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Statement by

William K. Black

Associate Professor of Economics and Law, University of Missouri – Kansas City

before the

Committee on Financial Services

United States House of Representatives

regarding

**"Public Policy Issues Raised by the Report of the
Lehman Bankruptcy Examiner"**

April 20, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for your invitation to discuss public policy issues arising from Lehman's failure. I will address the six issues you asked that I comment on in your letter of invitation.

1. The extent to which corporate governance should be enhanced to appropriately manage firm risk. Please share your views regarding the communication, knowledge and understanding among risk managers, Boards of Directors and senior management.
2. The role of the SEC as Lehman's primary regulator in oversight, examination and enforcement in advance of Lehman's bankruptcy filing, and the role of the other government agencies, including the Federal Reserve Bank of New York (FRBNY), that were monitoring Lehman during the crisis.
3. The relationship and means of communication, especially formal and informal information sharing, between the SEC and FRBNY as Lehman's financial condition deteriorated as well as between Lehman, the SEC, the Treasury Department, the Board of Governors Federal Reserve, and the FRBNY.
4. Please reflect on the appropriateness of accounting practices such as Repo 105 or 108 and the adequacy of the disclosure of such accounting practices.
5. The quality of Lehman's Management Discussion and Analysis disclosures in its public filings for the 2007 reporting periods.
6. Other issues that you deem relevant to the public policy issues raised by the Lehman Report.

I begin with a short description of my background that is relevant to your questions. My primary appointment is in economics. I have a joint appointment in law. I am a white-collar criminologist. My research specialization is financial fraud by elites and financial regulation. I was a senior regulator during the S&L debacle (and had the honor of testifying many times before this Committee). As a regulator, I was:

- The Litigation Director of the Federal Home Loan Bank Board (Bank Board). We had independent litigation authority – we were not represented by the Justice Department.
- The Deputy Director of the Federal Savings and Loan Insurance Corporation (FSLIC)
- The staff leader of the reregulation of the S&L industry in 1984-1987

- The Senior Vice President and General Counsel of the Federal Home Loan Bank of San Francisco (FHLBSF)
- The Senior Deputy Chief Counsel for Enforcement and Litigation (West Region) of the Office of Thrift Supervision (OTS)
- The Deputy Staff Director of the National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE)

Several aspects of this background may be of particular use to the Committee.

1. The Bank Board was both a safety and soundness regulator and a securities regulator for publicly traded savings & loan holding companies. We were vigorous in bringing actions against those that abused the accounting rules.
2. I worked extensively, and cooperatively, with many other regulatory agencies.
3. The Federal Home Loan Banks (before the passage of FIRREA in 1989), were similar to the Federal Reserve Banks. The FHLBs had boards of directors dominated by industry members and had both a lending function and a regulatory function. We used the information gained through, and the leverage inherent in, the FHLBSF's lending activities to aid our, and our sister agencies', supervisory effectiveness.
4. We always made extensive referrals to the SEC, the FBI, and the Department of Justice when we found evidence of unsafe and unsound practices or violations of law. I was one of the officials charged with making sure that these referrals became far more effective. One result was that the government obtained over 1000 priority felony convictions of S&L insiders and those that aided and abetted their frauds.
5. In late 1983, the agency recognized that the S&L crisis, which began as an interest rate risk crisis was entering a new phase in which elite frauds were the dominant problem. The agency realized that the frauds would defeat any regulatory approach based on standard operating procedures (SOP). Instead, the agency went to an emergency footing in which, for example, it took over 20 percent of the entire national examination force and sent it to the region (Dallas) where the frauds posed the greatest danger to the public.
6. Bank Board Chairman Gray, over the intense opposition of the administration, the industry, Speaker Wright, a majority of the Members of the House, the "Keating Five", and the financial press, proceeded to reregulate the industry. The administration was so outraged that OMB threatened to file a criminal referral against Chairman Gray – on the grounds that he was closing too many insolvent S&Ls. Because I was the staff leader of this reregulation, Speaker Wright tried to get me fired by Gray's successor, Chairman Wall. (The Speaker succeeded in getting Wall to fire our top supervisor in Texas.)

Charles Keating was so threatened by reregulation that he directed his chief political fixer that his “Highest Priority” was to “Get Black ... Kill him Dead.” Keating hired private detectives twice to investigate me and filed a \$400 million *Bivens* action against me and other regulators in our personal capacity. But we stayed the course.

The Members of the Committee know that the practices I have just described contrast sharply with the manner in which the federal officials behaved with regard to Lehman, as documented in the Valukas Report. The Senate Banking investigation of WaMu and the Treasury IG investigation of its regulators reveal equally distressing disregard for the public interest and the regulators’ oaths of office.

1. The extent to which corporate governance should be enhanced to appropriately manage firm risk. Please share your views regarding the communication, knowledge and understanding among risk managers, Boards of Directors and senior management.

