

Creditors Gone Wild: Foreclosure Fraud

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Accounting Control Fraud's Contribution to Foreclosure and Bankruptcy

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Financial economists have found that “control frauds” – frauds in which the senior officials that control a seemingly legitimate bank use it as a “weapon” to defraud creditors and shareholders have long been the leading cause of catastrophic bank failures in the United States. See James Pierce’s book, *The Future of Banking* (1991). Control frauds cause greater financial losses than all other forms of property crime – combined. Among fraudulent financial firms, accounting is the “weapon of choice.” The leading role that control frauds have played in modern U.S. economic crises is well documented.

How did a Relatively Small Number of Subprime Loans Cause a Record Crisis?

A number of analyses of the U.S. and global crisis begin by attempting to explain what they assume to be a paradox – how could so small a market segment (subprime housing and CDOs backed by subprime) have caused (1) the largest financial bubble in history, (2) a U.S. economic crisis, and (3) a nearly global crisis? To these scholars the obvious answer is that subprime lending could not have caused this traumatic trifecta. It follows that the importance of subprime lending must be overstated and there must be other, more powerful causes of the trifecta.

Subprime loans were and are a serious problem, but there has been a destructive overemphasis on subprime loans as the core of the U.S. crisis. “Liar’s” loans are a far greater problem, and *most problem subprime loans are actually liar’s loans*. While the nonprime mortgage industry’s preferred euphemisms were “alt-a” and “stated income” loans, it was the industry that accurately dubbed them liar’s loans. It was the industry that created liar’s loans and it is liar’s loans that made so many officers of firms engaged in mortgage finance wealthy.

The Bright Shining Lies Underlying Liar’s Loans

Lying lenders found liar’s loans ideal for predation. Yield and growth are the keys that determine which types of loans maximize fictional accounting income. The fundamental attraction of liar’s loans was the premium yield. The higher yield, of course, was harmful to the borrower and no rational, informed borrower who could qualify for an underwritten loan at a lower interest rate should have taken out a liar’s loan. Liar’s loans were marketed and sold under a series of bright shining lies. The primary lie was that liar’s loans were really prime (“A”) loans that were underwritten under an alternative, equally effective means – hence the term “alt-a.” The alternative to traditional underwriting was to rely instead almost entirely on the borrower’s credit score – without verifying the borrower’s income, employment, etc. This lie implicitly claimed that “alt-a” borrowers were providing the lenders a free, premium yield unrelated to increased risk.

The bright shining lie was premised on four subsidiary lies. One, “alt-a” borrowers really had the same credit quality as other prime borrowers but could not verify their income. Two, the reason borrowers could not verify their incomes did not constitute a credit risk. Three, the borrowers actually had the income stated on the loan application. Four, a borrower’s credit score is an equally effective alternative means of underwriting credit risk to traditional underwriting (which verifies the borrower’s actual income, employment, etc.).

The typical bright shining lie story was the self-employed business person who could not credibly verify his own income. The story was not simply nonsense; it was obvious nonsense. The IRS has long had a Form 4506 to cover this concern. Borrowers uses the form to authorize the IRS to provide information from their tax returns to the lender. There were two groups of borrowers who had acute needs to avoid disclosing their income and wealth – those engaged in tax fraud and those seeking to deceive their spouses or defraud their prior spouses and children in order to evade alimony and child support payments. (Remember when one of “C’s” in lending referred to “character” and we taught loan officers why one should not lend to those of bad character?) People who will cheat their kids are certain to be willing to cheat their lender.

The borrower signs it to authorize the IRS to release to the lender copies of the borrower’s federal income tax returns. Americans do not deliberately overstate their income on their tax returns because doing so would increase their taxes, so the tax return provides highly reliable information to the banker on the self-employed. The spread between prime and liar’s loans shrank over time (the opposite would have occurred if liar’s loans were not fraudulent and markets were efficient), but a liar’s loan was always substantially more costly to the borrower over the life of the loan. No honest self-employed borrower would opt to pay tens of thousands of dollars in additional interest rather than provide the IRS form and give the bank access to his tax returns. A credit score inherently cannot underwrite a borrower’s *ability* to repay a mortgage loan and it is an unreliable measure even of a borrower’s *willingness* to repay a jumbo mortgage loan. It is easy to game a credit score by taking out, and promptly repaying, a series of small loans and a borrower can readily fraudulently “borrow” another person’s higher credit score.

Why Borrowers took out Liar’s Loans

There are four obvious reasons why a borrower would pay the higher interest rate required to obtain a liar’s loan. One, the borrower did not have the income necessary to receive *any* mortgage loan. The loan officer and the loan broker knew the minimum incomes (though even the minimums were often negotiable). They would falsify the income or direct the borrower to falsify the income stated on the loan application. Normal underwriting easily detects and prevents this fraud – which is why credit losses on traditional residential mortgages were minimal for nearly 50 years. Fraudulent lenders designed liar’s loans to remove these underwriting protections against fraud. Their fraud-friendly design was so successful that their own industry anti-fraud experts (MARI) denounced their product as “an open invitation to fraudsters.” The officers controlling the lying lenders designed and implemented the perverse

incentives that produced the intended “echo” fraud epidemics among loan brokers, loan officers, appraisers – and some borrowers. The combination of liar’s loans and the echo epidemics helped the controlling officers produce the first two ingredients of the lender fraud recipe – rapid growth at premium yields. The officers that controlled the lying lenders wanted to be able to make loans to the uncreditworthy – as long as they could do so at a premium yield. Liar’s loans made it easy to make do both – and prevented the creation of an incriminating underwriting paper trail documenting that the lender knew the information on the loan application was false when it made the loan. The resultant deniability is implausible to anyone that understands fraud mechanisms, but it does fool the credulous.

