Bill Black on Financial Crisis & Fraud

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Zain Raza (ZR):
Welcome to Know Your Stuff. A program aimed at educating on historical concepts and societal issues. My name is Zain Raza. Today we're joined by William Bill Black, former financial regulator and an academic. He's also Professor of Economics and Law at the University of Missouri, Kansas City, and is the author of the book called "The Best Way To Rob A Bank Is To Own One".
Bill thanks for your time.

Bill Black (BB): Thank you.

ZR: So let us start with finance. We often hear the stories of financiers, hedge funds and philanthropy, or top 50 Forbes lists, but we rarely hear the story of a financial regulator – which you were during the 80s.
Talk about the role of a financial regulator, what it is and how does an eventful day look?

BB: So the role of a financial regulator is heavily contested. I'll tell you what it meant back in our day when I joined the agency, which was April 2nd 1984 – and I can only remember that because it was the second birthday of our first child – it was supposed to be a very quiet job. Banks rarely failed, they certainly weren't conceived as failing due to fraud, and it was anti-regulatory times in both of our major parties in the United States. The Democrats and the Republicans agreed, regulators really weren't supposed to do much regulation. And so the joke in the industry we regulated was that it was run under the 3-6-3 rule: borrow money at 3% , loan money at 6%, and be on the golf course by 3:00 pm. And the regulators could join them at 4:30, except we didn't have enough money/weren't paid enough, to afford the good golf courses.

ZR: OK. So in the 1980s one could argue you were quite aggressive pursuing white collar criminals. You were responsible for re-regulating the Savings & Loan industry and prosecuted over a thousand elite white collar criminals. For our viewers, please explain what the Savings & Loan crisis was, and thereafter talk about the fraud that you uncovered during that time.

BB: Right. So that sleepy world that I was talking about had actually ended several years earlier. So the first thing you need to know about Savings & Loans is that in that day they made very long term loans – typically 30 years at a fixed interest rate. And that meant, if interest rates went up a whole lot, the market value of those mortgages was going to fall really sharply. And the head of our central bank – the Federal Reserve in the United States – increased interest rates to unprecedented levels in US history – above 20%. And so every Savings & Loan was insolvent on a market value basis. There were roughly 3000 of them and they were insolvent by about a total of 150 billion dollars. We were

also the federal insurance fund for the industry and we had 6 billion in the till for the insurance fund. Well, 150 billion is a lot bigger than 6 billion.

So that was the first phase of the crisis. It's called the interest rate risk phase. And that's basically 1979 to 1982. By 1983, there are 300 Savings & Loans and every one of them is growing at least 50% a year. Now the rule of thumb in banking is if you grow more than 25% a year, you're probably going to collapse. And many of these weren't growing just 50%, some of them were growing more than a 1000% a year. Those entities were the frauds.

So what we had to have was this enormous change in the way we thought about things, where we could conceive of a seemingly legitimate financial entity as actually a criminal enterprise. Run, not for the benefit of the bank, but for the benefit of the CEO, and using all the seeming legitimacy and all the power the CEO can bring to bear of a major corporation to run those frauds.

So what happened? We decided to – we called it – "autopsy" every failure, (in) 1983/1984, to look for patterns and we did, we found what we called the fraud recipe, which had four ingredients:

One – grow like crazy 50% or more a year. Two – and here's the real kicker, by making really really really crappy loans, horrible loans in quality, but with a high nominal yield. You could hear me stress the word nominal because, of course, if you make super risky loans and you charge say 14% when most people are charging 8%, you're not actually going to get 14% because a lot of those loans are going to default. So the nominal rate is just the contract rate. What matters is what you can actually collect. The third thing was extreme leverage, that's just jargon for a whole lot of debt compared to equity. So equity is what protect you against failure, if you have a whole lot of debt compared to equity you're much more vulnerable to failure. And fourth – by setting aside virtually no loss reserves, – remember those inevitable losses of making really risky loans, you are going to have tons and tons of losses – well they set aside virtually nothing as a reserve for those.

If you do those four things (which are super simple to do, a moron can do those four things) then there are three sure things we discovered. One – the Savings & Loan would promptly report that it was the most profitable Savings & Loan in America. Two – under modern executive compensation the officers would be made incredibly wealthy. And third but only many years later potentially – the institution would fail catastrophically.