The Report documents at least three major deficiencies in Lehman’s corporate governance that need to be addressed globally. First, it points out that Lehman, and many other Delaware corporations, have eliminated the fiduciary duty of “care.” This statutory change is the product of a naïve “law and economics” theory of corporate law that I addressed in an article (Black 2003). Judge Easterbrook and Professor Fischel are the leading proponent of the theory. They view managers as so pure that “a rule against fraud is not an essential or even necessarily an important ingredient of securities markets” (1991: 283). Alan Greenspan has admitted that he had a similar view and that events have falsified this naïve account. It is insane to withdraw accountability for negligence. Doing so encourages negligence. Congress should mandate that corporate officers and directors be subject to the fiduciary duties of care and loyalty. They will still, of course, have the very substantial protection of the business judgment rule.

Second, there same individual should not serve as the CEO and Chair of the Board of Directors of a large corporation. The imperial CEO is a consistent problem in this and prior crises.

Third, Lehman ignored its stated risk “limits” and simply increased its limits retroactively to accommodate its violations of its risk limits. In plain English, that means it had no meaningful limits. Systemically dangerous institutions (SDIs) (aka “too big to fail”) should be required to have, and comply with, prudent risk limits.

I have a different view than Mr. Valukas about the overall state of Lehman’s corporate governance. First, Lehman’s nominal corporate governance structure was a sham. Lehman was deliberately out of control with regard to “risk” in its dominant operation – making “liar’s loans.” Lehman did not “manage” the risk of making liar’s loans. It engaged in massive, fraudulent transactions that were “sure things” (Akerlof & Romer 1993). The Valukas Report bears witness to the consequences of these transactions. The Report provides further evidence of the accuracy of Akerlof’s and Romer’s famous article – “Looting: Bankruptcy for Profit.” George Akerlof is

a Nobel Laureate in Economics (2001) and Paul Romer is a Professor of Economics at Stanford, so their work is an important component of modern economic understanding of the elite frauds that can cause economic crises. The “looting” that Akerlof & Romer identified is a “sure thing” in both directions – firms that loot through accounting scams will report superb (fictional) income in the short-term and catastrophic losses in the long-term. (The title of my book reflects the same concept – *The Best Way to Rob a Bank is to Own One.*)

Akerlof & Romer’s insights were based in part on research by S&L regulators. Their insights have been confirmed by white-collar criminologists. Lehman was a “control fraud.” That is a criminology term that refers to situation in which the persons controlling a seemingly legitimate entity use it as a “weapon” (Wheeler & Rothman 1982) of fraud (Black 2005). Financial control frauds’ “weapon of choice” for looting is accounting.

Lehman’s principal source of (fictional) income and real losses was making (and selling) what the trade accurately called “liar’s loans” through its subsidiary, Aurora. (The bland euphemism for liar’s loans was “Alt-A.”) Liar’s loans are “criminogenic” (they create epidemics of mortgage fraud) because they create strong incentives to provide false information on loan applications. The FBI began warning publicly about the epidemic of mortgage fraud in 2004 (CNN). Liar’s loans also produce intense “adverse selection” – even the borrowers who are not fraudulent will tend to be the least creditworthy. The combination of these two perverse incentives means that liar’s loans, in economics jargon, have a deeply “negative expected value” to the lender. In English, that means that the average dollar lent on a liar’s loan creates a loss ranging from 50 – 85 cents.

The value of Lehman's Alt-A mortgage holdings fell 60 percent during the past six months to \$5.9 billion, the firm reported last week.¹

Gambling against the casino creates a negative expected value, but making liar’s loans creates inevitable, catastrophic losses.

That loss, however, may not be recognized for many years – particularly if the liar’s loans become so large that they help hyper-inflate a financial bubble. In the near-term, making massive amounts of liar’s losses loans creates a mathematical guarantee of producing record (albeit fictional) accounting income. (As long as the bubble inflates, the liar’s loans can be refinanced – creating additional fictional income and delaying (but increasing) the eventual loss. The industry saying for this during the S&L debacle was: “a rolling loan gathers no loss.”

Lehman’s underlying problem that doomed it was that it was insolvent because it made so many bad loans and investments. It hid its insolvency through the traditional means – it refused to

¹ http://www.denverpost.com/headlines/ci_10473057 “Local Lehman arm led in Alt-A loans.” **By Greg Griffin** *The Denver Post*. Posted: 09/16/2008 12:30:00 AM MDT

recognize its losses honestly. It could not resolve its liquidity crisis because it was insolvent and its primary source of fictional accounting income collapsed with the collapse of the secondary market in nonprime loans. If Lehman sold its assets to get cash it would have to recognize these massive losses and report that it was insolvent. Investors knew that Lehman was grossly inflating its asset values, so they were generally unwilling buy stock in Lehman or acquire it.

There is no way to “manage” the “risk” of making massive amounts of liar’s loans. Lehman was the world leader in making liar’s loans. As the name makes clear, Lehman’s top managers knew that their principal source of income was making fraudulent loans. It was necessary, therefore, that Lehman not document that its liar’s loans were frequently fraudulent. Lehman, instead, classified its massively fraudulent liar’s loans as “prime” loans. Its disclosures did not identify how many of the “prime” loans it held were actually liar’s loans. As I will discuss in more detail in response to your final question, Lehman personnel that pointed out the fraudulent liar’s loans were attacked, even fired, by Lehman’s management. Honest managers, of course, would be delighted if employees identified frauds.