Two, the borrowers would pay the higher interest rate if they had the requisite income but were hiding its existence from their current or prior spouse or the IRS. Do not make the mistake of believing that this situation represents minimal credit risk to the lender. A borrower who will lie to loved ones and the government (both of which are typically criminal acts) in order to keep from paying them legal obligations poses an exceptionally great credit risk to the lender. The borrower’s character is one of the most important determinants of credit risk.

Three, the borrowers could receive better loan terms if they inflated their income on the loan application. This could prompt borrowers to engage in fraud. Fraudulent borrowers could get larger loans at a lower interest rate if they made the debt-to-income ratio on the loan appear to be smaller by inflating their incomes. Borrower fraud of this nature obviously posed an enormous credit risk to the lender.

The third and fourth categories of borrowers who would be willing to take liar’s loans illustrate the complexity of accounting control fraud. To understand these categories of borrowers one must understand the officers who controlled the lying lenders. The controlling officers wanted to make large loans, in enormous, growing volumes, at premium yields because doing so produce a “sure thing” of record (albeit fictional) short-term income and high bonuses. The controlling officers, of course, have preferred to maximize the yield on liar’s loans but they did not have the power to do so.

The controlling officers faced several tradeoffs. If they got *honest* information on the uncreditworthy lenders they could not grow rapidly by making loans at a premium yield to that group – and lending to that group was essential to their fraud strategy. In a reasonably competitive, mature industry like home lending a bank cannot grow rapidly and achieve premium yields by making enormous numbers of high quality loans. High quality borrowers typically can borrow from any bank at a low yield. A lender that tried to grow rapidly by making high quality residential loans would have to “buy market share” by lowering its yield. Its competitors would match the lower yields and the result would be that the home lenders active in that regional market would suffer materially lower reported income (reducing executive compensation). The implication of this first tradeoff (among growth, yield, and credit quality) was that the only sure way to grow rapidly and charge premium yields in a reasonably

competitive, mature home loan market (ingredients one and two in the fraud recipe) is to make large numbers of loans to the uncreditworthy.

The other major tradeoff arose from the need to loan to the uncreditworthy. I have explained why this always requires the lender's controlling officers to suborn the bank's underwriting and internal and external controls in order to implement their strategy of accounting control fraud (what Akerlof & Romer aptly termed "looting"). Control frauds are so dangerous in large part because they are routinely able to suborn successfully these systems. Suborning underwriting and controls, however, requires a tradeoff. It inherently leaves the lender exceptionally vulnerable to internal and external frauds by parties other than the controlling officers. Fraud begets fraud. Eviscerating underwriting and controls makes the bank environment highly criminogenic and often kicks off an "echo" epidemic of fraud by others.

Strictly speaking, the controlling officers who are looting the bank through accounting fraud neither desire nor necessarily know in advance of the specific acts of secondary fraud by others. The CEO that is looting "his" bank would prefer not to share to the fraud gains with others, but this represents another tradeoff. The fraudulent bank CEO needs to incent large numbers of individuals to act perversely in order to accomplish the primary fraud that he is directing. He must unhinge effective underwriting and controls, so he must expose the bank to secondary internal and external fraud by others. Similarly, fraudulent bank CEOs frequently found it desirable to pay generous bonuses to their agents (i.e., loan officers and loan brokers) in order to incent them to make loans to the uncreditworthy and produce false loan applications and appraisals that would cause the loans to deceptively appear to be far less risky – which translates into far more valuable loans (which are a lender's assets). Again, they traded much greater growth in loans with premium yields that falsely appeared to be of relatively low credit risk for loans that were, in reality, far more likely to be based on fraudulently inflated borrower income and appraised values and therefore far more likely to default and to cause larger losses upon default. The perverse incentive structures the officers controlling the lying lenders created for their employees and agents made it inevitable that liar's loans would be pervasively fraudulent. The law allows us to hold the CEO's who controlled the lying lenders criminally responsible for the predictable consequences of these perverse incentives.

Indeed, accounting control fraud is finance's "weapon of choice" in much of the developed world because it is the superior solution to the tradeoff between the risk of being sanctioned for looting and the rewards from looting. Even the most powerful bank CEO faces a grave risk of being imprisoned if he sticks his hand in the till and steals \$10,000. If, instead, he uses accounting control fraud to loot the bank of \$50 million he has an excellent chance of never even being prosecuted. All he has to do is limit his means of converting bank assets to his personal benefit to seemingly normal executive compensation received because the bank "earned record profits" in the short-term. The recipe for accounting fraud is a "sure thing" that will produce those (fictional) record profits and quickly make the CEO exceptionally wealthy. The record income, of course, will be blessed by a top tier audit firm.

The recipe fraudulent U.S. bank CEOs use maximize short-term reported income and their compensation is attractive because it is a “sure thing” with minimal risk of prosecution, but it does represent a tradeoff. Fraudulent CEOs can convert a higher proportion of bank assets to their personal benefit (“fraud efficiency”) if they make themselves the direct beneficiary of the fraud. They can do so by stealing money from the vault, causing the bank to lend money to them that they do not repay, or causing the bank to lend money to them through a nominee (also called “straw man” or a “shell”). Indeed, the fact that most fraudulent U.S. bankers overwhelmingly loot “their” banks through accounting control fraud tells us that they still fear prosecution. In nations where the CEOs believe that they can loot directly with impunity they employ cruder frauds that achieve greater fraud efficiency.