So this changed everything about how we regulate and we realized we weren't dealing with risk really. We were really dealing with deliberate frauds. And we also recognized this recipe had an Achilles heel that we can go after – we had very few people, very little money (as I told you) to be able to close the frauds – we couldn't close the great bulk of the frauds as we didn't have the funds to do it, and so we restricted growth. That was their Achilles heel, because these are in essence Ponzi schemes. In a Ponzi scheme you survive by paying off the old folks with new money you're bringing in, so you have to grow extremely rapidly. Well by restricting growth we doom those institutions. But we did more.

We went after them when they were the most politically powerful entities, in many ways, in America. They were able to recruit the second most powerful elected official in America. Let's call the speaker of the house. His name was Jim Wright then. But also five US senators – we only have one hundred US senators – to try to stop our crackdowns. And we proceeded despite this political opposition. And

then, as you said, we embarrassed the Department of Justice into prosecuting. The way we did it was by making criminal referrals. What we did was make public every month how many criminal referrals we made, and pretty soon the Washington Post was asking the Department of Justice every month, “wait a minute, there are 3000 criminal referrals but there are only 12 cases pending of prosecutions. What's going on?” And eventually the Department of Justice was getting kicked so much – we eventually made over 30 000 criminal referrals – that they made a deal with us. And the deal was, we'll work with you to create the hundred worst fraud schemes in the country. Those involved 310 Savings & Loans and about 600 individuals. So this is the most elite of the elite. Our motto was, “Never be the ones chasing mice while lions roam the campsite.” So we went after the Lions, and the people with the immense political power, and prioritized them for the prosecution.

Now they have the best criminal defense lawyers in the world. America still does some things well and they'll spend money like water to keep the CEO out of prison, but we had more than a 90% conviction rate, and we convicted over a 1000 of these elites of felony. It was harder in that year to actually get prison time but we got prison time for 80% of them. It's the greatest success against a elite white collar criminals and prosecutions, even today, and we did this despite all of their immense political intervention and ultimately, we so embarrassed the politicians, that even the sleaziest of them were wearing buttons, literally six inches in diameter, that said “Jail the S&L crooks”. Now it was complete hypocrisy, but it tells you that you had won. So it can be done, regulation can succeed, but many people had to give up their careers, are absolutely unemployable. People at our most senior levels, the frauds will attack you using anything, and so people had their careers destroyed because they were gay, for example. They were fired, with the speaker of the House – a Democratic speaker of the House – demanding that they be removed on the “grounds” that they were gay.

ZR: So this reminds me of the 2008 financial crisis in terms of Ponzi scheme, not in terms of criminal prosecutions. But before we talk about the connection between the Savings & Loan crisis and the 2008 crisis, I want to talk to you briefly about the infrastructure of the financial industry. I'm talking, for example, about high frequency trading, and also about the methods that are used to gamble like stock buybacks or derivatives. Could you, for our young viewers, explain the infrastructure as well as the methods that are used to profit?

BB: OK. So the key is nobody wants to gamble. Gamble has very little chance of winning; a high risk gamble. And so the art is the sure thing, and the sure thing is fraud and predation and having an advantage. So let me give you an example, you mentioned high frequency trading. So high frequency trading, the trades are made not through humans making decisions – because we're too slow – but through algorithms that we've created. And basically they say this, when corporation A's stock goes up, usually corporation B's stock goes up thereafter. And so as soon as we have an algorithm that monitors prices. As soon as A goes up. Literally within nanoseconds – a nanosecond is an incredibly short amount of time – an order goes out to buy big. And that's great but it's not a sure thing. So what did they do to do a sure thing? Well, for example my university, the University of Michigan where I got most of my training, puts out something called the Business Confidence Index. And that moves markets. So when it comes out, if it says business is more confident, stock market prices will rise.

So people doing high frequency trading bought access to that before it was publicly disclosed and to its shame, the university actually did that. But here's the additional scam. So that was like a group of a couple of hundred folks that they gave this premature access to so that they could trade quicker than

other folks, but then in secret they had another tier, and that other tier only got like one minute. The other folks got like a half hour to an hour, of extra notice. These other folks only got like one additional minute earlier and so they scammed all the scammers, because all the algorithms essentially are the same because the data is the same. If A then B. So you know what the other guys are going to do or if you know what the other guys are able to do and you're gonna trade first, well you know then you can (well there's a bad word for it in the trade that we don't want to use)... But these are very nasty practices.