That same pattern of conscious managerial indifference to pervasive mortgage and accounting fraud was the norm at other nonprime mortgage participants that have been investigated. I refer to it as the financial “don’t ask; don’t tell” policy. Here is a classic example from Standard & Poors. The context is that the professional credit rating specialist has asked his boss for a copy of the “tapes” which contain the nonprime loan files that are the “underlying” backing a collateralized debt obligation (CDO). The professional plans to review a sample of the lender’s loan files so that he can evaluate their credit quality. Here is the response he receives (the punctuation is from the original).

Any request for loan level tapes is **TOTALLY UNREASONABLE!!!** Most investors don't have it and can't provide it. [W]e **MUST** produce a credit estimate. It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.²

Making liar’s loans is not risky – it is suicidal. That is why every significant lender specializing in liar’s loans failed. The pervasive fraud cannot be admitted – for Lehman’s entire business model was premised on massive sales of liar’s loans to others. If Lehman admitted that its liar’s loans were often fraudulent it could not sell them – cutting off one of its largest sources of income. Worse, it would be stuck with a portfolio full of fraudulent loans and have to recognize (or hide through further accounting fraud) that it was insolvent. Worse still, if it admitted its liar’s loans were often fraudulent it would risk having to repay past purchasers of its liar’s loans and risk SEC suits and criminal prosecutions. This is why “risk management” is always a sham at firms holding liar’s loans. Risk management is premised on honest operations, honest data,

² [E-mail from Frank Raiter to Richard Gugliada et al., March 20, 2001](http://oversight.house.gov/story.asp?ID=2250) <http://oversight.house.gov/story.asp?ID=2250>

and honest managers. Honesty is fatal to entities making, or purchasing, large amounts of liar's loans.

Second, the right "tone at the top" is essential to effective corporate governance. Lehman's managers too often created an unethical tone. The Valukas Report contains an example of this problem. When SVP Lee blew the whistle on accounting abuses, as he was required to do under Lehman's employee policies, management responded by firing him.

Lehman is alleged to have treated another whistleblower in a similar fashion.

The HR lady pulled Michael Walker into a room and told him he was fired. The reason: Talking to the FBI. It was a violation of the company's privacy policy. "I was stunned," Walker told me. "I couldn't believe it. But that's what she said." Walker, a "high-risk specialist," was then walked out of the building as if he were the risk. His job at Aurora Loan Services LLC, Littleton, Colo., ended on Sept. 4, 2008.

Aurora was a subsidiary of Lehman Brothers, the big, failing Wall Street investment bank that didn't get a bailout. A week after Walker was fired, Lehman filed history's biggest bankruptcy.

His job was to uncover mortgage fraud. But he claims he was fired for doing it. In a lawsuit recently filed in Denver District Court, he claims Lehman's mortgage subsidiary wanted to remain profitably unaware of fraud.

Aurora made its loans through independent mortgage brokers, who often didn't have to meet any criteria to be brokers, not even criminal background checks in some cases. Inevitably, some percentage of the mortgage applications they took would be laced with fraud. But like everyone else, they got paid by loan volume, not by loan quality.

Consequently, Walker and his fraud-seeking colleagues were always busy. "They just absolutely flooded us with work," he said. "There was no way we could possibly keep up with it. And that's what they wanted.

"They were putting the loans into an investment trust," he explained. "When they became aware of fraud, they had to buy those loans back out of the trust. So it ended up costing them money."

What were the chances that Bob's Fly-By-Night Mortgage Co. Would be able to return the funds it got from Aurora? What were the chances that the losses could be recovered through foreclosure? Better to let it ride.

But Walker couldn't play this game. A "Suspicious Activity Report" that he filed in 2006 led to interviews with the FBI and the IRS in 2008, and then ultimately to his bizarre dismissal.³

Walker endangered the fraud scheme that lay at the heart of Lehman's (fictional) profitability because he violated the "don't ask; don't tell" rule and brought the FBI to Aurora's offices. Control fraud turns everything that is normally good about private markets perverse. It creates a "Gresham's dynamic" in which bad ethics drives good ethics from the marketplace.

The Walker case is stunning, but it is important to step back and see the contours of the forest. Any firm that specializes in making liar's loans that it purchases from others (who are paid on the basis of volume and conducted no meaningful underwriting prior to lending) and sells to others without any meaningful underwriting will have a pervasive corrupt tone.

Lehman's senior managers consciously chose to take the unethical path because they viewed it as extraordinarily profitable.

Mr. Hibbert was a vice-president at Lehman Brothers and he'd been sent to meet First Alliance founder Brian Chisick to see if Lehman could form some kind of relationship with the mortgage lender.

"This is a weird place," he wrote later in an internal memo. While he noted the company's "efficient use of their tools to create their own niche," he also pointed out that "there is something really unethical about the type of business in which [First Alliance] is engaged."

Mr. Chisick had become one of the biggest players in subprime loans. First Alliance's annual revenue had doubled in four years to nearly \$60-million (U.S.) and its profit had increased threefold to \$30-million.

