

The Disastrous Unexpected Consequences of Private Compensation Reforms

TESTIMONY

of

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William Black is a professor with dual appointments in economics and law at the University of Missouri-Kansas City. He is also a white-collar criminologist and a former senior financial regulator.¹ He was the staff leader of the reregulation of the savings & loan industry in 2004-07. He developed the concept of “control fraud” – in which those that control seemingly legitimate entities use them as “weapons” of fraud. He has served as the deputy staff director of the national commission that investigated the causes of the S&L debacle, as a consultant for the World Bank on anti-corruption efforts, and as an expert witness for the government in its enforcement action against Fannie Mae’s former senior leaders.

Dr. Akerlof described Dr. Black’s book about control fraud (*The Best Way to Rob a Bank is to Own One*) as “a classic.” Paul Volcker and Representatives Leach and Levitas also praised it. Bill Black has also taught at the LBJ School of Public Affairs at the University of Texas at Austin and at Santa Clara University. He is co-authoring a new book on the ongoing crisis with Professors Galbraith and Auerbach of the LBJ School of Public Affairs.

¹ His regulatory career is profiled in Chapter 2 of Professor Riccucci's book *Unsung Heroes* (Georgetown U. Press: 1995), Chapter 4 (“The Consummate Professional: Creating Leadership”) of Professor Bowman, et al’s book *The Professional Edge* (M.E. Sharpe 2004), and Joseph M. Tonon’s article: “The Costs of Speaking Truth to Power: How Professionalism Facilitates Credible Communication” *Journal of Public Administration Research and Theory* 2008 18(2):275-295.

Chairman Towns, Ranking Member Issa, and Distinguished Members of the Committee:

Here are my main points:

- This crisis, like prior crises, is primarily a story of accounting “control fraud”
- Accounting control fraud produces guaranteed, record (fictional) profits
- When it is epidemic it hyper-inflates financial bubbles and leads to crisis
- The FBI began warning publicly about mortgage fraud “epidemic” in September 2004 and later added that 80% of the losses were caused when lender personnel were involved – yet nothing was done against the control frauds
- Executive compensation is central to why we have recurrent, intensifying crises: it creates perverse incentives for accounting control fraud and it creates a perfect crime – if you create perfect crimes you will cause disaster. Average CFO’s tenure is three years.
- Executive compensation combined with accounting control fraud doesn’t simply defeat “private market discipline” – it renders it perverse; it aids the fraud
- This creates a Gresham’s dynamic in which bad ethics drives out good ethics
- Only government, through regulation and prosecution, can prevent such perfect crimes. The issue isn’t regulation v. markets. The rule of law is essential to make markets function properly. Right now, the markets are too often “spontaneously generating” fraud networks. This is the consequence of deregulation and desupervision. Sometimes that consequence is unintended.
- Deregulation, non-regulation, and desupervision of financial sectors are all equivalent to decriminalizing accounting control fraud – without effective regulators the Department of Justice cannot succeed
- The compensation problem is far broader than the compensation of senior executives and the compensation of executives at entities that received TARP aid
- “Too big to fail” enshrines systemically dangerous institutions (SDIs) and exacerbates these perverse incentives, but ending bailouts would *not* restore effective private market discipline
- The refusal of elite business officials to take responsibility for their often criminal actions, the constant effort to blame it all on “the government,” is not simply fallacious – it turns CEOs into infants
- We, the citizens, need to go on strike. The CEOs that caused this crisis are not “Atlas” – holding up the world for us. We, the U.S. citizens, held up the world for them when their frauds caused the world to come crashing down. If they were to go on strike the world would be a far better place. They are the parasites. As Professor Roberts has said, they have used the disaster they created and their political power to turn the U.S. into “crony capitalism.” So, we, the productive and honest class must go on strike. Not one more penny should go to bail out failed firms or their creditors unless there is a clear legal obligation to do so (the FDIC, of course, will pay its obligations). Let us investigate and prosecute the control frauds and recover compensation gained through accounting fraud. No more bonuses for any lender that takes advantage of the accounting gimmicks the bankers demanded to hide their losses – thereby inflating their “profits” and compensation. No more bonuses for firms that continue the “don’t ask; don’t tell”

Americans are not nearly as angry as they should be about executive compensation. If they knew more, they would be angrier. The current crisis is only the latest in a series of intensifying crises brought on by epidemics of “control fraud.” “Control fraud” is a white-collar criminology theory that explains frauds in which those that control a seemingly legitimate entity use it as a “weapon.” In the financial sphere, accounting is the “weapon of choice.” Accounting control frauds’ ability to create record (fictional) profits means that compensation is a major driver of fraud epidemics and executive compensation is the primary means by which control frauds convert a firm’s assets to their own personal benefit – while minimizing the risk of prosecution.

