9-8-2010

Notes from Interview of Prof. Bill Black

United States: Financial Crisis Inquiry Commission (FCIC)

William K. Black

Univ. Mich Econ 73
law U Mich 76
PhD criminology ~~86~~ '98
U CA - Irvine -

Jobs - Squire Sanders dempsey May 76
Justice / Civil Div 1980 - 1981
Squire Sanders -
Home Loan Bank Bd 1984
Dep. dir. FSLIC - program Jan. 1987
> Detailed gen counsel
FHLB - SAN Fran April 1987 -
detailed dep dir. FSLIC end June 1987

Resident in SAN Fran
SVP -
OTS - SR dep chief counsel for enforcement & litig.
Nat'l Comm on Fin Inst Reform
causes of S&L debacle 92-93

OTS - left 1994 → Univ Calif - Irvine

Asst Prof LBJ School / Austin
ABD - Fall 1996
Santa Clara Univ Biz/law School
Applied Ethics School

Univ. Mo - KC - 2006
Split semesters - Economics & law (jt. appt.)

Black - FBI - Epidemic of mortgage Fraud
Sept 2004
Rt shifting the demand curve -
#s not reliable on stated income loans
Credit Suisse - >50% originations

Mike - Research on #s -
WB - ~~Chris~~ - failure to report stated income -
big challenge to come up w/ # -
Marginal mortgage became the basic loan
large entry to more markets -

"Regul. took a holiday for about 10 yrs."

I prompted the Huff Post reporter
OTS - OCC done zero criminal referrals -

WB - gone from thousands to zero.
Reporter comment was - what a weird question -
why would we do criminal referrals -?

Be Sherpas - 20-30pp. docs w/ 300pp attachments -
FBI agents - try to investigate & bring these cases -
W/o regulators, FBI completely lost

FBI formed partnership w/ Mortg Bankers Assoc. -
Came out w/ all fraud divided into 2 parts -
Stupid - in neither is CEO ever at fault -

Also leverage Imp. Its a way you optimize
fraud

ingredients of crisis
1) Grow
2) Bad loans @ prem. yield - + they're related
(Comp. - you'd slash yields + reduce status inc.)
That's why you grow rapidly by making
bad loans)
3) Extreme leverage
4) Trivial loss reserves

"virtuous cycle" self-sustaining for a time

Fallacy of Composition = can work for some, but
not all. Common in Finance. Reason for
Black Monday.
Works the opposite w/ widespread
control fraud.

Growing rapidly. what hpns to price? Price goes
up if you glut the market
Fraud recipe - they are going to blow up.

Looting Bankruptcy for Profit - Entity fails + the
actors walk away rich. But not conspiracy.
Akerlof + Romer - 1993 - paper
emulation for $

Average CEO is 3 yrs. - a big problem - no
long-term perspective. You rightly
fear as CEO that you must emulate
this activity. Bonuses for ~~off~~ executive
+ Bd.

Loan Quality - gets worse
Spread Falls - Seeing that.

profitability -
Loss Reserves as asset quality ↓, fall every ye
Record lows not seen since S+L crisis

But loan quality + incidence of fraud grows -
Liar loans
origination
appraisal fraud

WAMU - Cuomo - black list for appraisals who were honest

= "Industry that is effectively displaying endemic fraud" before you get a subst. # of players willing to commit fraud.

ex. Appraisers - 90% report coercion

When put these things tog: fraud income
appraisal fraud
=
losses thru the system

Don't need great conspiracy

Ex Aurora = Lehman's entity - fires risk mgr. who makes a referral bec. they say violation of privacy

Citicorp - % nonconforming loans - testimony to FCIC -
50 - 80% noncompliance

They assumed away that fraud could come from top.

Even tho we just came out of Enron

Did it thru: compensation
Ex. S+L

SPV (SIVs) - 3% Enron never made 3% - it gamed it
by bringing in Fastow + Banks -
all the banks said yes.
Penalty was civil liability + hundreds
of millions of $.