In his detailed report, he described the marketing operation as a "work of art" and marvelled at the profit margin, cash flow, collection practices and growth prospects of First Alliance.

But Mr. Hibbert also had some concerns. The company targeted too many elderly customers; he had seen several 30-year loans given to people in their 70s. "It is a sweat shop," he wrote. "High pressure sales for people who are in a weak state." First Alliance is "the used car salesperson of [subprime] lending. It is a requirement to leave your ethics at the door. ... So far there has been little official intervention into this market sector, but if one firm was to be singled out for governmental action, this may be it."

³ <http://www.foxbusiness.com/story/markets/al-lewis-privacy-policy-hides-mortgage-fraud/> (December 31, 2009).

Despite the warning, Lehman officials recommended a \$100-million loan facility for First Alliance. Mr. Chisick turned it down, but he agreed to take a \$25-million line of credit and hire Lehman to work with Prudential on several securitizations.

First Alliance was now set. It went public a year later on Nasdaq at \$17 a share, with Mr. Chisick keeping 75-per-cent control. The stock hit \$27 by year end and peaked at \$36.25 shortly afterward. Mr. Chisick opened two dozen offices across the U.S., and made other expansion plans. By 1997, First Alliance was on track to arrange more than \$500-million worth of loans, up from \$324-million a year earlier.

At this juncture, various state Attorneys General began to sue First Alliance for consumer fraud. Prudential terminated its ties with the lender.

But Lehman jumped at the opportunity to move in. Senior vice-president Frank Gihool asked Mr. Hibbert to pull together a review of First Alliance for Lehman's credit risk management team. Mr. Hibbert once again marvelled at the company's operations and financial outlook. But he also said the lawsuits posed a serious problem. The allegation about deceptive practices "is now more than a legal one, it has become political, with public relations headaches to come," he wrote.

Nonetheless, on Feb. 11, 1999, Lehman approved a \$150-million line of credit, and became the company's sole manager of asset-backed securities offerings. The bottom line for Lehman was made clear in another internal report: The firm expected to earn at least \$4.5-million in fees.

But within a year, the weight of the lawsuits crippled First Alliance. On March 23, 2000, the company filed for bankruptcy protection. Mr. Chisick managed to walk away with more than \$100-million in total compensation and stock sales over four years. Lehman, owed \$77-million, collected the full amount, plus interest.

First Alliance eventually settled the lawsuits filed by the state attorneys, agreeing to pay \$60-million. In the California class-action case, a jury found Lehman partially responsible for First Alliance's conduct and ordered the firm to pay roughly \$5-million.

Lehman acquired Aurora to be its liar's loan specialist. Aurora, which was inherently in the business of buying and selling often fraudulent loans, set its ethical tone at subterranean levels.

Mark Golan was getting frustrated as he met with a group of auditors from Lehman Brothers.

It was spring, 2006, and Mr. Golan was a manager at Colorado-based Aurora Loan Service LLC, which specialized in "Alt A" loans, considered a step above subprime lending. Aurora had become one of the largest players in that market, originating \$25-billion worth of loans in 2006. It was also the biggest supplier of loans to Lehman for securitization.

Lehman had acquired a stake in Aurora in 1998 and had taken control in 2003. By May, 2006, some people inside Lehman were becoming worried about Aurora's lending practices. The mortgage industry was facing scrutiny about billions of dollars worth of Alt-A mortgages, also known as “liar loans” – because they were given to people with little or no documentation. In some cases, borrowers demonstrated nothing more than “pride of ownership” to get a mortgage.

That spring, according to court filings, a group of internal Lehman auditors analyzed some Aurora loans and discovered that up to half contained material misrepresentations. But the mortgage market was growing too fast and Lehman's appetite for loans was insatiable. Mr. Golan stormed out of the meeting, allegedly yelling at the lead auditor: “Your people find too much fraud.”

Lehman senior management, however, responded to problems of fraud and unethical behaviour by cranking up the volume of liar’s loans by Aurora and BNC Mortgage (which specialized in subprime loans).

Lehman had become the only vertically integrated player in the industry, doing everything from making loans to securitizing them for sale to investors.

Lehman was a dominant player on all sides of the business. Through its subsidiaries – Aurora, BNC Mortgage LLC and Finance America – it was one of the 10 largest mortgage lenders in the U.S. The subsidiaries fed nearly all their loans to Lehman, making it one of the largest issuers of mortgage-backed securities. In 2007, Lehman securitized more than \$100-billion worth of residential mortgages.

These demands posed a much larger problem: contagion. Because these CDOs were thinly traded, many of them did not yet reflect the loss in value implied by their crumbling mortgage holdings. If Bear Stearns or its lenders began auctioning these CDOs off, and nobody wanted to buy them, prices would plummet, requiring all banks with mortgage exposure to begin adjusting their books with massive writedowns.

Lehman, despite its huge mortgage exposure, appeared less scathed than some. Mr. Fuld was awarded \$35-million in total compensation at the end of the year.

<http://www.theglobeandmail.com/report-on-business/article703526.ece>

Volume of liar’s loans and subprime was everything – as long as Lehman could sell the liar’s loans to other parties. Volume created immense real losses, but it also maximized Mr. Fuld’s compensation.