The National Commission on Financial Institution Reform Recovery and Enforcement (NCFIRRE) (1993), documented the distinctive pattern of business practices that lenders typically employ to optimize accounting control fraud.

The typical large [S&L] 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).

Enron, WorldCom and their ilk provided the second recent U.S. epidemic of accounting control fraud. The FBI began warning against the latest epidemic – mortgage fraud – in its congressional testimony in September 2004. The FBI has also emphasized that 80% of the losses from mortgage fraud occur when lender personnel are involved in the fraud.

Unfortunately, unlike the relatively prompt and properly focused FBI investigations during the S&L debacle, criminal investigations of the major nonprime lenders did not begin during the current crisis until the secondary market in nonprime mortgage paper collapsed in March 2007. The FBI has found:

Many of these bankrupt subprime lenders manipulated their reported loan portfolio risks and used various accounting schemes to inflate their financial reports (FBI Report FY07).

[It] would be irresponsible to neglect mortgage fraud's impact on the U.S. housing and financial markets (FBI testimony 2009).

Each of these control fraud epidemics emanated from the private sector, particularly from elite lenders and investors. They were made possible because ineffective regulation, perverse “private market discipline,” and modern compensation optimized a “criminogenic environment” in which strong, perverse incentives encouraged accounting fraud. It is essential that executive compensation and “private market discipline” be fixed before they cause another crisis. Effective regulation is the only means to do this.

The recipe for optimizing accounting control fraud

The formula for a lender optimizing accounting control fraud has four parts:

1. Grow extremely rapidly (Ponzi-like)
2. Lend to the uncreditworthy
3. Extreme leverage
4. Grossly inadequate loss reserves

The central fact that must be understood is that this formula produces nearly immediate, extraordinary, and guaranteed short-term “profits.” The formula is simple accounting mathematics. Accounting fraud is a sure thing – not a “risk” as we think of that term in finance (Akerlof & Romer 1993; Black 2005). Accounting frauds rarely engage in fraud for the purpose of slightly increasing reported profits. They typically engage in fraud to report exceptional profits.

The reason that extreme growth optimizes accounting fraud is obvious, but the concept that *deliberately* making uncreditworthy loans optimizes short-term accounting profits is counter-intuitive. The first two ingredients in the accounting fraud formula are related. Lenders in a mature market such as home mortgages cannot simply decide to grow rapidly by making *good* loans. Lenders can grow rapidly by making good loans through two means. They can acquire competitors (a strategy that inherently cannot be followed by a very large number of lenders) or they can drop their yields and seek to compete on the basis of price (i.e., their mortgage interest rate in this context). Their competitors are almost certain to match any reduction in mortgage interest rates, so the latter strategy generally fails to provide substantial growth while the lower price leads to reduced “profit” margins.

Lending to the uncreditworthy, however, allows exceptional growth and allows one to charge a higher interest rate. The combination maximizes accounting income. As James Pierce, Executive Director of the National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE) 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; see also Akerlof & Romer 1993; Black 1993; Black, Calavita & Pontell 1995; Black 2005)

In order to make bad loans a practice, a control fraud must gut its underwriting and internal and external controls. Under conventional (failed) economic theory this should be impossible for the existing bad loans would be obvious to any creditor or purchaser of the bad loans. In the ongoing crisis, the answer to this problem was the financial equivalent of “don’t ask; don’t tell.”

Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don't have it and can't provide it. [W]e MUST produce a credit estimate. It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so. [S&P '01]

The context is that a professional credit rater at Standard & Poors has asked for access the nonprime mortgage loan files backing an exotic derivative so that he can review a sample of them to evaluate credit risk. One cannot evaluate fraud risk, the most serious credit risk, without reviewing a sample of the loan files, so the request should be routinely granted. His supervisor’s answer, shown above (the punctuation is from the original), is facially insane. Note that the supervisor makes multiple revealing statements. In addition to the obvious – I don’t care how you do it, find a way to rate it favorably so we can get our (premium) fee – he notes that the “investors” typically do not have the loan files. The investors were the entities, generally investment banks, purchasing the underlying nonprime loans and pooling them to back structured financial derivatives, primarily collateralized debt obligations (CDOs). If the investment banks don’t have the loan files then it is extremely likely that they did not review a sample of the loan files before they purchased the mortgages. The entities that purchase interests in the CDOs from these investment banks obviously cannot conduct due diligence either before they purchase. This entire industry, supposedly composed of experts in evaluating risk, religiously avoided reviewing the primary risk – even during a massive bubble and even after the FBI’s warning of an epidemic of mortgage fraud.

