

Univ. Mich Econ 73
Law U Mich 76
PhD criminology ~~86~~ '98
UCA - Irvine -

Jobs - Squi Sanders dempsey May 76
Justice / Civ Dpt 1980 - 1981
Squi Sadun -
Home Loan Bank Bd 1984
Dep. dir. FISLIC - program Jan. 1987
> Detailed gen counsel
FILB - SAN Fran April 1987 -
detailed dep dir. FISLIC end June 1987

Resident in SAN Fran
SVP -

OTS - SR dep chief counsel for
enforcement & litig.

Part'l Comm on Fin Inst Reform
Causes of SFL 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. appl.)

Black - FBI - epidemic of mortgage fraud
Sept 2004

It shifting the demand curve -

#s not reliable on stated income loans

Credit Suisse - 150% originations

Tru - Research on #s -

WB - ~~Chase~~ - failure to report stated income -

big challenge to come up w/ # -

Marginal mortgage became the basis loan

large emy to move markets -

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

I prompted the Huff Post report

OTS - CC done zero criminal referrals -

WB - gone from thousands to zero.

Report comment was - what a weird question -
why would we do criminal referrals - ?

Be Sheras - 20-30 pp. docs w/ 300pp attachments -
FBI agents - try to investigate & bump these cases -

W/o regulators, FBI completely lost

FBI formed partnership w/ ^{Mark} Bankers Assoc. -
came out w/ all fraud divided into 2 parts -
Stupid - in neither is CEO ever at fault -

Also leverage Imp. It's a way you optimize fraud

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

Fallacy of Composition = ^{vicious cycle - self-sustaining for a time} can work for some, but not all. Common in Finance. Reason for Black Monday.

Works the opposite w/ widespread control fraud.

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

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

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~~ executives + Bd.

Loan Quality - gets worse
Spread Falls - seeing that.

Profitability -
Loss Reserves as asset quality ↓, fall every year
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 together:

fraud income
appraisal fraud
=

losses thru the system

Don't need great conspiracy

ex Quora = Lehman's entity - fines high mgs. who makes a referral bec. they say violation of privacy

Citigroup - 90% nonconforming loans - testimony to FDIC - 50-80% noncompliance

They assumed away that fraud could come from top.

Even tho we just come out of Enron

Did it there: 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 ppl 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.

Securitizations
Crap Toxic - we had killed it in 1990-1991 - toxic loans stopped w/ supervision.

What to look for: "Adverse selection"
don't walk for big loans
Creates negative expected value

This stuff predates Fannie + Freddie
Key was Rating 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?
Rating Agencies.

MOODY'S - said tried to hold line on mezzanine tier.
Try to put them in compet. to start, but the rating agencies are not where to start so.

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.

Understand 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 Zady market.

These are places, while risk exploding - they take less reserves to effective zero, not 1K% at loan quality (where massive problems found)

Ⓢ 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.

1 '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.

Volume 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 - unlaughed - No losses by rephrasing

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 assembly
Cruz document

TWB

Fannie + Freddie - They did it to get rich
+ everyone know it

Liars loans were NOT to low-income

The privatization of Fannie + Freddie that was the
disaster

Expert witness: against Frank 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 liars 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 -

File Sample - nearly every file (not random)
they were leg for bad loans -

90% of the applic. inflated income
50% inflated by 50% or more

Quera - (ck his ^{House w/ Fold} Lehman Testimony)
70-80% range

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

Loan Brokers - interviewed just doing a same

- > Wise AG investig. -
- > Cuomo " (appraisal firm) - WAMU -
- > Citicorp. (FCI investig.)

" What we have is a
Tremendous failure to investigate "

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

Chris 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? That's where you're hiding the asset risk.

End result is insolvency -

Lehman didn't admit to it & ppl didn't believe
Lehman. Pk skd. - 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

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

This hurts. Poor people - 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

> Eastbrook + Fischer - due to extreme leverage. Guaranteed 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. ^o was no private trading 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 (4 WOB) 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 Coats - MARK TO MARKET ACCTG - Fall '08 - cycle of prices -

Suspending it has exacerbated the crisis
come clear

See 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 ~~if~~ ^{they}
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 packages hired outside groups to look.)
That needs an investigation.

⊗ Fannie + Freddie = \$5T = 1/2 US market
Why did they take on more nonhalt 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 held as a regulator."

The liaisons loans in general would not have
given them credit under the liaisons loans.

You need an explanation of why they did
so many of the liaisons loans that -

This place was bonus driven - utterly
in their senior mgmt.

> Internal auditor of Fannie - Freddie supposed
to remain pure.

Raj Rajag - this is the least susceptible
player -

Internal auditor went bad

Raines saw the speech - praising him.

Derivatives - Role?

(Testified on this to Senate Ag.)

Focused on CDS

CDOs were enormous. No 2ndry 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%

CDS - AIG big - markets reeled = 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.

Chris
The value - pluses of CDS ?

MBIA > Nothing like promising insurance
AMBAC > 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.

Mini-Easterly
Q GSEs -

Not involved in S&L crisis

1968 - Termie was publicly traded

Profit orientation 1990s

SAP - ? what happened

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 (cutting)

His 4-part recipe
= "sure thing"

math. guarantee you report record profits +

guarantee of producing real losses.

~~Investors~~ see profit - NOT risk.

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

Efficient Regulation

CFTC -

SEC - inf. dir.
(NOT Chair)

part of it is leadership -
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 -
other agencies - tried to keep FDIC out of
their institution -

Strengthen FDIC backup -

Fed - terrible as regulator - never had superv.
as more than a tertiary auth.

Fed - did monet. policy - (men - dominated by
economists)

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Opportunistic vs. ^{Reactive} purposeful fraud

Exec. compensation -

CEOs find it hard to diversify
shareholders want more risk

Reputational concerns can lead to covering
y losses - acctg fraud - Rule 5X = Securities
fraud -

That's - pre fear falling rather than gaming.

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

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

Political - willing to give the wrong answer.

Q ICMA - cautionary tales - while
leading up to crisis -
one signal after another before crisis

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.
He know the modelers are bright.

Financial VAIK = reported assets are greater.

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

Chris - Sp. 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
Notes

15-year events - if you can't figure out the value of an asset - I 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 did that be true in terms of distributions.

If you recognize bubble - how big bubble?

Answer: Biggest bubble in history of world.

Most of them did not decrease as 5% -
Rating Agencies did not -

diversification were 10,000 bets -
wider or 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.

Rainis - 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 -

would have averted most of great Recession
+ most of the bubble -

The key thing was HOPA - 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 interfere}
w/ consumer choices.

↳ Bernanke

Housing → Not cause, but spark
of fragile fin. system

TWB - They are ^{final. systems} inherently ~~fragile~~ fragile.

"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 exponentially larger

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

Q - 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 liars loans → wld have burst a bubble - millions of mortgages wld have been made -

Use micro means - where ^{the problems} they 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 instt. to STOP?
How to do it?

WBI -

That's what we did. Institutions reporting biggest profits tend to be the greatest now. Have to intervene.

Reinventing for = refer to your reputation as
"your customer"
should get rid of that concept

Difficult to say no to top CEOs - Top 100 audit firms -
They had that in 1990 - 1991.

(STL) We just told them No - 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 ppl 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
Seek 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 mgmt. to get the answers they wanted
Raise: Exec. Compens. - tied to # + wave
any # + "good people will do bad things"

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

learned. 2x Fannie +