Aurora was originating more than \$3 billion a month of such loans in the first half of 2007.

Lehman's real estate businesses helped sales in the capital markets unit jump 56 percent from 2004 to 2006, faster than from investment banking or asset management, the company said in a filing. Lehman reported record earnings in 2005, 2006 and 2007.

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVZKah.at5fY>

September 15, 2008

2. The role of the SEC as Lehman's primary regulator in oversight, examination and enforcement in advance of Lehman's bankruptcy filing, and the role of the other government agencies, including the Federal Reserve Bank of New York (FRBNY), that were monitoring Lehman during the crisis.

The Consolidated Supervised Entities (CSE) program never made the SEC a real "primary regulator." The SEC is incapable, as constituted, staffed, and led to be a primary regulator of anything – and that includes the rating agencies. "Safety and soundness" regulation is a completely different concept than a "disclosure" regime. The SEC's expertise, which it has allowed to rust away for a decade, is in enforcing disclosure requirements. The SEC did not have the mindset, rules, or appropriate personnel to make the CSE program a success even if the agency had been a "junk yard dog." Given the fact that the SEC was self-neutered by its leadership during the period Lehman was in crisis in 2001-2008, there was no chance that it would succeed. Its only hope was to form an effective partnership with the Fed. The Fed had unique authority under the Home Ownership and Equity Protection Act of 1994 (HOEPA) to regulate all mortgage lenders and had unprecedented practical leverage during the crisis because of its ability to lend and convert investment banks to commercial bank holding companies. The Fed is supposed to be an experienced "safety and soundness" regulator (though I will express doubts that it is effective). An SEC/Fed partnership would at least have some chance. The Valukas report reveals that the FRBNY staff at Lehman recognized that the SEC staff at Lehman's offices were not capable of understanding its financial condition.

One approach that other nations use is to combine the securities and financial regulation functions in a single Financial Services Agency (FSA).

3. The relationship and means of communication, especially formal and informal information sharing, between the SEC and FRBNY as Lehman's financial condition deteriorated as well as between Lehman, the SEC, the Treasury Department, the Board of Governors Federal Reserve, and the FRBNY.

It was a painful, as a former regulator, to read the Valukas report's discussion of the FRBNY staff's open disdain for working cooperatively with the SEC to protect the public. The Valukas

report exposes the sick relationship between the country's main regulatory bodies and the systemically dangerous institutions (SDIs) they are supposed to be policing. The FRBNY, led by President Geithner, had a clear statutory mission -- promote the safety and soundness of the banking system and compliance with the law – stood by while Lehman deceived the public through a scheme that FRBNY officials likened to a “three card monte routine” (p. 1470).

The FRBNY discounted the value of Lehman’s pool to account for these collateral transfers. However, the FRBNY did not request that Lehman exclude this collateral from its reported

liquidity pool. In the words of one of the FRBNY’s on-site monitors: “how Lehman reports its

liquidity is between Lehman, the SEC, and the world” (p. 1472).

Translation: The FRBNY knew that Lehman was engaged in fraud designed to overstate its liquidity and, therefore, was unwilling to loan as much money to Lehman. The FRBNY did not, however, inform the SEC, the public, or the OTS (which regulated an S&L that Lehman owned) of the fraud. The Fed official doesn’t even make a pretense that the Fed believes it is supposed to protect the public. The FRBNY remained willing to lend to a fraudulent systemically dangerous institution (SDI). This is an egregious violation of the public trust, and the regulatory perpetrators must be held accountable. The Fed wanted to maintain a fiction that toxic mortgage product were simply misunderstood assets, so it allowed Lehman to keep dealing the three card monte scam. We now know from Valukas and from former Treasury Secretary Paulson that the Treasury and the Fed knew that Lehman was massively overstating its on-book asset values: “According to Paulson, Lehman had liquidity problems and no hard assets against which to lend” (p. 1530). We know from Valukas’ interview of Geithner (p. 1502):

The challenge for the Government, and for troubled firms like Lehman, was to reduce risk exposure, and the act of reducing risk by selling assets could result in “collateral damage” by demonstrating weakness and exposing “air” in the marks.

Or, in plain English, the Fed didn’t want Lehman and other SDIs to sell their toxic assets because the sales prices would reveal that the values Lehman (and all the other SDIs) placed on their toxic assets (the “marks”) were inflated with worthless hot air. Lehman claimed its toxic assets were worth “par” (no losses) (p. 1159), but Citicorp called them “bottom of the barrel” and “junk” (p. 1218). JPMorgan concluded: “the emperor had no clothes” (p. 1140). The FRBNY acted shamefully in covering up Lehman’s inflated asset values and liquidity. It constructed three, progressively weaker, stress tests – Lehman failed even the weakest test. The FRBNY then allowed Lehman to administer its own stress test. Surprise, it passed.