I need to emphasize several words of caution about the concept of optimization, particularly when applied to very large corporations. Readers who have lived through conventional microeconomics and then worked in the real world know that the neo-classical claims of firm optimization in perfect competition are, to be gentle, misleading. Neo-classical economists’ assumptions about rationality fail descriptively and often fail to predict behavior. Anyone that has dealt with CEOs knows that ego, a desire for fame, a feeling of exceptionalism – they are not subject to the same rules as govern lesser persons – and a consuming drive for dominance can drive decisions. Criminology arose from sociology and psychology is our cousin. White-collar criminologists have long employed a non-ideological view of rationality. We have long-recognized that from the perspective of the fraudulent CEO, the economic and psychological aspects of their fraud schemes tend to be mutually reinforcing. It is the rare CEO who is exceptional (in a positive manner) relative to his peers. The “sure thing” aspect of accounting control fraud simultaneously makes mediocre or failing CEOs wealthy, famous, and powerful. Criminologists never expect perfect optimization. Perfect optimization never occurs in large organizations. Large organizations have various fiefdoms which may have variant professional cultures. Unfortunately, neither honest nor fraudulent CEOs require perfection to pursue (imperfectly) an overall banking strategy.

Lying lenders that sold their liar’s loans found other aspects of these loans optimal. The best loan originations from the perspective of the secondary market had four characteristics: a premium yield, on a larger loan, loan structures that would postpone as many early defaults as possible (e.g., “teaser” initial interest rates so low that they failed even to pay the interest – producing negative amortization), and the appearance of relatively low credit risk. Liar’s loans were superb devices for obtaining, simultaneously, these four (sometimes inconsistent) objectives. The loan brokers commonly inflated seriously the borrowers’ real income and knew that this would produce very high early period defaults (EPDs) unless the borrowers’ payments were reduced substantially. The loan broker could structure the loan to employ an initial, far lower, “teaser” rate in order to greatly reduce EPDs. The loan brokers and loan officers frequently created a “Gresham’s” dynamic (bad ethics drives good ethics out of the market) to induce an echo epidemic of appraisal fraud. By inflating the appraisal and the borrower’s

income, the loan officers and brokers were able to maximize their fees and bring in huge loan volume. Inflating the borrowers' income lowered the reported debt-to-income ratio and inflating the appraisal lowered the reported loan-to-value (LTV) ratio. The two forms of fraud made it appear to those purchasing liar's loans that the loans were lower risk. By structuring the loans to delay the inevitable defaults the loan brokers and officers were able to reduce EPDs and allow more time to refinance the liar's loans. Collectively, these characteristics led to premium prices being paid by those purchasing liar's loans for the secondary market. The officers controlling the lying lenders structured the perverse financial incentives they paid to the loan brokers and officers – and made it clear to them by approving liar's loans and paying the brokers and officers large bonuses for making fraudulent loans sure to default frequently – that they would not effectively kick the tires to prevent the endemic fraud the criminogenic incentives were certain to produce. Liar's loans were the financial variant of “don't ask; don't tell.”

Four, some borrowers who took out liar's loans were relatively low risk, even prime, borrowers. The ideal mortgage loan for an accounting control fraud is a very low risk loan paying a premium yield. (Recall that this was the lying lenders' bright shining lie about liar's loans.) Theoclassical economists asserted that it was impossible to make loans having both characteristics. Such loans would not occur in efficient financial markets. They can occur, however, under predation. Predatory lenders take advantage of information asymmetries to induce lower-risk borrowers to borrow at excessive yields. The information asymmetry is greatest when lending to the financially unsophisticated and those that cannot comprehend the loan terms because they are not literate in the language used in the loan documents. Those asymmetries, statistically, are more likely to be large among Latinos and African-Americans. Some borrowers, therefore, could have provided “free” premium yields to the lying lenders. However, one should be cautious about assuming that the premium yield was a “free” premium even in cases of predation. Loan brokers and officers were operating under such perverse incentives (created by the lying lenders), that they are likely to have exploited the information asymmetries by encouraging financially unsophisticated clients to purchase homes they could not afford under the premises/promises that the loan could always be refinanced and home prices always rose. The more expensive the home being purchased, the larger the loan, and the greater the fee the loan brokers and officers would receive. But this also meant that the victims of predation were being abused in multiple ways and put into homes and loans they could not afford – which caused severe credit risk and meant the purported yield premium was not remotely large enough to compensate the bank for the credit risk of making the liar's loan.

Why did CEOs Make Liar's Loans?

The purpose of liar's loans was to make the CEOs' wealthier. Creating endemic fraud throughout the mortgage process – from origination to the sale of collateralized debt obligations (CDOs) backed by liar's loans (“cradle to grave” fraud) optimized short-term (fictional) reported income, which maximized the controlling officers' income. The lies in liar's loans were so endemic and so egregious that the financial version of “don't ask; don't tell” was essential at

every step of the process. Liar's loans were also perfect for the loan origination level variant of "don't ask; don't tell."

Liar's loans were not underwritten. The borrower did ask about income, but only in the sense made famous by *Monty Python* ("wink, wink; nod, nod"). The lender agreed that it would not verify the borrowers' "stated income" (and often the borrowers' jobs and assets). The lenders that specialized in making liar's loans frequently outsourced much of the job of finding the borrowers who would take out the liar's loans to loan brokers. We have known for centuries that not underwriting produces severe "adverse selection" and that lending under conditions of adverse selection produces a "negative expected value" for the lender. In plain English, if you don't underwrite mortgage loans you are guaranteed to make loans that lose money. Honest mortgage lenders, therefore, underwrite. Indeed, that is their essential skill.

Consider the eerie similarities of the pro-fraud business practices that Akerlof & Romer found were dominant twenty years ago during the S&L debacle and those used to create the ongoing crisis.

The problem with [economists' conventional description of moral hazard as an] explanation for events of the 1980s is that someone who is gambling that his thrift might actually make a profit would never operate the way many thrifts did, with total disregard for even the most basic principles of lending: maintaining reasonable documentation about loans, protecting against external fraud and abuse, verifying information on loan applications, even bothering to have borrowers fill out loan applications. Examinations of the operation of many such thrifts show that the owners acted as if future losses were somebody else's problem. They were right (1993: 4)."