Fitch, the smallest of the big three rating agencies, finally reviewed a small sample of the underlying nonprime loans in November 1007. The date that they released their study is important, for it came after the collapse of the entire secondary nonprime market. In other words, they wouldn’t lose any business because new CDOs were not being created and rated. Fitch’s twin findings were:

The result of the [Fitch loan file] analysis was disconcerting...as there was the appearance of fraud or misrepresentation in almost every file.

[T]he files indicated that fraud was not only present, but, in most cases, could have been identified with adequate underwriting ...prior to the loan funding.
[Fitch 11.07]

Note that Fitch did not find these frauds through a field investigation. It simply did a file review and reported on frauds so crude that they were obvious from the files.

When competitors mimic this optimization strategy the net effect of this competition further optimizes accounting fraud. This perverse competitive effect is also counter-intuitive. As more firms emulated the initial accounting control frauds strategy of making subprime and “liar’s loans” to buyers that could not repay the loans the competition among the lenders reduced non-prime mortgage interest rates. That effect, of course, reduced their accounting profits. (“Alt A” loans were, falsely, represented by their issuers as equivalent in risk to (extremely low risk) “prime” loans. They were made without verifying the borrower’s most important representations. In the trade, they were known as “liar’s loans” because failing to verify such information maximizes “adverse selection” and leads to pervasive deceit.) The dominant effects of rapidly expanding nonprime lending, however, were to massively expand growth and to extend and hyper-inflate the housing bubble. The net effect of increased competition among non-prime lenders was to substantially increase short-term “profits.”

The greater a firm’s leverage (debt to equity ratio), the greater its return on equity, the more likely its stock to increase in value, and the larger the executive compensation. If the lender were to place the loss reserves appropriate to lending (and required by generally accepted accounting principles (GAAP)) primarily to the borrowers least likely to repay the loans its “profits” would disappear and it would report that it was insolvent and unprofitable. The executives would not be paid any bonuses and their stock options and shares would be worthless. It would also make it impossible to sell their non-prime mortgages to others. Accounting control frauds therefore do not comply with GAAP and record proper loss reserves. This optimizes their short-term “profits” but constitutes securities fraud if they are publicly traded.

Optimizing the Ability to Make Bad Loans

The glaring difficulty with a lender adopting a strategy of deliberately making an enormous number of bad loans is that an honest lender’s entire institutional structure and culture is designed to prevent bad loans. Large lenders, and bubbles are inherently the product of the actions of large lenders, have multiple layers of internal and external controls that are typically extremely effective in preventing bad home mortgage loans. Losses on prime home mortgage loans are generally well under one percent.

The internal controls at large lenders are supposed to include the loan officer, the loan officer’s supervisor, loan underwriters, internal appraisers, the credit committee, the senior risk manager, the internal auditor, the audit committee, the chief operations officer (COO), CFO and CEO, the asset/liability committee, and the board of directors. The external controls include the outside auditor, rating agencies, and appraisers. A large lender will have roughly a dozen overlapping controls that are supposed to stop any practice that leads to significant numbers of preventable bad loans.

Each of these control layers must fail – contemporaneously – to permit an overall strategy of making tens of thousands of bad loans. The odds against each of these controls failing contemporaneously and independently due to random events are miniscule. The odds that the controls will all fail independently and the failures will continue for five years without being restored are essentially zero.

Lenders that engage in accounting control fraud need to end normal, prudent underwriting and to pervert multiple layers of “controls” into non-controls that will (1) endorse a lending strategy of making bad loans, (2) fail to book loss reserves that will cover the resultant losses, (3) produce and “bless” fraudulent accounting statements that purport to show that making bad loans is exceptionally profitable, and (4) pay extraordinary bonuses premised on the fraudulent profits. It is impossible to produce and maintain such a pervasively fraudulent firm (and suborn the external controls) without the active support of the senior officers controlling the firm (Black, Calavita & Ponetell 1995; Calavita, Pontell & Tillman 1997; Black 2002).

Creating a Corrupt “Tone at the Top” Suborns Internal Controls

A large firm obviously cannot send a memorandum or email message to a thousand employees instructing them to commit accounting fraud. The firm can, however, send the same message without any risk of criminal prosecution through its compensation system.

Modern executive compensation systems suborn internal controls. (Control frauds do not “defeat” controls — they turn them into oxymoronic allies.) The Business Roundtable is made up of the nation’s 100 largest firms. In response to the series of accounting control fraud failures (e.g., Enron and WorldCom) in 2001 and 2002, the Roundtable chose Franklin Raines, then Fannie Mae's CEO, as its spokesman to explain why that epidemic of fraud had occurred. In a *Business Week* interview he was asked:

[Businessweek:] We've had a terrible scandal on Wall Street. What is your view?