The Fed's defense of its disgraceful refusal to protect the public is meritless. It argues that it was not there in its regulatory capacity and that it sent only a few staffers that lacked the capacity or the leverage to accomplish any supervisory goals. This is either a deliberate obfuscation or a confession of a core failure. As Senior Vice President and General Counsel of the FHLBSF I was always a regulator – even when I was providing involved in credit-side activities. As a lender, the FHLBSF often learned material information about the institutions we regulated because we engaged in effective underwriting of asset quality. My predecessor famously used the leverage of the FHLBSF as lender of last resort for the largest S&L in America, which was in a liquidity crisis, to force out the fraudulent CEO controlling the institution and to enter into a broad array of steps that greatly reduced the institution's risk exposure and frauds. At its peak, we had roughly 50 FHLBSF credit personnel resident at the S&L. The fact that the FRBNY, which had far more resources than the FHLBSF, chose to send only a token crew to be on-site at a potential global catastrophe is a demonstration of failure, not a valid excuse for their failure to act to protect the public. The FRBNY has vastly greater leverage than the FHLBSF ever had and in the context of the Lehman crisis it had the leverage to force any change it believed was necessary, including an immediate conversion of Lehman to a bank holding company and a commercial bank.

The Fed has inherent problems even in safety & soundness regulation due to its structure. First, the regional FRBs have boards of directors dominated by the industry. Congress already made the policy decision, in removing all regulatory functions from the FHLBs in the 1989 FIRREA legislation, that this is an unacceptable conflict of interest.

Second, supervision is, at best, a tertiary activity at the Fed and regional banks. Monetary policy gets all the emphasis, the credit windows come second, and economic research and safety & soundness regulation vie for a distant third place. (Consumer regulation is a bastard step child at the Fed and most agencies.)

Third, the Fed is far too close to the systemically dangerous institutions. The SDIs are in an ideal position to exploit opportunities for regulatory “capture.”

Fourth, the Fed is dominated by neo-classical economists that have no theory of, experience with, or interest in the complex financial frauds that are the dominant cause of our recurring, intensifying financial crises. Bernanke appointed an economist, Patrick Parkinson, with no examination or supervision experience to head all Fed examination and supervision.

Fifth, the Fed is addicted to opaqueness and its senior ranks believe the bankers when they claim that the people must never be allowed to learn the truth about asset losses. One of the conflicts of interest that a banking regulator must never succumb to is the temptation to encourage or allow the regulated entity to lie about its financial condition for the purported purpose of preventing a run on the bank. Geithner, unfortunately, embraced that temptation and stated it

openly to the Bankruptcy Examiner. It is very easy, psychologically, to believe that you are letting a bank lie to the public for a noble reason – protecting the public. The bankers always tell the regulators that the world will end if the banks tell the truth – but that is a lie. Regulators’ greatest asset is their integrity. I was one of the four FHLBSF regulators that met with the “Keating Five.” To this day, I have no idea what political affiliations, if any, my three colleagues hold. We simply insisted on honest disclosures and we always made a referral to our agency to alert the SEC (and the FBI) to any efforts we found to use accounting to deceive the investors or the regulators.

4. Please reflect on the appropriateness of accounting practices such as Repo 105 or 108 and the adequacy of the disclosure of such accounting practices.

The reason accounting approaches are used to attempt to achieve GAAP treatments that are contrary to the true economic substance of the transaction is to deceive. There are no social benefits to such deception and there are enormous harms. At law, the element that distinguishes fraud from other forms of larceny is deceit. Fraudsters get the victim to trust them – then betray that trust in order to cheat them. This is why fraud is the most effective acid for destroying trust. We need trust in most areas of life, including economics and finance. When bankers no longer trust bankers, markets fail rather than “clear.” This can cause global contagion. The economic substance, in every case, of Lehman’s Repo transactions was a loan, not a true sale. The sole purpose of entering into the transactions was to attempt to achieve an accounting treatment directly contrary to the true nature of the transaction for the purpose of deceiving investors and regulators. If these transactions are not frauds, then accounting and accountancy have ceased to have any value or integrity. It is time for accountants, business people, and regulators to demand an end to the deliberate use of accounting to deceive.

5. The quality of Lehman’s Management Discussion and Analysis disclosures in its public filings for the 2007 reporting periods.

Wholly inadequate and deceptive, but may I respectfully suggest that the question needs to be broadened to prior years. Lehman, for example, lumped fraudulent liar’s loans in with prime loans and called them all “prime.” This is a disgrace and an attempt to deceive. Even after multiple warnings, including the FBI in 2004, about the “epidemic” of mortgage fraud and even after the rare serious internal review was made of Aurora’s liar’s loan portfolio was made and revealed endemic fraud, Lehman made no meaningful disclosure of the fraud or the fatal consequences of selling fraudulent loans to other parties as a business strategy.

6. Other issues that you deem relevant to the public policy issues raised by the Lehman Report.

Lehman was an international leader in making "Alt a" loans. The trade called alt a loans "liar's loans" for the very good reason that they are liar's loans. The failure of the SEC and Fed to deal

effectively with something the trade openly called fraudulent is astonishing. Wherever we have looked we find a staggering incidence of fraud in liar's loans (often 90%). Any lender that made large amounts of liar's loans was guaranteed in the short-term (and the intermediate term given the bubble that liar's loans and subprime caused to hyper-inflate) to report record (albeit fictional) profits. The bubble leads to "refis", which mask the true loss for several years. (They can even lead to "cash out" refis through a second or third liar's loan that makes the borrower deeply underwater on his mortgage but provides him with lots of cash).