That's an example of a sure thing that poses as a risk, poses as if it were a technological advance. But it does nothing good for the world. It just divides up who will be the winners and the most elite folks with the greatest wealth that can have these systems are gonna be the winners. But here's the further kicker. Because these algorithms are the same because the data is the same, there's a huge danger that we'll all do the same thing. So I told you about if stock A goes up then stock B goes up, and therefore we buy stock B as soon as we see stock A increase. The same thing works on the downside, if stock A goes down stock C tends to go down. So what do we do? We all sell C. But what if all of us try to sell C at the same time? Well guess what? Market makers, they lose money. In fact they go bankrupt and then markets collapse. What happens to market value of something if there's no market? If you can't sell it then prices decline catastrophically and then more folks go bankrupt. And this was the flash crash, but before it it was Black Monday in the United States, and it's an enormous risk to the world.

So we do something, we allow something that is hyper-frequency trading that provides no net benefits to the world, aids the sleaziest folks, and creates an enormous what we call systemic risk. A risk that the whole system can be brought down. It is crazy. And that is emblematic of so much of finance. It's a rigged system and it's crazy. It creates crises. So other infrastructure – the economists loved what they called the shadow financial sector in the United States, and they loved it because it had essentially no regulation, and their ideology said, if there is no regulation and no deposit insurance it will be super safe and will be stable. And even if it isn't, who cares? It's one rich guy ripping off another rich guy. What could that hurt? Well it turns out, what it can do is plunge the entire world into great financial crisis.

Right. So this was pure ideology. I've described the first two acts of the Savings & Loan debacle, the first being the interest rate phase, and the second being the fraud phase (the three hundreds). Right at the end, while we were super busy fighting the second phase – all those prosecutions, all those enforcement actions, civil actions we brought to make sure they kept none of the fraud money. Completely different than in 2008

A new scam arose, and in America all good financial scams start in Orange County California. Which was, you know, back in the day a hotbed of right wing anti-regulatory type stuff. And we had jurisdiction over that particular area. So our examiners came to us and said, “This is crazy. The lenders are not even checking on the borrower's income to verify the borrower's income. This has to end in disaster.”

And so while we were super busy dealing with a second act of the crisis, we knocked off a team of people, and they went after these Orange County folks; who were not only making bad loans, they were also for the first time really engaging in substantial predation. Predation particularly against

blacks and latinos, and most particularly against elderly female blacks who were often widowed. Right? The people they viewed as the most vulnerable.

So this is really nasty stuff. And we, by 1994, drove the absolute last one doing that out of the industry. They voluntarily gave up federal deposit insurance for the sole purpose of escaping our jurisdiction and they became the third act of the Savings & Loan crisis. And that act actually grows for 14 years and produces the Great Financial Crisis. That entity was called Long Beach Savings, it gave up deposit insurance so it became a mortgage bank, called itself Ameriquest.

So first, we pushed them out – because they were so sleazy – of the entire industry. Second – on the way out where we have no more jurisdiction over them as banking regulators, the Department of Justice still had jurisdiction over them for discriminatory lending on the basis of race and ethnicity. So we made a referral to the Department of Justice. They slammed Ameriquest. That was the second. The third time around, the Federal Trade Commission slammed them. The fourth time around, 49 state attorney generals brought an action against Ameriquest. Now after that entire pattern over the course of 10 years of fraud and predation, did we make the CEO Roland Arnall, (a) a guest of our prisons? Or (b) did we make him our ambassador to the Netherlands? And of course the answer is, we made him our ambassador to the Netherlands. Why? Because he was the largest political contributor in the nation to the President of the United States, George Bush.

ZR: So I want to connect the Savings & Loan crisis with the big crash in 2008. Although you guys went after so many white collar criminals, why did it continue? And (b) why were there no prosecutions following to 2008? What happened during that period?

BB: So that's what we were just discussing: why was it able to continue? Because it was in the shadow financial sector. And the federal regulators – us – could no longer take any action against them. We have no jurisdiction to do so. Why beyond that? Well because the ideology, as I said, of orthodox economists was, oh the shadow sector is perfectly safe. Everybody will have the right incentives because the government isn't there. We all know regulators don't do anything. Well of course we had just proven the lie to that. So who cares that there's no regulation. There will be self-regulation. In economic jargon it is called private market discipline, but of course the lend lenders are supposed to provide that discipline, they're supposed to refuse to lend to bad folks.