Akerlof & Romer were right to conclude that no honest lender would engage in such behavior. (Full disclosure, Akerlof & Romer cited my work in support of this passage.)

Studies by various state attorney generals, white-collar criminologists, and private and public investigators have confirmed that it is lenders and their agents (loan brokers and loan officers) who overwhelmingly put the lies in liar's loans. There are independent analytical reasons to believe these findings.

- A. Doing so maximized the lenders' (and their loan brokers') reported (albeit fictional) income (and their controlling officers' bonuses). The greater the stated income, the more likely the loan would be made, the larger the size of the loan, and the greater the resale value of the loan in the secondary market. Each of these elements drove the agents' and loan officers' compensation up – and by very large amounts.
- B. By inflating the borrowers' stated income, the lender and its brokers could make the loan appear to be less risky and sell it for a premium to the secondary market greatly inflating the borrower's stated income. The liar's loan lenders could also make the loan appear to

be less risky to the regulators (though unregulated mortgage bankers probably made most of the liar's loans), credit rating agencies, and auditors. These entities typically treated the (fictional, far reduced) "debt-to-income" ratio arising from inflating the borrower's stated income as if it were real. (In reality, this willingness to believe, without real due diligence, the lies that would make these professionals wealthy were another variant of "don't ask; don't tell.") It was not exactly difficult for anyone in the trade to figure out that they must never treat as truthful the stated income in something the trade called a "liar's" loan. Indeed, the ability of everyone in the trade to know that they should never treat the loans as honest was made even more simple when the mortgage lending industry's own experts as deserving of that label because such loans were "an open invitation to fraudsters" (MARI 2006) – during what the FBI had termed as early as September 2004 to be an "epidemic" of mortgage fraud. Depressing the real debt-to-income ratio by inflating reported income was a useful lie to everyone with a financial stake in the liar's loan machine – which was most of our largest financial firms in the U.S.

- C. Not verifying the borrowers' stated income simultaneously facilitated the lenders' and their brokers' ability to sell fraudulent loans at a premium in the secondary market and minimized risk of the lenders' and their brokers' controlling officers being sanctioned for their frauds essential to their origination and sale of liar's loans. The brokers and lenders obviously, could not verify the fictional incomes that they had inflated. They would have had three choices. They could have honestly sought to verify something they knew to be false – which would have prevented the loans from being made and dramatically reduced their income. They could have claimed that they had verified the income but provided no records of their efforts at verification or the borrowers' true income. That strategy would have added another act of fraud (a false certification of verification) while providing no credible evidence. The other alternative would be for the brokers and officers to forge documents purporting to show that they had conducted due diligence as to the borrowers' true income and attesting to the accuracy of the stated income. This strategy would have made it simple for the Justice Department to convict the loan brokers and officers. The ideal strategy is for the loan brokers and officers to do no underwriting of the stated income and to purport that the borrowers' credit rating (FICO score), in conjunction with the fraudulent LTV and debt-to-income ratios, proves that the loan has risk characteristics equivalent to prime loans. FICO scores, of course, can never demonstrate that the borrower has the capacity to repay a home loan and there are common scams that use someone with a good FICO score as a shill to obtain a loan.

Liar's loans were equally useful in facilitating accounting control fraud by those involved in the CDO process. The secondary market had to rely on "don't ask; don't tell" to be able to securitize and sell CDOs. CDOs were largely backed by liar's loans and fraud was so endemic and so obvious among liar's loans if one engaged in due diligence that it

was ideal to claim that liar's loans required no meaningful due diligence and could not be the subject of meaningful due diligence because there were no underwriting files to review because the lender did no real underwriting. Again, consider what would have happened if the securitizers, credit rating agencies, or auditors had actually looked at any reliable sample of the liar's loans for evidence of fraud. They would have reported, as did Fitch in November 2007, that there was evidence of fraud in the nearly every file. If they asked, they could not sell. Their files would show that they knew they were knowingly selling securities backed primarily by fraudulent loans – and claiming the CDOs were “AAA.”

The Mortgage Bankers Association, the trade association of the “perps,” warned its members in 2006 (through its anti-fraud unit, MARI) that stated income loans were an “open invitation to fraudsters” and lived down to the term the industry used behind closed doors to describe them – “liar's loans” because they were pervasively fraudulent. *MARI reported a fraud incidence in liar's loans of 90 percent.*

Investigations, to date, have confirmed this logic. The fraudulent nonprime lenders and brokers typically initiated, directed, and sometimes even directly created the lies on the liar's loans. The testimony of Thomas J. Miller (Miller, 2007), Attorney General of Iowa, at a 2007 Federal Reserve Board hearing began by describing the Gresham's dynamic that the interaction of accounting control fraud and modern executive compensation produces:

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. (p. 3)

Despite the well documented performance struggles of 2006 vintage loans, originators continued to use products with the same characteristics in 2007. (note 2)

[Many originators invent] non-existent occupations or income sources, or simply inflat[e] income totals to support loan applications. A review of 100 stated income loans by one lender found that a shocking 90% of the applications overstated income by 5% or more and almost 60% overstated income by more than 50%. Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer. (p. 10)

Miller, T. J. (August 14, 2007). Home Equity Lending Market Request for Comment. Docket No. OP-1288.

http://www.iowa.gov/government/ag/latest_news/releases/aug_2007/Federal_Reserve_HOEP_A.pdf

A small sample review of nonprime loan files by Fitch, the smallest of the three large rating agencies, adds support for the view that fraud became endemic in 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. (Pendley, Costello, & Kelsch, 2007, p. 4)

Fitch did not investigate these loans. It simply reviewed the loan files and servicing files to identify frauds obvious on the face of the documents. They were able to identify likely frauds "in almost every file." Any honest, mildly competent review of the loan files by the loan brokers and lenders would have prevented these loans from being closed. The logical conclusion is that the lenders and brokers encouraged fraudulent loans.