→ "Really bizarre" that ple stopped thinking that
fraud could be a problem.

A lot of what we see - what we'd have had w/
no 2ndry Market = Wld have choked more
quickly.

Nobody cared because they just sold it.

Crap Securitizations Toxic - we had killed it
in 1990-1991 - Liars loans stopped w/
Supervision

What to look for: "Adverse selection"
dsnt work for big loans
Creates negative expected value

This stuff predates Fannie + Freddie
Key was Ratings Agencies to give AAA:
How?
Why do they always go to top tier firms? Allies.
Who is most like an auditor in terms of rep?
Ratings Agencies.

MOODY'S - said tried to hold line on mezzanine tiers.
Try to put them in compet to start, but
the ratings agencies are not where top grads go.

can make $. (40% of book.)
They made a fortune
I call it "Don't Ask, Don't Tell."

Open invitation to fraud.

Fitch - Nov. 2007 - nonrandom - looked + results
were appearance of fraud in almost
Every file we looked - on face of files -

If any reasonable underwriting, would have
seen.
Understated every file as fraudulent.

Mortgage Bankers. - S+L switched to become mortgage
bankers. ⟶ desupervision 1990s.

Were not going to be able to keep it out of
the 2ndry market.

These are places, while risk exploding - they take
loss reserves to effective zero + not lkg. at
loan quality (where massive problems
found)

Q Chris - You see Alt-A - LIAR LOANS - yes, a lot
of lying + fraud. But until late 2006,
even w/ that, they can deal w/ it. Not
rising delinquency yet (2006, still can sell or refi)
When home prices ↓ then the music stops.
longer span of years ⟶ You don't see it blow
up until fall 2007.

"lousy" underwriting?

Q [WB] - That is NOT a contrary argument - That is my argument. It is part of fraud. This extended the bubble.

Neoclassical model is that fraud has to be exceptional

S+L - failure = fraud present.

Volumes commissions = disaster - every lender knows the

Ex New Century examiner report - quotes them - "Unless we actually put quality into our compen. system ~~the~~ result will be farcical"

WAMU - lack of investig. by agencies = pervasive. Volume of commissions weighted by yield -

This is nothing New - very

[WB] - Int'l acctg. Iceland - unlawful - No losses by repricing

SEC - "Cookie JAR" abuses are dangerous
Freddie - did cookie jar + caught
Fannie - took big interest rate losses - hedge acctg. games to show no losses + pay out bonuses

SEC - as bad as they were, they were better than OFHEO -

> How did they sell this insanity
Can't document

TWB Fannie + Freddie – They did it to get rich
+ everyone knew it

Liar's Loans were NOT to low-income

The privatization of Fannie + Freddie that was the disaster

Expert witness: against Franks Raines – They settled.
2 hr. briefing for – + 90" for leaders + 2 hrs. for everyone in OFHEO –
These ppl did not think it was legit. to regulate.

Bush best friend ran OFHEO – didn't feel approp. to regulate.

They did get conned on the liar's loans.

Stated income loans = Prime loans (ratings)
Market was blowing up – STATS – late 2006 –
delinquency up – (5% you're dead w/delinquency)

Chris ex. – Credit Suisse 50% were stated income loans
50–80% + some are fraudulent
Blow Up 2007–2008 – sources of nailing down –
% stated income fraudulent –

Fitch Sample – nearly every file (not random)
they were lkg for bad loans –

90% of the applic. inflat- income
58% inflate by 50% or more

Aurora - (ck his Lehman ~~Testimony~~ House w/ Fuld)
70-80% range

WAMU - Senate investig. - at least 2 audits
by internal personnel. 50-85% incidence of fraud

Loan Brokers - interviewed just doing a service

> Wisc. AG investig -
> Cuomo " (appraisal front) - WAMU.
> Citcorp. (FCIC investig.)
" ~~What we have is a~~ !
Tremendous failure to investigate"

Not investigating - that's the first thing we wld have done.