[Raines:] Investment banking is a business that's so denominated in dollars that the temptations are great, so you have to have very strong rules. My experience is where there is a one-to-one relation between if I do X, money will hit my pocket, you tend to see people doing X a lot. You've got to be very careful about that. Don't just say: "If you hit this revenue number, your bonus is going to be this." It sets up an incentive that's overwhelming. You wave enough money in front of people, and good people will do bad things.

Unfortunately, Raines' insights stemmed from his implementation of just such a system.² Raines knew that the unit that should have been most resistant to this "overwhelming" financial incentive, Fannie Mae's Internal Audit department, had

² Raines' observation about the perverse impact of such compensation systems has been confirmed by statistical tests. As Bebchuk & Fried, the leading experts on compensation systems, observed in their study of Fannie Mae's compensation system:

As we noted at the outset, we do not know whether Raines and Howard were in any way influenced by the incentives to inflate earnings created by their compensation packages. There is a growing body of evidence, however, that in the aggregate, the structure of executive pay affects the incentive to inflate earnings.¹⁰ For example, pay arrangements that enable executives to time the unwinding of equity incentives have been correlated with attempts to increase short-term stock prices by inflating earnings. Thus, the problem of rewards for short-term results is of general concern.

n. 10 See, e.g., Scott L. Summers & John T. Sweeney, **Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis**, 73 *Acct. Rev.* 131 (1998). For further discussion of this problem, see [Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004):] at 183-85.

Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage. Lucian A. Bebchuk and Jesse M. Fried. *Journal of Corporation Law*, 2005, Vol. 30, pp. 807-822 (at p. 811).

Even scholars opposed to many aspects of financial regulation have noted the endemic nature of these perverse incentives and their close ties to accounting and securities fraud. Markham, Jerry W. **Regulating Excessive Executive Compensation – Why Bother?** (available on SSRN: See, e.g., pp. 20- 21). The depth of consensus on this issue is shown by the strong concurrence of the intellectual father of executive bonus systems, Michael Jensen, who has concluded that (as implemented) they have caused pervasive perverse incentives and led to endemic accounting and securities fraud. Jensen concludes:

- When managers make any decisions other than those that maximize value in order to affect reporting to the capital markets they are lying
- And for too long we in finance have implicitly condoned or even collaborated in this lying. Specifically I am referring to “managing earnings”, “income smoothing”, etc.
- When we use terms other than lying to describe earnings management behavior we inadvertently encourage the sacrifice of integrity in corporations and in board rooms and elsewhere

Recent Evidence from Survey of 401 CFO's Reveals Fundamental Lack of Integrity

- Graham, Harvey & Rajgopal survey (“Economic Implications of Corp. Fin. Reporting” <http://ssrn.com/abstract=491627>) of 401 CFOs find:
- 78% of surveyed executives willing to knowingly sacrifice value to smooth earnings
- Recent scandals have made CFOs less willing to use accounting manipulations to manage earnings, but
- Perfectly willing to change the real operating decisions of the firm to destroy long run value to support short run earnings targets

Jensen, Michael. **Putting Integrity Into Finance Theory and Practice: A Positive Approach (June 9, 2007)** (available on SSRN).

succumbed to it. Mr. Rajappa, its head, instructed his internal auditors in a formal address in 2000 (and provided the text to Raines, who praised it):

By now every one of you must have 6.46 [the earnings per share bonus target] branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breath and dream 6.46, you must be obsessed on 6.46.... After all, thanks to Frank [Raines], we all have a lot of money riding on it.... We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%. Remember, Frank has given us an opportunity to earn not *just* our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46. So it is our *moral obligation* to give well above our 100% and if we do this, we would have made tangible contributions to Frank's goals [emphasis in original].

Internal audit is the "anti-canary" in the corporate "mines"; by the time it is suborned every other unit is corrupted.

The CEO does not have to order, or be aware of, the specific frauds – some employees will do whatever is needed to "earn" their top bonus. The CEO simply communicates – by paying large bonuses based on fictional profits – that he does not care *how* they meet the target. This can create a perfect crime for it gives the CEO ideal deniability. The most common example of this in the housing crisis was the nearly universal practice among nonprime lenders of paying loan officers bonuses on the basis of loan volume irrespective of loan quality. As their peers see that the worst loan officers who make the worst loans maximize their bonuses (and that the “controls” approve even horrific loans), many of them will mimic the worst loan officers’ practices. The most moral loan officers leave. This is one example of a Gresham’s dynamic in which bad ethics drive good ethics out of the marketplace.