Hudson also explains the tactics that loan officers use to intimidate borrowers to ensure that they did not read the false disclosures that the officers had fabricated (p. 157).

Recent studies by criminologists show the leading role that lenders and loan brokers took in creating fraudulent loan applications. Tomson H. Nguyen and Henry N. Pontell recently published an article reporting the results of their interviews with lender personnel and loan brokers. (I published the responsive policy essay on their article.)

<http://onlinelibrary.wiley.com/doi/10.1111/cpp.2010.9.issue-3/issuetoc>

Appraisal Fraud as a "Marker" of Accounting Control Fraud

Liar's loan borrowers had no leverage to create a "Gresham's" dynamic among appraisers. *There is no **honest** reason why a mortgage lender would inflate the appraised value and the size of the loan.* Causing or permitting large numbers of inflated appraisals is a superb "marker" of accounting control fraud by the lender because the senior officers directing an accounting control fraud do maximize short-term reported (fictional) income (and real losses) by inflating appraisals and stated income. Lenders and their agents frequently suborned appraisers by deliberately creating a Gresham's dynamic to try to induce them to inflate market values, leaked the loan amount to the appraisers, drove the appraisal fraud, and made it endemic. A national poll of

appraisers in early 2004 found that 75% of respondents reported being subjected to coercion in the last 12 months to inflate appraisals. A follow-up survey in 2007 found that the percentage that had been subjected to coercion had risen to 90 percent. Appraisers reported that when they refused to inflate appraisals 68% had lost at least one client and 45% were not paid for at least one appraisal in the prior 12 months. In 2005, Demos warned of an “epidemic” of appraisal fraud.

As with inflating income in order to minimize the reported debt-to-income ratio, inflating the appraisal allowed everyone with a financial stake in the lies to minimize the reported loan-to-value (LTV) ratio and allowed everyone to pretend that the loan was far less risky because it had such a large (but yet again fictional) equity cushion. Given that we know that appraisal fraud was endemic, that endemic appraisal fraud is impossible without being led or permitted by the lenders and their agents, and that no honest lender would permit or cause widespread inflated appraisals, the logical inference is that the lenders and their agents led both the stated income and the appraisal fraud. Appraisal fraud is particularly pernicious because the borrower does not know it has occurred. He may be told that the home he offered to pay \$400,000 to acquire (subject to an appraisal contingency) has a market value of \$480,000 when its true market value is \$350,000. This constitutes fraud in the inducement.

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

New York Attorney General Andrew Cuomo said [that] a major real estate appraisal company colluded with the nation's largest savings and loan companies to inflate the values of homes nationwide, contributing to the subprime mortgage crisis.

"This is a case we believe is indicative of an industrywide problem," Cuomo said in a news conference.

Cuomo announced the civil lawsuit against eAppraiseIT that accuses the First American Corp. subsidiary of caving in to pressure from Washington Mutual Inc. to use a list of "proven appraisers" who he claims inflated home appraisals.

He also released e-mails that he said show executives were aware they were violating federal regulations. The lawsuit filed in state Supreme Court in Manhattan seeks to stop the practice, recover profits and assess penalties.

"These blatant actions of First American and eAppraiseIT have contributed to the growing foreclosure crisis and turmoil in the housing market," Cuomo said in a statement. "By allowing Washington Mutual to hand-pick appraisers who inflated values, First American helped set the current mortgage crisis in motion."

"First American and eAppraiseIT violated that independence when Washington Mutual strong-armed them into a system designed to rip off homeowners and investors alike," he said (*The Seattle Times*, November 1, 2007).

Note particularly Attorney General Cuomo's claim that WaMu "rip[ped] off ... investors." That is an express claim that it operated as an accounting control fraud and inflated appraisals in order to maximize accounting "profits." A Senate investigation has found compelling evidence that WaMu acted in a manner that fits the accounting control fraud pattern.

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

Pressure to inflate appraisals was endemic among nonprime lending specialists.

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

Inducing endemic appraisal fraud is an optimal strategy for a lender that is engaged in "accounting control fraud." Accounting control frauds drove the second phase of the S&L debacle, the Enron era crisis, and the ongoing crisis.

Michael W. Hudson's new book, *The Monster*, reports on the results of numerous interviews with nonprime lenders. (He focused on Ameriquest.) Hudson reports that fraudulent nonprime lender personnel were compensated through perverse bonus programs that successfully encouraged them to do whatever it took to get liar's loans approved. That included forging the borrower's signature and changing information provided by the borrower to inflate income. He notes that:

One former loan officer and branch manager testified that inflating property appraisals served the "dual purpose of both making sure the loan was approved by the home office as well as making the loan more attractive to sell to investors" (p. 156).

Only the lenders and their agents had the inside information and expertise to know how to optimize the deceit in the loan application process. Many of the housing speculators who bought a material number of homes and sought to flip them were industry insiders, and many of them also committed fraud by indicating that they intended to make each of the houses (simultaneously) their principal dwelling. These professionals would have known of the details of the lenders' term sheets and could have picked the debt-to-income and LTV ratios (and sometimes had illegal side deals with appraisals to inflate the appraisals to secure the desired LTV. The great bulk, however, of those that borrowed through liar's loans were not financially sophisticated and had no way of knowing how much they needed to inflate reported income to hit the "sweet spot" that would maximize the loan broker's and the loan officer's fees and

bonuses. Loan brokers willing to specialize in making liar's loans had to be able to lead the lies about the borrowers' income that would maximize the loan broker's fees.

