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The Financial Crisis: Why Won't We Use the F-(raud) Word?

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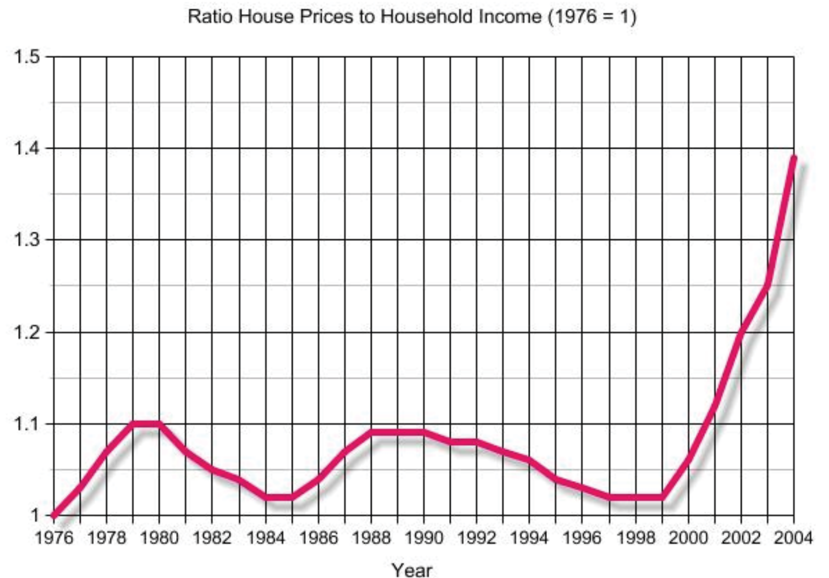
IN THE LATE 1980S AND EARLY 1990S many parts of the United States experienced a housing bubble followed by a bust. The history of the bubble as manifested in southern California is cataloged in "History of a Housing Bubble,"[1] where newspaper headlines change from "Housing Sales Boom Keeps Inventories Slim" in 1986 to "County's New Home Sales Plunge 42 Percent in Quarter" in 1991. In the mid 2000s another housing bubble occurred in many parts of the United States and the bursting of that bubble, beginning approximately in 2007, precipitated a global financial crisis (GFC).

The Joint Risk Management Section[2] (JRMS) also sponsored a research project "The Financial Crisis and Lessons Learned for Insurers."[3] The project placed primary blame on the key assumption utilized both by modelers and the banks when they assessed and priced the massive risk that caused the crisis. That assumption was that housing prices never go down. "This optimistic belief was shared by policymakers, economists, and market participants in general, permeated the models used by rating agencies to assign inflated ratings to securities built from subprime mortgages, and was reinforced, for a time, in market prices through a self-fulfilling prophecy."[4] What is most stunning about this assumption is that it refutes the actual lived experience of many people, i.e., the housing bubble and bust in the late '80s and early '90s. In addition, publically available statistics could readily have been used to carefully assess the critical assumptions about housing prices. An example displaying housing prices relative to median household income is shown in Chart 1.

Chart 1: Ratio of House Price to Household Income[5]



Lewis[6] makes clear that some investment professionals were stunned at the impropriety of the assumption and believed that at least some of the principals involved knew or suspected that a bubble was underway and that mortgage-related assets were overpriced. The widespread use of inappropriate assumptions invites an examination of the behavior of individual actors in the GFC. Numerous authors have implicated incentive compensation and moral hazard as playing a key role in the GFC. For instance the publication *Risk Management: Current Financial Crisis, Lessons Learned and Future Implications* sponsored by the JRMS presented the views of 35 authors about the roots of the GFC. Some of the causes cited by authors included:

- moral hazard resulting from transferring risk to others, through securitization, leading to a complete failure to underwrite and manage the risks
- compensation incentives that encouraged taking on imprudent risk exposures
- systemic failure of regulatory system
- lack of confidence resulting from accounting opacity and gimmickry
- a bubble of historic proportions that could have been predicted from information available to bank managers and regulators at the time
- inappropriate use of models without consideration of their limitations and without scrutinizing their assumptions for reasonableness