By paying large bonuses if extreme “profits” are obtained even to junior officers the CEO also minimizes the risk of whistleblowers. Whistleblowers are the most common means by which authorities learn of these elite frauds. They pose a special risk to the senior officers running an accounting fraud because they can place the officers on notice of the firm’s fraudulent accounting practices by communicating the frauds to the officers. Ignoring the fraudulent practices, or covering them up, can establish the senior officers’ knowledge of the frauds and their intent to permit or assist the fraud. Even if the whistleblower communicates the fraud only to junior officers they may inform the senior managers or the internal or external auditors in the belief that it reduces their risk of prosecution. Some potential whistleblowers may be discouraged from blowing the whistle because they will lose their bonus. More, however, are likely to be discouraged from blowing the whistle if scores of their friends and peers will lose their bonuses and cease to be their friends.

When the CEO leads the fraud and uses executive compensation to suborn internal “controls” he and his subordinate officers can also use the power to hire, fire, reward, and discipline to break any resistance to making bad loans. The best employees will reject bad loans – and be criticized and overruled by their superiors. If they persist in rejecting bad loans they can be disciplined or fired – and their vacant cubical will serve as a warning to their peers. It is less grisly than the King placing his enemy’s head on a pike, but probably more effective in deterring undesired (desirable) behavior.

Using Compensation to Suborn External Controls

Accounting control frauds optimize their frauds not by “defeating” external controls, but rather by suborning them and turning them into their most valuable allies. U.S. accounting control frauds typically retain top tier audit firms precisely because these firms’ reputation is so valuable in assisting their frauds. The value of a top tier audit firm “blessing” fraudulent financial statements is obvious. The blessing helps the control fraud deceive creditors, investors, and regulators. It also makes it difficult to prosecute the CEO who “relied” on the outside auditors.

The value of having one of the top three rating agencies give a collateralized debt obligation (CDO) “tranche” backed by “liar’s loans” a “AAA” rating is even more obvious. (CDOs are a variety of “structured finance” in which the cash flows from the underlying mortgages go in order of priority to the owners of different layers of financial derivatives. The top CDO layer (tranche) has the first claim to cash flows and is the least toxic of an extraordinarily toxic instrument. A tranche rated “AAA” (while the nonprime secondary market was still operating), was considerably more valuable and more liquid. The “AAA” rating also appears to validate the “high” quality of the nonprime assets and demonstrate that the nonprime mortgage lenders must be prudent.

Appraisers cannot provide substantial reputation advantages to a control fraud because no appraisal firm has a national reputation remotely analogous to a top tier audit or ratings firm. Nevertheless, outside appraisers can appear to provide an independent, expert, and professional opinion of the market value of the pledged real estate. That opinion, if materially inflated, offers two advantages to accounting control frauds. It allows the lender to make a substantially larger loan (which increases fees and “income”) and it allows the lender to claim that the loan is prudent even if the borrower defaults. Appraisers can make horrific loans appear to be good loans.

Control frauds suborn each of these controls primarily by using compensation to create a Gresham’s dynamic. In the case of audit firms they also exploit “agency” problems. It is important to understand that while a Gresham’s dynamic can lead to endemic corruption of these “controls” they can cause a crisis by suborning only a small portion of the professionals. The senior officers at the control fraud choose the professionals the lender will employ and they can choose the weakest link to provide the opinions they need to aid their accounting fraud.

The existence of a strong Gresham's dynamic has been confirmed in each of these three external "controls."

[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).

The typical large S&L fraud invariably used a top tier audit firm and was successful in getting "clean" opinions for several years. Enron, WorldCom and their ilk were consistently able to obtain clean opinions from top tier audit firms, as were the large nonprime specialty lenders.

A major rating agency has confirmed that customers created a Gresham's dynamic during the current crisis. Moody's (2007) reports how much business it lost when it sought to give more realistic (i.e., lower) ratings to the most toxic tranches of toxic CDOs:

[I]t was a slippery slope. What happened in '04 and '05 with respect to subordinated tranches is ... our competition, Fitch and S&P, went nuts. Everything was investment grade. We lost 50% of our coverage [business share]....

One should not have too much sympathy for Moody's loss of market share on "subordinated tranches." The real money for the agencies on CDOs was the top tranche. The agencies (ludicrously) helped their clients structure their CDO tranches such that the overwhelming bulk of CDOs composed of nonprime loans was purportedly top tier. Moody's joined its peers in giving virtually all of the (toxic) top tier "AAA" or "AA" ratings even though that was facially absurd. Its competitors, by giving even the toxic subordinated tranches "investment grade" ratings, made it possible for pension funds and governments to acquire for investment billions of dollars of ultra-toxic assets that would suffer nearly total losses of market value.

The Gresham's dynamic in appraisals has been established repeatedly in surveys of appraisers.