The fact that the lenders and their agents specializing in making liar's loans led the stated income frauds does not, of course, mean that the borrowers had no ethical responsibility or culpability. There are millions of cases of mortgage fraud through liar's loans. There are doubtless hundreds of thousands of borrowers who knew that the incomes the brokers and officers told them to report on the loan applications were false.

Yes, it does appear to have been common for the loan brokers and officers to create the false loan applications and even forge the borrowers' signatures. Some of the lenders are reported to have referred to these practices as "Arts and Crafts" weekends. We don't know how common this level of lender fraud was because the regulatory agencies and prosecutors have not publicly reported their investigations. Indeed, there is no public evidence that the regulators or prosecutors are even conducting comprehensive investigations of the endemic accounting control fraud by the lenders that made large amounts of liar's loans.

Liar's Loans Grew Enormously

We now have the analytical basis to begin to explain the supposed paradox as to how such a relatively small number of subprime loans caused an intense global crisis. Here are the central points.

- Many subprime loans were also liar's loans
- Many hybrid loans existed with greatly reduced underwriting
- There were, and are, no official definitions of the loan categories "alt-a", "subprime", or the many hybrid forms
- Because there is no definition and the categories of "subprime" and "liar's" loans are not mutually exclusive, there is inherent uncertainty and a need to use judgment to form useful estimates. Credit Suisse reported (2007) that 49% of new originations in 2006 were "alt-a" loans (i.e., liar's loans). The incidence of fraud among liar's loans found in most independent studies is 80% or above. If the Credit Suisse figure is even close to accurate (and some caution is vital there), then we are suffering from over a million cases of mortgage fraud annually in 2005 and 2005 and the frauds were growing in 2007 until the secondary market collapsed. Data on criminal referrals are, when extrapolated, consistent with that level of fraud incidence. The supposed paradox arises from a factual error. Nonprime loans were common. Liar's loans grew massively and hyper-inflated the financial bubble. The size of the bubble and the fraud losses were enormous relative to bank capital. Indeed, the very lack of reliable data on the true composition of liar's loans (Fannie, Freddie, and Lehman all

reported them as “prime” loans for most purposes) in mortgage portfolios and CDOs was itself one of the factors driving systemic risk. Investors, rightly, feared that most large financial institutions had huge exposures to fraudulent loans.

- At law, fraud’s defining element is deceit. The fraudster gets the victim to trust him and then betrays that trust. This is why control fraud by our elite financial institutions is such a powerful acid to erode trust. Trust is vital to an effective economy. Markets shut down in the crisis because bankers no longer trusted other bankers’ asset valuations.
- Other nations (Iceland and to a far lesser extent Ireland) that have had moderately serious investigations of the causes of their crises have produced reports that provide compelling evidence of accounting control fraud as major drivers in their crises. Spain is notorious for its’ banks’ accounting abuses, but Spain has not provided any true investigative reports.
- The FDIC and OTS created a data base well after the crisis began. It sought (false) precision at the cost of analytical usefulness. It creates a false dichotomy between “alt-a” and “subprime” based on reported FICO scores (which it implicitly assumes to be real). The result is that one cannot use the data to study loans made without underwriting. That category – the single most important characteristic for studying, measuring, and predicting losses – does not exist in their data. It is vital that researchers understand that the FDIC mortgage data base is unreliable and it is vital that the FDIC create a new, reliable data base.

Accounting Control Fraud Drives our Recurrent, Intensifying Crises

No one has ever argued that fraud is the only cause of bank failures or financial crises. The first phase of the savings and loan (S&L) debacle, for example, was produced by the industry’s systematic exposure to interest rate risk and the Federal Reserve’s action in sharply raising interest rates. By contrast, the current financial crisis occurred in a financial environment so exceptionally benign that Ben Bernanke made it famous as the “Great Moderation.” When a massive banking crisis arises in a benign financial environment the most logical explanation, historically, is widespread accounting control fraud among banks.

Accounting control frauds were the primary driver of the second (and far costlier) phase of the S&L debacle. The National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE), which investigated the causes of the major S&L failures, confirmed the pervasive presence of accounting control fraud among these failures.

The typical large failure was a stockholder-owned, state-chartered institution in Texas or California where regulation and supervision were most lax.... [It] had grown at an extremely rapid rate, achieving high concentrations of assets in risky ventures....

[E]very accounting trick available was used to make the institution look profitable, safe, and solvent. Evidence of fraud was invariably present as was the ability of the operators to “milk” the organization through high dividends and salaries, bonuses, perks and other means (NCFIRRE 1993: 3-4).

[A]busive operators of S&L[s] sought out compliant and cooperative accountants. The result was a sort of "Gresham's Law" in which the bad professionals forced out the good (NCFIRRE 1993: 76).

James Pierce, NCFIRRE’s Executive Director, explained:

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

A lender optimizes accounting control fraud through a four-part recipe. Top financial economists (including the Nobel Prize winning George Akerlof), the nation’s top white-collar criminologists specializing in elite financial frauds, and the S&L regulators agreed that this recipe is a “sure thing.” The key criminology articles and books that research the question of the contribution of fraud to the S&L debacle include “The Savings and Loan Debacle of the 1980's: White-Collar Crime or Risky Business? (W. Black with K. Calavita and H. Pontell) *Law and Policy*. Vol. 17, No. 1 (January 1995: 23-55); *Big Money Crime* (K. Calavita, H. Pontell, and R. Tillman 1997); and *The Best Way to Rob a Bank is to Own One* (W. Black 2005).

The same fraud recipe produces guaranteed, record (fictional) near-term profits, guaranteed wealth for the controlling officers through seemingly normal executive compensation, and guaranteed catastrophic losses in the longer-term. George Akerlof & Paul Romer (1993) termed the strategy: *Looting: the Economic Underworld of Bankruptcy for Profit*. The firm fails, but the officers become wealthy. (In the modern era if the firm is large enough we bail it out, leave the CEO that defrauded it in place, change the accounting rules so that the bank does not have to recognize losses on its bad loans, and allow the CEO to cause the bank to resume paying him extraordinary income on the basis of the fictional income produced by not recognizing losses.)