Crisis - liquidity crisis - Big institutions -

Rises out of ENRON - very similar
Liquidity crisis - Lehman - see his House Testimony
↳ is because of asset quality

Banks stopped trusting other banks - good reasons
not to trust. "What if they're doing the same
thing"

SIVs took tremendous liquidity risk
Why? Thats where you're hiding the asset risk.
End result is insolvency -
Lehman didn't admit to it + ple didn't believe
Lehman. Ple lkd. - attempts to sell.

Q Why did they keep toxic on the books?
WB - Answer is tremendous yield. The $.
Phantom - fraud on assets
Ex New Century - disastrous but selling product

"Greatest destruction of working class wealth ... since the Great Depression"

This hurts. Poor ple - that had to be fraud.

Real Estate is lumpy. This is not a truly nat'l market.
Commercial is really lumpy.

> FDIC - they ignored concentrations (less regulation)

Q Low interest rates + inflow of $ into U.S.?

WB - They are the same thing essentially.
first, at the time, this was the greatest thing possible.
Productive investment. US subsidized by global investors = superior econ. growth

> Easterbrook + Fischel - ode to extreme leverage. Guarantee against fraud. A lot of $ instantly, or you go out of biz quickly.

> High debt - low interest rate - supposedly the best thing in the world.

What was diff. was the private 2ndry market
(back during days S+L) only had Fannie +
Freddie -

Fannie created concept of prime by
looking @ best practices + creating high bar
against toxic crap loans

S+L was contained in portfolio.
You can create big ($150B) fin. scandal,
but smaller than this crisis

" If you have regulators, losses won't grow as
much, either."

Q Regulators - look @ on-balance sheet, not
asset quality because it's off-book.?

WB - The truth is - Dodd-Frank - make you have
a stake in it -
formerly - recourse
New Century - always fighting on recourse because
kickback

Fannie + Freddie - if they kickback to BofA or
Citi -

Stuff sold w/ recourse

Asset value - essential to health of inst.

Regulators - if didn't look @ fraud - Then they didn't
look @ recourse - That's embarrassment, not truth

Q Acctg - MARK TO MARKET ACCTG - FALL '08 - cycle
of pricing -

Suspending it has exacerbated the crises
come clean
Sell bad
get rid of bad assets
→ being the UN-JAPAN best

I don't think these folks marked them down to market, bec. if they did they would have been massively insolvent.

I don't see this as a temp. problem or liquidity problem —

> Stress tests – did not look @ underlying assets. Never done, as far as we can tell.

Fitch did not look @ underlying until Nov. 2007 (CDOs + liar loans)

(Some packagers hired outside groups to look.) That needs an investigation.

Fannie + Freddie = \$5T = 1/2 US market
Why did they take on more nontrad'l loans.
Subprime
They lost a lot of market share

– SEC catching them –

Chris: 05-06-07 – See them buying more subprime
They are buying more risk layers than before

OFHEO

Fannie + Freddie emphasized
Stated income + it was essent. subprime
+ OFHEO bought this
"OFHEO appeared to be utterly blind"
" This simply wasn't even on their radar screen"
Before (3 mos) - scandal

WAMU
Countrywide
"These were not hard as a regulator."

The liars loans in general wld not have given them credit under the liars loans.
You need an explanation of why they did so many of the liars loans ~~that~~ -
This place was bonus driven utterly in their senior mgmt.

> Internal auditor of Fannie Freddie supposed to remain pure.
Raj Apaz - this is the least susceptible player -
Internal auditor went bad
Raines saw the speech - praising him.