The items on this list are suggestive of significant lapses in good management (accompanied by accommodative lapses in good regulation), if not outright fraud. Compared to past financial debacles, such as the S&L crisis and the Enron bankruptcy, the role of fraud in the GFC seems not to have received much

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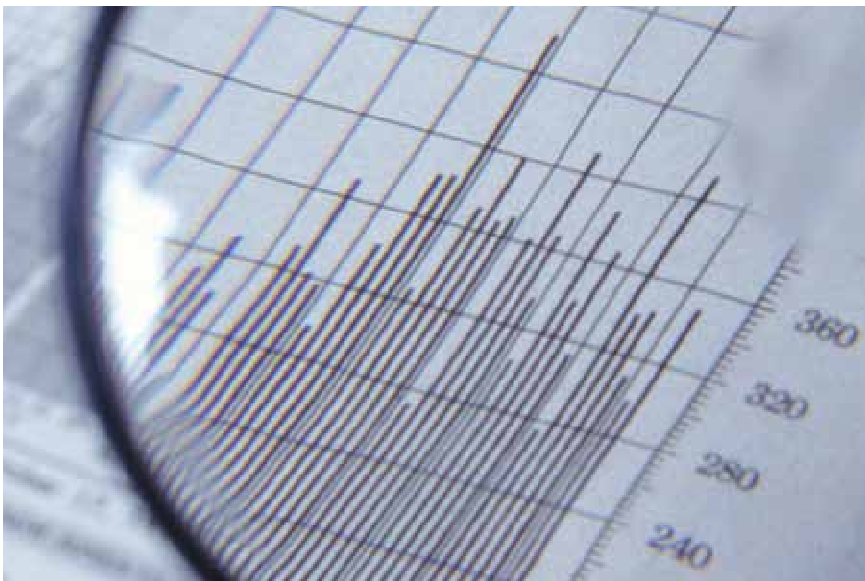
scrutiny. Even in Senate hearings that were highly critical of some of the large investment firms' behavior, there seems to have been an unwillingness to use the F-(raud) word[7].

A former regulator (during the S&L crisis) William Black[8] has been very outspoken about the role of fraud in the GFC. A brief list of some of the evidence of fraud is:

- The regulator of Long Beach (a WaMu subsidiary) found it to be one of the 13 worst institutions in 1997 through 2003[9]. In 2003, the company had so much trouble that WaMu temporarily stopped securitizations from it. However, operations were soon resumed, and Long Beach was to cost WaMu many billions of dollars in losses.
- Lewis documented that the rating agencies performed a minimal analysis of the mortgage securities underlying the pools they rated and refused to develop detailed databases that could have been used for a rigorous evaluation of mortgage loan portfolios.
- Levin and Black[10] cite a memo of S&P management to their employees demanding that they not request loan level data from the companies. Black accuses the rating agencies, as well as the managements of companies that securitized the loans of having a "don't ask, don't tell" policy that limited their exposure to negative data and information that would contradict the high-quality ratings that were assigned.
- Lewis describes how the investment banks devised strategies to convince the credit rating agencies to assign A or better ratings to subprime pools that did not merit the high ratings. These securities could then be packaged and sold to pension funds and ordinary investors as high-quality fixed investment products.
- Black (2010) refers to certain kinds of mortgages, such as those dubbed by the industry as "liar loans," as negative expected value products. That is, the product is structured so as to create adverse selection that guarantees a loss.
- The investigative journalism organization ProPublica[11] published a report describing how a hedge fund named Magnitar colluded with brokers and investment banks to select some of the most toxic securities to be included in Collateralized Debt Obligations that they then bet against using credit default swaps (CDSs). Their investigation indicated that the Magnitar deals helped to keep the bubble going for an extra two years.



Many Americans have been angered at the extravagant compensation reaped by the managements of the firms that caused the crisis. Prins[12] reported that the CEOs of three firms that experienced subprime related problems, Countrywide, Merrill Lynch and Citigroup, earned a total of $460 million between 2002 and 2006.

