of institutions that run amok; to imperfections of markets – especially financial markets – that can cause the economy's operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don't believe in regulation."[88] As critical as this statement is, it nonetheless trivializes the issue of criminality***. Institutions that "run amok" also engage in illegal activities that exacerbate the initial problems created by "bad economics" and corresponding flawed financial policy to crisis proportions. Moreover, and at the root of the current crisis, at both the loan originator and holder level the cover-up is rational, albeit unlawful and immoral.*** Neo-classical economists' unfamiliarity with fraud mechanisms causes them (ironically, given their excessive "rational actor" emphasis) to assert that the transactions that dominate this cover-up phase are inexplicable, crazy, or produced by "an increased appetite for risk." Krugman explains:

> The theoretical model that finance economists developed by assuming that every investor balances risk against reward – the so-called Capital Asset Pricing Model, or CAPM (pronounced cap-em) – is wonderfully elegant. And if you accept its premises it's also extremely useful. CAPM not only tells you how to choose your portfolio –even more important from the financial industry's point of view, it tells you how to put a price on financial derivatives, claims on claims….
>
> Finance economists rarely asked the seemingly obvious (though not easily answered) question of whether asset prices made sense given real-world fundamentals like earnings. Instead they asked only whether asset prices made sense given other asset prices….Finance theorists continued to believe that their models were essentially right, and so did many people making real-world decisions. Not least among these was Alan Greenspan…a long-time supporter of financial deregulation whose rejection of calls to rein in subprime lending or address the ever-inflating housing bubble rested in large part on the belief that modern financial economics had everything under control. There was a telling moment in 2005, at a conference held in honor of Greenspan's tenure at the Fed. One brave attendee, Raghuram Rajan (of the University of Chicago, surprisingly), presented a paper warning that the financial system was taking on potentially dangerous levels of risk. He was mocked by almost all present…
>
> By October of last year, however, Greenspan was admitting that he was in a state of "shocked disbelief," because "the whole intellectual edifice" had

[85] Black, 2008, *op. cit.*
[86] Krugman, Paul. "How did economists get it so wrong*? New York Times Magazine*, Sept. 2, 2009: p. 36-38.
[87] *Ibid.,* p. 36
[88] Ibid.

> "collapsed." Since this collapse of the intellectual edifice was also a collapse of real-world markets, the result was a severe recession – the worst, by many measures, since the Great Depression.[89]

Ironically, and even more tragically, econometric analysis and modeling during a wave of accounting control fraud actually compounds the problem noted by Krugman in that such models lead to perverse policies that optimize such crimes. Accounting control fraud techniques greatly increase reported income and suppress reported losses. Econometric studies, therefore, must find a strong, positive relationship between profitability (or share prices) and techniques that optimize accounting fraud (e.g., rapid growth, high leverage, making "no doc" subprime loans, and qualifying non-creditworthy borrowers on the basis of initial "teaser" rates). Neo-classical economists portray these naïve econometric studies as the height of sophistication and argue that they prove that regulatory concern about the techniques is baseless. The trivialization of white-collar crime is clearly evident in the fact that these studies never consider an alternative hypothesis; that the techniques are positively associated with income because they aid accounting fraud. The influence that such studies have on policy make it difficult to impossible for an agency to take regulatory or enforcement action against such fraud.[90]

In terms of the current global economic crisis, three major issues stand out. The first is that executive compensation policies turned private market discipline into perverse incentives encouraging massive control fraud even at the most elite firms. The emphasis on short-term results encourages executives to engage in high-risk and illegal practices in order to obtain better compensation packages, which threatens long-term stability in their companies.[91] Second, despite accurately warning since September 2004 that mortgage fraud was becoming "epidemic," the FBI reacted to its severe system capacity problems in a manner that failed to challenge Bush administration policies that virtually guaranteed that the FBI would fail to stem the tide of fraud. The FBI had found that 80 percent of mortgage fraud losses occurred when lender personnel were involved in the fraud.[92]

The FBI engaged in an acute form of fraud trivialization when it assumed – without investigation – that mortgage lenders' senior managers could not be guiding a fraud. In March 2007, with the non-prime secondary market in collapse and many non-prime mortgage lending specialists that lacked deposit insurance already failed or obviously failing, the FBI announced a "partnership" with the Mortgage Bankers Association (MBA). The move demonstrates that the FBI trivialized the mortgage fraud epidemic in four reinforcing ways. First, the MBA is the trade association representing the "perps" – the non-prime specialty lenders that were accounting control frauds. The FBI could not have picked a worse "partner" to battle mortgage fraud. Second, the FBI, without investigating the CEOs of non-prime mortgage specialists, conclusively assumed that such elites could not be frauds. Its claim that "there are two kinds [of] mortgage fraud" implicitly excludes "control fraud." Third, the FBI treated the elite mortgage lending institutions as the victims and the (largely lower status) non-prime borrowers as the criminals. It created, in partnership with the MBA, a poster warning customers that if they cheated the mortgage lenders the FBI would investigate the borrowers. Fourth, the idea that a poster

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[89] *Ibid.*, p.37.
[90] Black, 2008, *op. cit.*
[91] *Ibid*., Friedrichs, 2009, *op. cit.*
[92] Federal Bureau of Investigation. Mortgage fraud: New partnership to combat problem. Retrieved August 3, 2009 from http://www.fbi.gov/page2/march07/mortgage030907.htm.

warning that the FBI would investigate mortgage fraud being a meaningful response to an unprecedented epidemic of crime in the home lending industry trivialized the scale of the crisis.