Q Derivatives - Role?
(Testified on this to Senate Ag.)
Focused on CDS
CDOs were enormous. No 2ndy market = not as big a disaster (less to burn, quicker to burn out)

Complexity → Start off w/ Toxic + end up w/ AAA
Top Tranche = 3% of it bad, not 80%

earlier than 2006-2007

CDS - AIG big - markets roiled = worry bec. AIG so big. So shocked // Treasury + Fed // breaking of the buck. Didn't anticipate

" They believed they had stepped not just on a mine, but a nuclear mine. "

Reinsurance = Worry

[CFMA] - Because of law, they didn't know anything abt this market (futures, counterparties,

" You just cannot regulate effectively when you have no data "

CDSs - AIG = Big deal - They thought it could be hyper-critical - Prob. they were wrong. It was all proprietary.

CDS - going down the road = very scary - Exchange wld not have prevented because the valuations would have been all over the place.

Q Chris The Value - pluses of CDS?

MBIA
AMBAC > Nothing like promising insurance you can't pay.
All could not keep their promises if things went bad.

(As soon as you create a profit motive, someone will fill that gap -)

There is actually safety in weakness.

Q ~~Mike~~ Easterly
GSEs -
Not involved in S&L crisis
1968 - Fannie was publicly traded
Profit orientation 1990s

SAP - ? what happened
~~BH~~ WB Exec. Compensation becomes more imp.

If compens. is tied to short-term income

Q ME? Discipline - who can?
Shareholders, equity holders, labor market
Restricted stock reform
WB - Add #5 - subordinated debt - is supposed to deal w/ TOO BIG TO FAIL
1) only held by soph. folks
2) only buy in large Amts
3) Bec. it's subordinated, you will be wiped OUT @ failure
Except in ENRON + Now = NOBODY ptd. to subdebt holder exercising market discipline (or trying)

His 4-part recipe = "sure thing"
math. guarantee you report record profits + guarantee of producing real losses.
~~Creditors~~ Investors see profit - Not risk.

That's why discipline in market doesn't work.

Effective Regulation

CFTC -
SEC - enf. dir.
(NOT Chair)

part of it is ldrship -
put in good regulatory leaders -

Institutionalize a regul. culture
FDIC - there are places where you
come up through ranks - have to know
something -

FDIC - more conserv. bec. of insurance function -
sister agencies - tried to keep FDIC out of
their institutions -

Strengthen FDIC backup -
Fed - terrible as regulator - never had superv.
as more than a tertiary auth.
Fed - did monet. policy - (mem - dominated by
economists)

Reactive
Opportunistic vs. ~~purposeful~~ fraud

Exec. compensation -
CEOs find it hard to diversify
Shareholders want more risk

Reputational concerns can lead to coverup of losses - accts fraud - Rule 5X = securities fraud -

That's - ple fear failing rather than gaming.

Opportunistic - many folks aren't geniuses
Can make polit. contributions
Fame = record profits -
why?

Tribal - afraid to put ple in who have not run a big organiz.
CEOs

Political - willing to give the wrong answer.

ICMA - cautionary tales - while leading up to crises -
one signal after another before crises
Principles suffered - a little embarrassing -
all ended up w/ employment

Major problem: Not black swans
Not perfect storm
(there are fat tails in modeling)

If assume normal distrib. - increased the value of the asset model. You do it by subst. amt.
Tails are 5X as big as a normal distrib.
Ple know the modelers are bright.

"Truncate VAR = reported assets are
greater.

There is no "distribution" - all of this assumes
there is some "external" world out
there. It's endogenous.

Q [Chris] - Sr. executives "-have argued
we had good risk mgmt, but didn't
model for 30% housing prices"

Realized loan product - unclear, new, innovative.
Comment?

12:20 pm resumes
15-year events - if you can't figure out
the value of an asset - + rely
on really superb underwriting,
reduce leverage, incr. capital
+ loss reserves -
They went the opposite direction.

If they believe bubbles don't matter, why or how
could that be true in terms of distributions.

If you recognize bubble - how big bubble?
Answer: Biggest bubble in HISTORY of
world.