The dual role of perverse executive compensation in encouraging accounting control fraud and providing a means for the controlling officers to loot the bank through a means that reduces the risk of prosecution has been confirmed by NCFIRRE, top economists, top criminologists, the S&L regulators at the Office of Thrift Supervision (OTS), and experts specializing in compensation (Bebchuk, Cohen& Spamann 2010). Recall that the fraud recipe for lenders has four ingredients:

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

Akerlof & Romer (1993) and the OTS found that part of the reason why the S&L accounting control frauds caused such disproportionate losses was that they hyper-inflated a real estate bubble in the Southwest. The fraud recipe explains the multiple reasons why epidemics of accounting control fraud are likely to hyper-inflate financial bubbles.

1. The frauds grow at an exceptional rate. The S&L control frauds' average annual growth in 1983 was 50%.
2. The growth imperative and deliberate indifference to poor asset quality leads accounting control frauds to continue to lend into the teeth of a glut. There are scores of millions of potential American borrowers who cannot afford to repay the loans they would need to purchase a home. By lending to borrowers who often are incapable of repaying their home loans the accounting control frauds "right-shift" the demand curve for homes – which must cause a bubble to hyper-inflate. The number of borrowers who were unlikely to be able to repay their home loans was in the millions, so the increase in demand for housing brought on by the fraudulent lenders was so large and so unrelated to economic fundamentals that it was an enormous contributor to the hyper-inflation and extension of the life of the bubble. Losses are unlikely to rise in a linear fashion when a bubble hyper-inflates. A further five percent increase in a bubble could produce a materially larger increase in losses and the severity of the resulting recession.
3. The exceptional leverage of the fraud recipe, and the high reported (albeit fictional) income produced by the recipe makes it easier for the frauds to grow rapidly by borrowing
4. Certain assets and industry characteristics aid accounting control fraud. Assets that lack readily verifiable market values and have values established by experts that the accounting control frauds can suborn constitute superior "ammunition" for accounting fraud. Financial industries that have been subjected to the "three de's" – deregulation, desupervision, and *de facto* decriminalization and have easy entry are more criminogenic. These asset and industry characteristics lead to accounting control frauds clustering in the assets, industries, and regions that are most criminogenic. (NCFIRRE found such clustering in Texas and California S&Ls investing primarily in commercial real estate.)
5. Fraud begets fraud, or in criminological jargon, accounting control fraud is criminogenic.
 - a) As the fraud causes the bubble to hyper-inflate it becomes simple to delay the recognition of the inevitable, massive losses inherent in the second ingredient of the fraud recipe by refinancing the loans.
 - b) The record reported income of the fraudulent lenders and the resulting exceptional compensation of the senior officers encourages other lenders to mimic the fraudulent lenders' business strategy. The fraud recipe is easy to mimic, it does not require any great managerial skill.
 - c) Another route to mimicking the control frauds can arise through coercion. The record reported income of the fraudulent lenders and resultant exceptional compensation that the senior bank officers receive (not "earn") can lead bank CEOs to create a "Gresham's" dynamic in which bad ethics tends to drive good ethics out of the marketplace. The bank CEO may coerce his CFO to mimic the fraud recipe by threatening to fire the CFO if he does not mimic the fraud recipe or by tying the CFO's opportunity to receive exceptional compensation primarily to the bank reporting extreme short-term reported income.

- d) The record reported income and resultant large compensation to more junior officials discourages whistle blowing. A whistle blower who reveals the accounting control fraud risk not only losing his job and generous bonuses, but also is treated as being responsible for costing all of his peers their bonuses. Whistle blowers are the most common means by which inside corporate fraud is detected.

Accounting Control Fraud Drove the Ongoing Crisis

Nonprime mortgage lenders followed the same fraud recipe in the current crisis. Growth was extreme.

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

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

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

Leverage was exceptional. Unregulated nonprime lenders had no meaningful capital rules. Indeed, they had no capital – they were insolvent on any real economic basis because of the large, inherent losses on the fraudulent loans that were always in their “pipeline.”

Honest lenders making liar’s loans would establish record high allowances for loan and lease losses (ALLL) pursuant to the requirements of generally accepted accounting principles (GAAP). As these liar’s loans became far riskier (due to “layered” risk) GAAP required the ALLL provisions to grow substantially. The nonprime lenders routinely violated GAAP and did the opposite. “The industry’s reserves-to-loan ratio has been setting new record lows for the past four years” (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). Later, “loan loss reserves are down to levels not seen since 1985” (roughly one percent) (A.M. Best 2007: 1). A.M. Best noted that these inadequate loss reserves in 1985 led to banking and S&L crises. In 2009, IMF estimated losses on U.S. originated assets of \$2.7 trillion (IMF 2009: 35 Table 1.3) (roughly 30 times larger than bank loss reserves). U.S. securities registrants must file financial statements that comport with GAAP. The intentional failure to do so, as to any accounting matter that is “material” constitutes federal securities fraud – which is a felony.