We have known for centuries that underwriting home loans is essential to avoid "adverse selection." We have known for centuries that adverse selection (1) is "criminogenic" -- it can produce widespread fraud and (2) has a "negative expected value." To put that in English, it means that, on average, you lose money by making liar's loans. That loss is inherent -- it can be masked for a time by a rapidly inflating bubble (in which case, the loss grows greatly) and it may be passed to others -- but it is inescapable that someone will bear that loss (successful hedging, for example, simply shifts the loss to another victim). Both "principals" to the "alt a" loan generally suffer severe losses. The borrower is put into a home he cannot afford at a true market value that is significantly smaller than his mortgage. The lender (or whoever bears the loss when the loan defaults) loses. We need not have any sympathy for the fraudulent borrower, but it turns out that the fraudulent loan applications and appraisals were commonly prepared by the lender personnel or their agents. The unfaithful agents gain -- and their gains are large. The SEC's failure to take action against such blatant misrepresentations to shareholders was egregious.) Those purported profits led to very large bonuses (and stock appreciation) for Lehman's senior officers. Given Lehman's origination and sale of enormous amounts of liar's loans, I believe that the data would show that it was largely the fraudulent origination and sale of liar's loans (and mortgage paper backed by such loans) that made Lehman's officers exceptionally wealthy in 2003-2006.

Industry observers began to use the term "epidemic" to describe mortgage fraud as early as 2003. The FBI warned in Congressional testimony in 2004 of an "epidemic" of mortgage fraud. In 2005, observers released a report documenting widespread inflated appraisals. No honest secured lender would cause, or permit, widespread inflated appraisals, yet studies of appraisers demonstrate that the intimidation (and reprisals where intimidation failed) of appraisers grew sharply and became endemic after these warnings. The SEC took (1) no effective regulatory action against the securities firms it regulated that originated, sold, and purchased liar's loan product and (2) no effective action against firms that failed to disclose (1) the acute risk of failure that comes from originating, selling, or purchasing liar's loans or (2) the losses from making or purchasing liar's loans. (It may seem strange to talk of "risk" or "losses" from selling liar's loans, but such sales were typically made with "reps & warranties" and with "put" options where the purchaser had a right to demand that the seller repurchase bad loans. Contrary to the common refrain, the contracts were typically drawn to require that the sellers of nonprime mortgages retain some "skin in the game.")

The Fed deserves special criticism for its failure to respond to these warnings by taking any effective action to stop liar's loans. The Fed had unique authority under HOEPA to ban liar's

loans, which would have prevented the bubble from hyper-inflating and contained the rapidly growing epidemic of mortgage fraud. Most liar's loans were made by lenders that were not federally insured or regulated, so only the Fed had the power to crack down on all liar's loans. The Fed refused to use its authority under HOEPA (until mid-2008) -- a full year after the secondary market in nonprime loans collapsed. Seven years late and \$2.5 trillion short (roughly the amount of nonprime loans).

Criminologists refer to entities that spread fraud epidemics as "vectors" (continuing the public health metaphor, the anopheles mosquito is a "vector" that spreads malaria and can create epidemics). Lehman was one of the largest vectors that spread the fraud epidemic. We must not focus only on what bad assets it held in portfolio at a particular time. If Lehman, for example, had sold more of its "alt a" loans earlier its losses would, of course, have been reduced but system losses on liar's loans would be unchanged. If Lehman had sold large amounts of "alt a" loans at an earlier date to Fannie and Freddie, for example, it might have caused them to collapse at an earlier date with even greater losses. This might have set off an even worse global crisis. The Fed, due to its unique HOEPA authority, and the SEC, because it has jurisdiction over every publicly traded company, were the only entities that could have shut down the vectors spreading the fraud epidemic. This should have been their most important priority. They had ample warnings of the epidemic of liar's loans and the fact that it was spreading rapidly. Lehman, Citi, WaMu, Indymac, and Bear Stearns were on everyone's list of the worst vectors, yet the Fed and the SEC took no effective action until after virtually every major originator of liar's loans had failed. It would be as if the Public Health Service waited to start killing mosquitoes until 2.5 million Americans had died of malaria over the course of a decade.

It is critical to understand that making liar's loans required multiple frauds by multiple parties. Because liar's loans create an intensely criminogenic environment, they produce fraud epidemics. Because liar's loans also create severe adverse selection, they inherently have a negative expected value. It's easy to put that in English. When Aurora (Lehman's firm that specialized in making liar's loans) made a \$400,000 liar's loan they created annual (fictional) accounting income of perhaps \$50,000. They also created a real loss of \$200,000 - \$300,000. If Lehman sold the \$400,000 liar's loan to another company for \$410,000, Lehman created a (real - but likely fraudulent) gain of \$10,000. This, however, simply increased the purchaser's eventual loss to \$210,000 - \$310,000. Whatever entity purchased the liar's loan (directly or via a CDO) owned an asset with massive real losses (50% - 85%). Assume a realistic hypothetical. Fannie purchases \$60 billion in liar's loan paper from Lehman. The liar's loans are really worth \$20 billion, so Fannie has just suffered a real \$40 billion loss. Ask yourself: will Fannie's senior officers recognize this loss? If they do, Fannie will report that it is massively unprofitable and insolvent. The senior officers will not get their bonuses and will almost certainly be fired. Not a hard decision for Fannie's senior leadership.