Most of them didn't decrease as 5% -
Ratings Agencies did NOT -

diversification were 10,000 bets –
widen out to spreads of norm

Flight to quality – spread widens during flight to quality
made their situation WORSE
10,000 x

Crushes a whole series of investments

Antecedent of Note is Japan + was on
US firms' minds.

Nikkei – was @ 25% of peak value
15-20 yrs later
Dow losing 75% value – can you imagine?
(NASDAQ lost 50% + has not come back in last 10

All the relevant antecedents had to be
ignored –

Everybody passed their stress TESTS –
Fannie + Freddie passed their stress TESTS
up to the day they died.
Raines. they could survive a nuclear winter

AIG – passed
3 Icelandic banks passed

Lehman failed + Fed let them create their own
Stress tests + they passed

" All gamed + Everyone knew that."

Simultaneously broke down

is Economists -

Autopsies - have to talk to them + look for the patterns -

Systemic regulation S+L good bec. they listened to the examiners -

Wld have averted most of Great Recession + most of the bubble -

The Key thing was HOEPA - Fed had unique auth. to regulate all mortgage originators
(80% originated loans not supervised by a federal entity/regulator)

→ Only way to do that was to use Fed auth. + Greenspan refused.

They didn't believe it was legitimate to ~~intervene~~ interfere w/ consumer choices.

Q Bernanke
Housing → Not cause, but spark
fragile fin. system

TWB - They are inherently ~~fin.~~ fragile.
final. systems

"We are essentially rolling the dice every day" -

It could have converted Lehman to a bank holding co.

"They sent 2 credit guys to an inst. That could blow up the world"

I don't buy the Fed story @ all.

Bubbles cause severe econ. losses in terms of efficiency.

Fed -

When you get a bubble - losses get exponentionaly larger

> Monetary Policy - weak tool agnst bubbles - (not that Fed by definition has failed)

Q - $\boxed{\text{Fed}}$ have said - we don't use monetary policy to burst bubbles, but to stabilize after it bursts -

Not only choice to let a bubble grow.
End liar's loans → wld have burst a bubble - millions of mortgages wld have been made -
Use micro means - where the problems are -
(Use a scalpel, not a sledgehammer)
for the bad stuff / for the good stuff

Q When institutions growing + reporting record profits - regulators not telling them of problems, difficult to tell these instit. to STOP?
How to do it?

$\boxed{\text{WB}}$ - That's what we did. Institutions reporting biggest profits tend to be the greatest risk. Have to intervene.

Reinventing gov't = refer to your regulatee as "your customer"
should get rid of that concept

Difficult to say no to top CEOs - Top Tier's audit firms -
They had that in 1990 - 1991.

(STL) We just told them x10 - we gave them the analysis.

Q Chris - What is left to add?

" When you get substantial fraud, it will kick it off in other sectors inherently."
mortgage
loan broker
'interconnectivity of the Fraud dynamic -

Function - drink - 1 in 100 is contaminated ≥ Zero
Once ple start worrying about fraud - can cause markets to shut down.

frauds by elites -

Continuing - lack of strong recovery - because of hiding - markets don't clear -

Shadow inventory - the amt of delinquency - not recorded - relative to foreclosure -

(Way As Japan did it) —

Hangover — housing stock deteriorating
limbo + worried —

Use honest acctg. 4 yrs. since it
Recognize the losses
Sell w/ assistance the ones that failed
Enforce prompt corrective action law

[Capital has no meaning except in sound acctg. regime]

Fannie + Freddie: "disaster"
Caused huge losses
+ perverse incentives for senior mgmt.
The mgmt extended the incentives to
middle mgrs. to get the answers they wanted
Raines: Exec. Compen. — tied to # + wave
any # + "good ple will do bad things"

People made a ton of $ based on short term
acctg. returns that were "really big"

Scandal. 2X Fannie +