The *de facto* Decriminalization of Accounting Control Fraud During this Crisis

The OTS made well over 10,000 criminal referrals during the S&L debacle. It worked closely with the FBI and the Department of Justice (DOJ) to prioritize the worst 100 fraudulent S&Ls (that “Top 100” list represented roughly 600-700 elite individuals targeted for investigation and likely prosecution). The process produced over 1000 felony convictions in cases DOJ designated as “major.” The convictions were primarily of individuals identified through the Top 100 process, so the prosecutions targeted the most elite, most destructive white-collar criminals in the industry. The head of the OTS’ predecessor agency (Ed Gray) and the first head of OTS appointed with the Senate’s “advice and consent” (Tim Ryan) made the prosecution of the elite criminal among the highest priorities of their agencies. A bank will virtually never file a criminal referral against its CEO. Only the banking regulators are likely to have the expertise and the independence necessary to file the criminal referrals that are essential if the FBI and the DOJ are to successfully prosecute fraudulent bank CEOs. As investigations by David Heath of the *Huffington Post* and Gretchen Morgenson and Louise Story of the *New York Times* have revealed, the criminal referral process collapsed at the banking regulatory agencies prior to the onset of the crisis.

David Heath, “Too Big to Jail” (May 3, 2010).

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

Gretchen Morgenson and Louise Story, “In Financial Crisis, No Prosecutions of Top Figures” (April 14, 2011).

<http://www.nytimes.com/2011/04/14/business/14prosecute.html>

Indeed, the collapse of the criminal referral process at the banking regulatory agencies is one of the important contributors to the intensely criminogenic environment that produced the fraud epidemics that drove the current crisis. It is also a central part of the explanation of why there have been virtually no prosecutions of the accounting control frauds that drove the current crisis. With no criminal referrals against the control frauds to guide them, the FBI assigned its tiny component of agents investigating mortgage fraud among its many field offices in a manner that made it impossible to investigate any major fraudulent lender.

Prosecutions for Mortgage Fraud Have Become Obscure

Joe Nocera’s March 25, 2011 column, “In Prison for a Taking a Liar Loan” discusses the case that illustrates the anti-priorities driving DOJ prosecutions of mortgage fraud.

<http://www.nytimes.com/2011/03/26/business/26nocera.html?emc=eta1>

The twist in Joe Nocera’s column is that the borrower on a liar’s loan from Countrywide is in prison for lying on a loan product that Countrywide’s controlling officers structured knowing that it would produce endemic fraudulent applications. Countrywide’s controlling officers structured their liar’s loans in this manner to facilitate their vastly greater looting of

Countrywide's creditors and shareholders. The prosecution of Countrywide's borrowers for fraudulent liar's loan applications is the modern variant of the old joke.

“What does *chutzpah* mean?”

“A son killed his parents and asked the court for mercy because he was an orphan.”

Nocera's story is also a wonderful illustration of how insane our lack of prioritization is in prosecuting the lying lenders that drove the “epidemic” of mortgage fraud that hyper-inflated the financial bubble and caused our financial crisis and the Great Recession. Only ten senior officers of the significant nonprime lenders that caused the catastrophe have been prosecuted. All ten convictions arose from a single case of a large, but obscure mortgage bank. The prosecution is a special case because the investigation and indictment were triggered by an alleged effort to defraud the TARP program. The contrast to the S&L debacle, where we obtained over 1000 felony convictions in “major” cases and ensured that the most culpable, most elite frauds would be prosecuted by creating the “Top 100” list of fraudulent S&Ls is stark and should prompt public outrage. The FBI deserves great credit for warning about the “epidemic” of mortgage fraud in its September 2004 testimony – over six-and-a-half years ago – and predicting that it would cause a financial crisis if it were not contained. Countrywide went heavily into liar's loans after that warning and went even more heavily after MARI denounced the loans in 2006 as “open invitations to fraudsters.”

The FBI can place undercover agents in banks without even changing their resumes or names. If it had sent undercover agents into the ten largest lying lenders in 2004 it could have prevented the Great Recession. Banks engaged in accounting control frauds operate in ways designed to superficially mimic honest lenders, but there are clear markers of fraud that a special agent who understands fraud mechanisms would be able to spot within days. Honest lenders do not make liar's loans, do not inflate appraisals, do not suborn their underwriting staff and internal and external controls, do not create perverse incentives for loan brokers and officers and other corporate officers, do not forge borrowers' signatures, and do not suggest or provide false information on loan applications. Lying lenders and/or their agents routinely did each of these things. The IRS, in a situation in which we prosecute none of the lying lenders' controlling officers and only prosecute around 1000 of the roughly one million annual cases of mortgage fraud – a strategy that guarantees failure – used a wired undercover special agent to investigate one of those individual frauds. It did so while giving a pass to Countrywide's CEO, the exemplar of “bankruptcy for profit.” Countrywide was shocked, shocked to hear that there was lying going on in its liar's loans. The loan broker (a confessed fraud) suggested the fraudulent statement of income on the loan application and may have forged the borrower's name on the application. (Both practices were common because lying lenders, including Countrywide, structured their bonuses to loan brokers to ensure that the brokers could make very large amounts of money by fraudulently inflating the borrower's income and appraised value of the home.

Nocera's story demonstrates that the Justice Department has mastered the art of unintentional self-parody. As I submit this article breaking news states that the U.S. Attorney in Seattle is dropping the "moribund" investigation of WaMu – one of the world's largest accounting control frauds. But the truth is that there never was an "investigation" of WaMu worthy of the name. The Justice Department has its eyes in mortgage fraud fixed firmly on small frauds.

The Economic Consequences of this Epidemic of Accounting Control Fraud

The fraud scheme of making millions of liar's loans was guaranteed to devastate the U.S. and global economy. It hyper-inflated the real estate bubble and made the crisis far worse. It guaranteed that millions of Americans would lose their homes through foreclosure. Recent data have confirmed what we predicted – the liar's loans have caused the greatest loss of minority wealth in U.S. history. The strategy of making fraudulent liar's loans also guaranteed that the lenders would become insolvent (unless bailed out by the Treasury and the Fed) and that millions of Americans would be forced into bankruptcy. The title of Akerlof & Romer's 1993 article says it all: "Looting: the Economic Underworld of Bankruptcy for Profit."

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