A new survey of the national appraisal industry found that 90 percent of appraisers reported that mortgage brokers, real estate agents, lenders and even consumers have put pressure on them to raise property valuations to enable deals to go through. That percentage is up sharply from a parallel survey conducted in 2003, when 55 percent of appraisers reported attempts to influence their findings and 45 percent reported "never." Now the latter category is down to just 10 percent.

The survey found that 75 percent of appraisers reported "negative ramifications" if they refused to cooperate and come in with a higher valuation. Sixty-eight percent said they lost the client -- typically a mortgage broker or lender --

following their refusal to fudge the numbers, and 45 percent reported not receiving payment for their appraisal.

Though mortgage brokers were ranked the most common source of pressure -- 71 percent of appraisers said brokers had sought to interfere with their work -- agents came in a close second at 56 percent. Both numbers were up significantly from where they were in the 2003 survey. Also identified as sources of pressure were consumers -- typically home sellers (35 percent) -- as well as mortgage lenders (33 percent) and appraisal management companies (25 percent) (*Washington Post*, February 3, 2007).

Appraisal profession leaders have been remarkably open about the destructive effects of this Gresham's dynamic.

Given the decline in mortgage activity, appraisers are scrambling for work in a way that's testing the industry's moral fiber, especially in hard-hit markets such as South Florida. It's getting to the point where, says Faravelli [Manager of the California Association of Real Estate Appraisers], with unusual candor for a trade-group official, "You show me an honest appraiser and I'll show you a [financially] poor one" (*Market Watch*, April 24, 2007).

The intimidation can be extreme. Mr. Inserra, an Illinois appraiser testified before Congress about a physical threat:

Inserra knows how intense the pressure to inflate values can get. Three years ago, he found himself battling one of his largest clients. The bank's senior vice president in charge of mortgage lending tried to get Inserra to "hit a number," industry parlance for inflating the appraisal. He wouldn't do it.

"The discussion got so heated," recalled Inserra, "that he threatened to do harm to my family if I didn't co-operate. I really thought he might do it. I got a restraining order from a judge."

In the end, the banker didn't hurt his family, but he did punish Inserra by depriving him of the \$200,000 in annual business he had been getting from the bank (*Ibid*).

Inflating an appraisal is an act of fraud and the only reason that a lender would seek an inflated appraisal – or tolerate inflated appraisals – is if it is an accounting control fraud. Lenders and their trade associations emphasize this point.

"We have absolutely no incentive to have appraisers inflate home values," Washington Mutual said in a release. "We use third-party appraisal companies to make sure that appraisals are objective and accurate" (*The Seattle Times*, November 1, 2007).

The Mortgage Bankers Association (MBA) first noted why it would be irrational for a lender to inflate appraised values, particularly during a mortgage fraud epidemic.

If the appraisal contains inflated, inaccurate or material omissions related to the value of the property, the lender will likely suffer a greater loss if the loan goes into foreclosure. Furthermore, a borrower who obtains financing based on an inflated value may be less likely to continue making payments when he or she discovers the value of their home is lower than the outstanding loan balance.

MBA recognizes that mortgage fraud is a burgeoning crime that is impacting more and more companies and communities.

MBA opposes all fraud that affects the mortgage industry, and it is important to understand that mortgage lending institutions do not benefit from inflated appraisals (MBA October 2007).

MBA's logic is impeccable, but it does not explain why lenders were a significant direct source of pressure to inflate appraisals and why they permitted their agents (e.g., loan brokers) to be an even larger source of appraisal intimidation given their incentive and ability to ensure that appraisals they relied on were not inflated. Why did so many lenders directly, or indirectly through their agents, push for inflated appraisals when inflated appraisals are disastrous for the lender? Why did the nonprime specialty lenders routinely pay their loan officers and brokers primarily through compensation systems that created an intense incentive for them to pressure the appraisers to inflate the appraisals? The answer is accounting control fraud. Inflating the appraisal allowed the lender to make more, and larger, loans to uncreditworthy borrowers that would pay a premium interest rate. That maximized short-term accounting "profits" and the senior officers' compensation. Accounting control frauds do not act to further the best interests of the lender. They maximize the CEO's interests at the expense of the lender. The CEO loots the firm through accounting fraud.

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." 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).