Similarly, the typical Fannie purchase requires "reps and warranties" from the seller that the assets it is selling conform to higher underwriting and credit quality standards. (See Mr. Bowen's (Citi) testimony before FCIC.) Will Lehman senior managers disclose to Fannie's senior managers that the liar's loans do not conform? If they do, the deal likely dies. The typical Fannie purchase allows Fannie to "put" bad loans back to the seller. Will Fannie senior

managers, once it is "pregnant" with a portfolio filled with scores of billions of dollars of nonprime loans, choose to "put" \$60 billion in liar's loan paper to Lehman in, say, June 2008? If Fannie's senior managers do so they (1) will cause Lehman to collapse and (2) will violate the key "don't ask, don't tell" rule that governed nonprime mortgages. If Fannie exercises the "put" it will be announcing to the world that (1) fraud is pervasive in liar's loans, (2) Lehman sold fraudulent liar's loans to a large number of financial firms at grossly inflated prices -- and those firms have not recognized their losses, and (3) Fannie (and presumably Freddie and other investment bankers and end purchasers) are all likely to start exercising their "put" options on liar's loan paper issues by entities other than Lehman. The (previously grossly inflated) price of liar's loans will promptly collapse to the real value (which is only 15 - 50 cents on the dollar). Among the entities that will have to report that they are massively insolvent are Fannie and Freddie. Which is to say, Fannie was not about to exercise its put on any really large block of liar's loans.

Yes, Lehman went down in a liquidity crisis, but that crisis was caused overwhelmingly by its bad assets (leverage, of course, magnifies gains and losses in asset values). Lehman's fundamental problem was that it was insolvent and unprofitable. The operations that produced much of its fictional income produced these real losses. It could not sell enough assets to solve its liquidity problems because its assets were so bad that it would have to recognize fatal levels of losses on such sales. It could not sell enough equity (which also gives cash) to deal with its liquidity problems because everyone knew it was in desperate shape and had to (honest) means of making sufficient earnings to dig itself out of the hole. It could not find an acquirer for the same reason. Potential equity investors and acquirers could see by late 2008 that the music had stopped. House prices began to decline in late 2006. Most uninsured nonprime speciality lenders collapsed in 2007 or early 2008. The secondary market in nonprime paper collapsed in March 2007 (and there were no signs it would be recreated). Fitch (finally) went public in November 2006 with its study of CDOs backed by nonprime mortgages which found evidence of fraud in nearly every loan. Recall the repeated private efforts to create an industry fund to purchase (and hold at their inflated prices) nonprime paper -- it raised exactly \$0. Bankers no longer trusted other bankers' asset valuations, which shut down a series of markets.

The relevant issue was never: can Lehman be saved? The relevant issue, one that the SEC and the Fed appear never to have even asked, was: how can we stop Lehman from serving as a vector spreading the epidemic of liar's loans? They should have asked themselves that question - - and acted -- no later than 2001. We (OTS) acted in 1991 to contain a growing problem in nonprime lending because we understood adverse selection and its role in causing fraud and negative expected value. The Fed and the SEC, therefore, had the duty, the power, the background in economics, and the example of our successful regulatory intervention that prevented an earlier nonprime crisis -- all of which should have made it far easier for them to contain the crisis. Unlike 1991, when we acted to prevent a nonprime crisis, the loans that the current "alt a" lenders made were openly called "liar's loans" by the trade. How difficult was it for the SEC and the Fed to figure out that we should end "liar's loans"? Even if you assume that the SEC and the Fed were so committed to the mantra that regulation is the source of all evil, they have no excuse for their failure to respond effectively in 2004 when the FBI warned

them that the "epidemic" of mortgage fraud would cause a crisis if it were not contained. The SEC and the Fed had the unique authority to contain the crisis. They failed to do so.

Mortgage Fraud became Endemic

Roughly 40% of U.S. mortgage lending during 2006 was 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). Almost half of subprime loans, by 2006, did not conduct traditional underwriting. Nearly 30% of total mortgage lending in 2006 lacked traditional underwriting. 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.

[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.

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.

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 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 is perhaps 30 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 strategy of going after the small fry gave the control frauds a free pass and had to fail to deter the small fry. Representative Kaptur’s bill to fund the FBI’s replacement of the reassigned agents is a necessary step that I hope will gain bipartisan support.

What if We Had Looked?

Within the last month, facts have been revealed about four 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. In addition to Lehman, there have been recent disclosures on:

Members interested in reading the Senate Banking Committee report and the underlying documents can find them through this link:

<http://levin.senate.gov/newsroom/release.cfm?id=323765>

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 underwritten 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.

Goldman Sachs

The SEC charges that Goldman Sachs should be added to the list of elite financial frauds.

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