Instead, what they did is form these incredibly tight partnerships. So Ameriquest no longer has deposit insurance. That should make it hard for it to get money to make loans. So what does it do? It gets into a really close dancing relationship with Wall Street, which is also a shadow financial regulatory sector. The big five investment banks had essentially no federal regulation. Eventually they created a fake Potemkin regulation, but everybody knew it was designed to be a farce. So they were getting no effective regulation.

Why are the lenders willing to make terrible loans to people who are often not repaying them? Because the same fraud recipe that I talked about works for both the lender and the investment bank. The officers get rich even though the institutions are going to suffer catastrophic losses and three of the big five investment banks in the United States – massive institutions – failed as a result of these frauds that their officers were running and assisting.

Why no prosecutions? Well first thing is, the United States is a federal system as is Germany. And that means that there's dual sovereignty – the states have sovereignty and the national government has sovereignty, but when it comes to a collision between these two (in the United States context) it's called the Supremacy Clause, it means the feds win. So the state attorney generals were the ones who were going after these really sleazy folks: (a) because they're the ones who have the jurisdiction but (b) because they were less political than the federal government. And so they were doing these successful actions.

What was the federal regulatory response? To pre-empt, to use that supremacy clause, that says the states can't do anything if the feds don't want them to do it. And so, instead of blocking the way we had, and investigating the way we had, and prosecuting the way we had, the federal regulators were doing everything possible, not only to themselves not look, but to make sure that the states couldn't look. And if you don't investigate, what is there to make a criminal prosecution on? If we put our hands in front of our faces and close our ears and such, we see nothing, we say nothing, and that is basically what they did.

So, they also destroyed the criminal referral process. Remember I told you these federal banking agencies were much bigger than us, just our little agency made over 30 000 criminal referrals. Well, all of the federal agencies, regulatory agencies combined, made fewer than a dozen, fewer than twelve, criminal referrals in the 2008 financial crisis.

ZR: Wow.

BB: We knew how to succeed, you create task forces in the epicenters of fraud, and we know the epicenters of these frauds. And we know it's the same recipe. It is the third act of the Savings & Loan debacle that simply was allowed to grow in the shadow sector for 14 years.

And here is three warnings that your viewers really need to know about. The first one is in the year 2000. Now think how early that was. And actually they began the efforts in 1998. And those efforts were known to the federal regulators in 1998, so that's a full decade before Lehman Brothers collapses. Its appraisers, and the appraisal fraud was a major feature of the Savings & Loan debacle, and they did the same thing in the Great Financial Crisis. So you want to, as a fraudulent lender inflate the appraisal greatly. The appraisal is the market value of homes.

ZR: You basically value the home higher than in actual value it is, that's what you mean by appraisal, right?

BB: That's correct. So you're inflating the market value of the home that is pledged as security for the loan. And the whole purpose of this is to make the loan look much much safer. We want to artificially inflate what appears to be the safety of this loan, because the lower the perceived risk, the higher the price in finance. So this is going to be a scam that's going to further hyper inflate the bubble.

And again this is not a new scam. This was the same Savings & Loan heart of the scam that we had prosecuted. So the appraisers saw it because the way this scam works is from the banks. The bankers extort the appraisers to inflate the appraisals. And they blacklist you – in other words they send you no business – if you are honest (So utterly perverse). They and the appraisers in 2000 publicly online

created a petition explaining in really clear terms exactly what I said. They didn't pull any punches and eventually eleven thousand appraisers signed that petition and they were all risking losing all of their business by signing that petition, because the last thing in the world that the lenders wanted was honest appraisers. So that's the first warning – a full decade before Lehman. And what was done of course? Nothing.

Second warning: from the FBI, and not just like a random FBI, the senior FBI official in charge of dealing with mortgage fraud. In September 2004, he testifies publicly in front of Congress and then he deliberately gives a whole series of press conferences and interviews. And he says two things. One, there is an epidemic – his word: "epidemic" – of mortgage fraud developing. And two, he predicts that it will produce a financial crisis. Crisis is his word, not my interpretation of it. So you can't have a better warning than that from our premier law enforcement entity with specialization in white collar crime.