Modern Executive Compensation Minimizes the CEO's Risk of Prosecution

In addition to creating the perverse incentives discussed above, modern executive compensation allows CEOs running accounting control frauds to become enormously rich while minimizing the risk of detection and prosecution. Modern executive compensation is premised on the claim that senior officers must be paid extremely high bonuses to incentivize them to cause the firm to engage in riskier activities that could produce exceptional returns. Proponents claim that such compensation "aligns" the CEO's interests with those of the shareholders (Easterbrook & Fischel 1991). Control fraud theory demonstrates that it can do the opposite – further misalign the interests of fraudulent CEOs to both encourage them to loot the firm and provide an optimal means of looting the firm. I have discussed both aspects in some detail elsewhere (Black 2003, 2005) and will limit this discussion to a brief summary. Accounting control frauds normally control their boards of directors and cause their compensation to be based largely on short-term accounting gains and to be exceptionally large if the firm is highly "profitable." Accounting fraud guarantees extreme short-term profits while the bubble is inflating. Fraudulent CEOs use normal corporate mechanisms to convert firm assets to his personal benefit on the basis of the firm's record "profits." This minimizes the risk that their frauds will be detected or prosecuted. They can get rich enough through a year

or two of accounting fraud to retire wealthy. The firm's failure does not mean that the fraud mechanism has failed. Fraudulent CEOs maximize their "take" by maximizing accounting "profits" – through means that often cause the firm to fail. They maximize their income by causing the lender to grow rapidly as the bubble hyper-inflates, a strategy that often causes the firm to fail.

Why accounting control fraud turns private market discipline perverse

Accounting control fraud produces very large "profits" and "equity." Lenders worry primarily about insolvency, so firms reporting large profits and substantial equity are the customers to which they most wish to lend. Instead of providing discipline, creditors provide the bulk of the funds that control frauds loot.

Whenever these control fraud epidemics occur, however, theoclassical economists try to excuse the behavior of the elite frauds by blaming it all on the government. During the S&L debacle, they claimed that the problem was deposit insurance. The economists claimed that deposit insurance removed the incentive of creditors to engage in "private market discipline" (depositors are S&Ls' dominant creditor and most deposits are fully insured).

The logic was that because it is expensive to monitor for fraud, fully insured creditors (i.e., depositors) would not bear those expenses because they were fully protected from loss. This logic was falsified by the S&L debacle. First, shareholders are also supposed to provide effective discipline (indeed, they must do so under the "efficient markets hypothesis" – the core principle of modern finance). Shareholders are not insured and were routinely wiped out by S&L receiverships. Second, many S&L control frauds had subordinated debt. S&L receiverships also routinely wiped out the subordinated debt holders. Theoclassical economists argued that subordinated debt holders were the ideal form of private market discipline because (1) they are at exceptionally great risk of loss in the event of insolvency and (2) they are supposed to be particularly "sophisticated." In no case did subordinated debt holders provide effective discipline against an S&L control fraud. S&Ls also had uninsured risk exposure in receiverships through syndicated loans and joint ventures – none provided effective discipline. We resolve a number of the worst S&L control frauds through liquidating receiverships. Even general creditors knew they were at risk of loss.

Note also that a major fraudulent investment banker – Michael Milken's Drexel Burnham Lambert – failed during the S&L debacle. (Several of the worst S&L control frauds such as Charles Keating's Lincoln Savings were Drexel's "captives.") Drexel's creditors suffered serious losses.

The second recent epidemic of accounting control fraud, centered largely among high tech firms, again falsified the claim that private market discipline would stop accounting control frauds if there were no deposit insurance. None of the major control frauds in that epidemic was federally insured and their creditors suffered very large losses.

The current epidemic has also falsified the claim. The leading entities that specialized in making nonprime mortgage loans were overwhelmingly uninsured – as were the leading entities that purchased financial derivatives backed largely by fraudulent mortgage loans. Most of these entities went bankrupt and their creditors suffered major losses. The U.S. had not bailed out investment banks in any recent crisis. The recent precedents were that they, like hundreds of mortgage banking firms specializing in nonprime loans, were allowed to fail and their creditors suffered serious losses precisely because private market discipline was so ineffective in constraining losses. To sum it up, creditors had strong incentives to engage in private market discipline in 2002-06 when the housing bubble was expanding and particularly after the FBI's September 2004 warning that there was an "epidemic" of mortgage fraud developing, but they did engage in effective private market discipline. They did the opposite – they provided massive loans to fund extreme growth by the uninsured nonprime lending specialist firms. "Private market discipline" was an oxymoron. Instead, of discipline, the creditors acted like an accelerant spreading the arsonists' flames.

As Professor Roberts phrased it last month: "Who lent them the money? Each other." "That's sick, that's bad for capitalism, its bad for democracy."