A key environmental condition necessary for financial fraud to become widespread is toleration on the part of legislators and regulators. Markopolis[13] observed that a revolving door exists between the SEC and Wall Street, with inexperienced employees expecting to spend a few years as regulators followed by a move to much more lucrative jobs on Wall Street with the firms they were regulating. Black notes that for the past couple of decades federal regulators have been hostile to enforcement of anti-fraud regulations. He notes that the regulators believe that fraud regulation is unnecessary as the market will ultimately correct such abuses, despite abundant evidence from such debacles as the S&L crisis, Enron and other early 2000s frauds, as well a the

recent Madoff Ponzi scheme, that refutes this belief. The anti-regulatory ideology is responsible for some of the legislation that fostered the GFC, such as the elimination of Glass-Stiegel and the passage of the Commodities Futures Modernization Act (that prohibited regulating derivatives such as CDSs).

William Black is one of only a very few academics in calling for routine monitoring for fraud and suggests that the SEC needs a "chief criminologist." He points out the SEC is a law enforcement agency, but it is predominantly staffed with lawyers and economists with little expertise in fraud. It therefore needs staff with the experience, expertise and desire to pursue fraud (which will require eliminating the revolving door). He believes that the task of detecting fraud is relatively simple, as "red flag" indicators of fraud are well known and the information required is relatively easy to gather and review.

The Financial Reform bill of 2010 creates new systemic risk regulation. The systemic risk regulator is empowered to collect data, recommend new regulations and intervene when a company is considered to pose a risk. However, much of the new regulatory authority is invested with the Federal Reserve, an organization that some believe enabled the GFC and repeatedly refused to intervene. As Black pointed out, the Fed has the power to intervene in the subprime crisis but chose not to. It knew of deceptive accounting manipulations perpetrated by Lehman[14], but chose not to make them change their published financials. Its previous chair Alan Greenspan bluntly told another regulator, Brooksly Bourne[15], that he does not believe in pursuing and prosecuting fraud. Such a fraud friendly environment is bound to enable and even promote fraud. Thus, the author feels that the recently passed financial reforms may be ineffective in addressing a key factor in the GFC: fraud.

Regulators must search for and prosecute fraud. Increasing the emphasis on enforcement and on detecting fraud before it creates a system-wide crisis can be accomplished without any new legislation, though legislative changes in the late 1990s and early 2000s appear to have removed some barriers to fraud. The author of this essay suggests that if fraud is not addressed, future crises, perhaps even worse ones, will occur. ■

END NOTES:

[1] *http://rntl.net/history_of_a_housing_bubble.htm*

[2] a collaboration of the Society of Actuaries, Casualty Actuarial Society and Canadian Institute of Actuaries

[3] Klein R., Ma G., Ulm E., Wei X. and Zanjani G., "The Financial Crisis, Lessons Learned for Insurers", 2009, *http://www.soa.org/research/research-projects/finance-investment/research-fin-crisis.aspx*

[4] ibid., Klein et al, 2009, Executive Summary

[5] Graph from *http://photos1.blogger.com/photoInclude/img/243/2888/640/Ratio.jpg*

[6] Lewis, Michael, *The Big Short*, 2010.

[7] Levin, Statement to Senate Permanent Committee on Investigations, April, 2010

[8] Black is author of the book *The Best Way to Rob a Bank is to Own One*, that describes his experience with fraud during the S&L crisis, and lessons that should have been learned from it

[9] Levin, 2010

[10] Black, William, interview by Bill Moyers, Bill Moyers Journal, April 23, 2010, Black William, "Epidemics of Control Frauds Lead to Intensifying Financial Crises", 2010, *www.ssrn.com*

[11] Eisenger and Berstein, "The Magnitar Trade: How One Hedge Fund Keptthe Bubble Going", *www.propublica.org*, April, 2010.

[12] Prins, N, It Takes a Pillage, 2009.

[13] Markopolis, H. *No One Would Listen*, 2010.

[14] Valukas, Anton, "Report of the Anton R Velukas, Examiner", United States Bankruptcy Court, March, 2010

[15] Zacchino, N and Scheer, R, "The Woman Who Blew the Whistle on Wall Street", Ms Magazine Fall 2009