The FBI only began to investigate the non-prime specialty mortgage lenders after the secondary markets in non-prime mortgages collapsed in spring 2007. Those secondary markets remain collapsed three years later because of the extraordinary incidence of mortgage fraud. Note that this was only weeks after the FBI formed its infamous partnership with the MBA. The FBI investigations of the non-prime mortgage specialty lenders have been so eviscerated by system capacity limitations[93] (another product of the trivialization of elite white-collar crime even when it causes a global crisis) that they have not produced a single indictment of a CEO. While the FBI has correctly testified that the ongoing crisis "dwarves the S&L crisis" it has also testified that it has assigned during the peak of the crisis roughly one-fifth as many agents to investigate mortgage frauds as it assigned to investigate S&L frauds. The FBI correctly realized, in part because of guidance from the regulators, that control frauds were the key criminals in the S&L debacle.[94] In the current crisis, there were no regulators for the uninsured mortgage lenders that made 80 percent of the non-prime loans. And, even where there were lenders insured by the FDIC the regulators referred to the banks and S&Ls they were supposed to regulate as "customers."

Third, and central to the high incidence of subprime fraud, was the fact that no one involved in the process evaluated credit quality. Had they done so they could not have missed – or allowed--the widespread and severe nature of these frauds. This failure was pervasive throughout the industry, and included appraisers, review appraisers, underwriters, loan committee members, purchasers' underwriters, outside auditors at every level, stock analysts, mortgage insurers, and even the credit rating agencies.[95] The trivializing of white-collar crime is evident in the fact that the FBI's 2004 warning of a fraud epidemic due to these practices was ignored by policymakers, and that the mortgage industry's own term for many subprime loans was "liars' loans."[96] The former U.S. Attorney General declined to create a task force to investigate the roots of the subprime debacle, while likening the problem to "'white-collar street-crime' that could best be handled by individual United States attorneys' offices" in a decision that reflected the strong pro-business ideology of the Bush administration.[97]

Alan Greenspan's *mea culpa* made painfully clear that neoclassical economists and those who listen to them are blinded by an ideology that trivializes fraud, proclaims free markets as the panacea, and sees regulation as the bogeyman. Greenspan's "shock" that companies took advantage when they were handed the opportunity to do so may appear disingenuous, but it also stems from the refusal to acknowledge that these business contexts constituted what criminologists have for some time noted as "crime-facilitative environments"[98] where white-collar offending can flourish. Economists generally are either unaware or disdainful of the perspectives from other disciplines, and often show contempt for government interventions into

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93 Pontell, Henry N. *A Capacity to Punish: The Ecology of Crime and Punishment.* Bloomington: Indiana University Press, 1984.

94 Black, William K., Kitty Calavita and Henry N. Pontell. "The savings and loan debacle of the 1980's: White-collar crime or risky business? *Law and Policy*, 17:1 (January 1995): 23-55.

95 Black, 2008, *op. cit.*

96 Ibid.

97 Lichtblau, Eric, David Johnston and Ron Nixon. "FBI struggles to handle financial fraud cases." *The New York Times*, Oct.19, 2008. p. A1.

98 Needleman, Martin L. and Carolyn Needleman. Organizational crime: Two models of criminogenesis. *The Sociological Quarterly*, 20:4 (Autumn, 1979):517-528.

the marketplace. They have thus managed to trivialize the matter of fraud in formulating policies that govern banking and finance.

Neo-classical economists and those in key policy positions who subscribe to their models have refused to acknowledge fraud as an active element in creating, sustaining, and accelerating market bubbles. They need to make a major initial intellectual leap to identify market bubbles as *real phenomena* in the first place. In 2004, Greenspan dismissed the idea of a housing bubble, and in 2005, current Fed chair Ben Bernanke claimed that home-price increases "largely reflect strong economic fundamentals."[99] The general disbelief in bubbles is not only based on faulty analysis, or, at the extreme, sheer ideology, but is now clearly demonstrated to have disastrous policy consequences. As Krugman[100] has noted:

> What's striking, when you reread Greenspan's assurances, is that they weren't based on evidence – they were based on the a priori assertion that there simply can't be a bubble in housing. And the finance theorists were even more adamant on this point. In a 2007 interview, Eugene Fama, the father of the efficient-market hypothesis, declared that "the word 'bubble' drives me nuts," and went on to explain why we can trust the housing market: "Housing markets are less liquid, but people are very careful when they buy houses. It's typically the biggest investment they're going to make, so they look around very carefully and they compare prices. The bidding process is very detailed…" [T]his says nothing about whether the overall price of the house is justified.

Studies based upon limited definitions and conceptualizations, and/or necessarily incomplete official data taken at face value trivialize the nature, extent, and damage caused by white-collar and corporate crime. The results of this neglect not only appear regularly in terms of increasingly costly white-collar and corporate lawbreaking, but wreak massive social destruction and loss – now to an interdependent global economy -- when unrecognized endemic waves of fraud precede major financial debacles.

[99] Krugman, 2009, *op. cit.*, p. 38.
[100] Ibid.