One of the fundamental errors of logic is to impute causality to factors that occurred after the event one is trying to explain. Here, the bailout came after the perverse private market discipline and it came in circumstances where if creditors were to have predicted from past events they could have had no reasonable basis for believing that the U.S. government would bail out creditors not covered by federal deposit insurance. A second fundamental logical error is to offer an explanation that cannot explain the overall factual pattern. If the hope that the government would bail out uninsured creditors of lenders the government considered "too big to fail" is supposed to explain why Citi made insane loans to Lehman, what explains why lenders also made insane loans to relatively small mortgage banking firms that (a) were not in fact bailed out and (b) no one could have rationally believed would be bailed out? Something universal had to be involved to explain the pattern of a wholesale breakdown of private market discipline in lending to nonprime mortgage specialists. The FBI's accurate warnings that mortgage fraud was epidemic and coming primarily from the lenders are consistent with accounting control fraud, which explains the overall pattern of perverse private market discipline.

The private sector will not solve this problem

The private sector has actually gotten worse in many compensation dimensions.

James F. Reda & Associates, an independent compensation consultant in New York ... looked at proxy filings issued by almost 200 companies in the first half of 2009. The firm analyzed changes these companies made to their pay plans that take effect this year.

The biggest shock? Instead of seeing a greater reliance on long-term incentive programs, the Reda report found that changes in these companies' plans made

short-term incentive pay a bigger part of the compensation pie (Gretchen Morgenson NYT 8.16.09).

The fundamental problem is perverse incentives. The control frauds and the “merely abusive” will have the worst compensation systems. The best run companies will tend to have the best compensation systems. The Gresham’s dynamic and short-run nature of senior officers will remain. The only issues are how soon and how severe the next epidemic of accounting control fraud and financial crisis will be. Only the government, through regulation and prosecution, can break this dynamic. Once the dynamic is broken useful peer pressure might also reemerge. That won’t deter the control frauds, but it may be helpful against the abusive CEO.

The criticism that some are making of regulation of executive compensation is actually a testament to the need for regulation. The criticism is the claim that if we require compensation to be tied to real, long-term performance the best managers will flee America for the City of London (or China). In other words, the argument endorses a Gresham’s dynamic that drives a “competition in laxity” in which the nation with the weakest standards ends up with all the best business leaders.

This is a bizarre argument. It is based on the false assumption that the best leaders insist on being paid the most compensation based on short-term accounting gains that CEOs can produce at will. The dynamic enshrines and rewards abuse and fraud. The idea that the senior officers of the systemically dangerous institutions that created this global crisis represent the world’s greatest pool of talent is preposterous. In reality, the UK is cracking down on pay. If we really want to keep all these failed officers in the U.S. we can create a rule that we only bail out financial institutions whose operations are really based in the U.S. The U.S. taxpayers would be happy to see China, rather than the U.S., stuck with bailing out the failed bankers in the next crisis.

What we can do

We need to recognize that compensation, not simply executive compensation, is what has perverted private market discipline. Second, we need to recognize the critical role that executive compensation plays in producing epidemics of accounting control fraud. Third, we need a massive crackdown on accounting fraud – which will allow us to claw back the massive fruits of accounting fraud that executives have already received. We need to provide the FBI promptly with a minimum of 1000 new white-collar crime specialists and prioritize their investigations on the leading nonprime specialty lenders and investors. The Fourth, we need to realize that huge pay for senior executives must be given only on the basis of real, sustained performance.

That means the taxpayers should go on strike. No more money for bailouts – not a penny – until we recover the past compensation obtained through fraud and end executive compensation programs that produce a criminogenic environment for accounting control fraud. We need to end the accounting gimmicks that the industry demanded (and Congress provided) that allow lenders to avoid recognizing losses. This inflates net

worth and earnings enormously and maximizes “moral hazard.” It leads to completely unjustified compensation. No company that takes advantage of these accounting gimmicks should be allowed to use performance pay.

We also need to end “don’t ask; don’t tell.” Neither banks nor the regulators appear to be locating the underlying loan files on the toxic mortgages. This makes it impossible to spot frauds before it is too late, it inflates reported profits, and it slows the making of criminal referrals against the frauds.

We don’t have to set salaries. We need to set standards that better tie pay to long-term performance and have clear “clawback” authority where the numbers are frauds.

As Professor Roberts said on April 27, 2009:

The role of government is to mitigate those [crises]. And I think it historically can. And I think when it’s doesn’t it’s because the regulators have grown lax. It’s because you get things like the SEC, the Securities and Exchange Commission under George W. Bush, which really as in the Bernie Madoff case just to take an extreme example almost felt its mandate was to look the other way. I think if that’s what we have as regulators then “yes”, regulations under those conditions don’t work. So, you need a civil service and you need officials that are committed to this. But you can keep explosions from happening if government is vigilant.

What we need is a commitment to “vigilant” regulators who do not have a “mandate ... to look the other way.” That does mean professionals from the civil service rather than the shameful political appointees that were appointed precisely because they did not believe in regulation.