The third one: in the spring of 2006, this one is by the industries, the mortgage industry's own anti-fraud experts who are called MARI (Mortgage Asset Research Institute). Remember I told you that this new kind of loan developed around 1990 as the third act of the Savings & Loan debacle where you didn't verify the borrower's income – that was just called low documentation loan back in our era. But by this era – 2006 – behind closed doors the industry called these "liar's loans", which lacks a certain subtlety. So they studied these liar's loans, which were easy to study because you could check them against tax returns. So we know exactly what the income really was, and we know what was on the loan application forms and the incidence of fraud was 90%! They were virtually all fraudulent. And if you think this was due to trying to loan to minorities or poor people. No. No government regulator in the United States ever required/suggested/encouraged making liar's loans, they did exactly the opposite. And think, if the goal is to loan to people with low income, is inflating their income massively a good way to achieve that goal? Obviously not. So this is the third great warning.

And what did the industry do in response? It increased, from 2003 through 2006, the amount of liar's loans by over 500%. The loans that hyperinflated the bubble were liar's loans. The whole use of the phrase "this is the subprime crisis" is a myth. By 2006 half of all the loans the industry called subprime were also liar's loans. They're not mutually exclusive. And there's a recent study by a wonderful economist, Professor Herndon, that looks the first time at what actually produced the losses, not simply the defaults. A default is when you don't pay the loan. The loss is what you really care about. And he found that 70% of the total losses came from liar's loans.

So we have all those three warnings. Nobody can claim that I couldn't see it coming.

ZR: So I want to get to the solution aspect of this but before I do, my first question is, are we heading to a catastrophe again? Have things changed? And (b) what are the solutions to this. Should we see banking – given the huge risk it has on society – as a utility? Or should we just reform the banks and have them the same way we had them before. By utility I mean, like the way we receive water, it's in the public hands. So could you answer those two questions before we leave you?

BB: Yes. So let me start with the utility. And indeed we use that phrase in the United States as well. And that's the role that postal service banks played in many places, including the United States,

including Scandinavia, Japan as well. So it's relatively easy to use the postal system that people all over the world tend to have access to. And you can have a low risk savings that doesn't do any of these insane things that blow up the world.

How should you view banks? Well, in addition to what we've already said, at the same time that these massive frauds were going on – remember many of these frauds were actually larger in Europe than in the United States – you have people that are not just cheating in one area, they're cheating in everything. They cheat on taxes, their own taxes, they help rich people cheat on their taxes, they help money launder for terrorists, but they money launder from the drug cartels that are incredibly murderous and such. They cheated on Libor. They cheated on foreign exchange. Those two cartels are the largest cartels in world history by three orders of magnitude. They are a thousand times larger than anything we've seen before.

So you asked me about banks. Every large bank that was a member of the Libor system had to cheat to make the cheating work. The same was true in foreign exchange. So it isn't outliers that are cheating. It's not small banks that are cheating. It's the largest most prestigious banks in the world. And that's because they're really operating as criminal enterprises, and they don't just defraud, they also predate. So if you have viewers in the United Kingdom they'll be very familiar with the payment protection insurance scandal. In the United States, the variant was, you come in for a loan and I'm the loan broker, you come to me to arrange a loan – I know that the bank is willing to loan to you at 8%, but if I can get you to agree to pay 10% instead I get a kickback from the bank. That was a massive scam in the United States, Wells Fargo, the cross-selling. So it isn't just that they're fraudsters, it isn't just that they violate the criminal law. They also predate. And so their real business plan at many a large bank is, find customers, cheat customers. That's the business plan. So do we desperately need a public utility? Yes, that doesn't have that mentality. But worse than that, these fraud and predation schemes cause the entire system to break down.

So, here's an example, everybody has been to some kind of party or meeting in which everybody got a bottle of water. So how many of us would drink that bottle of water if we knew that just 1 in 100 was fouled with something vile?

ZR: I don't think I would drink it.

BB: Exactly. So long before fraud becomes endemic, it can cause entire markets to break down because it breaks down trust, and trust is one of the most important things in society.

So how should we look at banks? We should look at banks as the greatest danger. The ones that make impossible "free markets", they rig markets and they rig markets in ways that are really horrible for people, and, in they're not alone, they drive the financial incentives that help produce things like the VW scandal. I mean, think of that! That is a fraud involving at least 12 million frauds over a decade, from the highest level of the organization; where they not only cheat but then they say, “Aha, people might find we were cheating so let's go create an algorithm again that looks for testing. And as soon as we know we're testing we'll create a phony engine performance to scam.” So it's a scam upon a scam upon a scam. These things are clever but that one literally kills people: when you lie about emission levels and actually produce vehicles that have emission levels of – in that case nitrous oxide – five times what they purport, the result is that people die. So that's how we should look at them.

Deutsche Bank is one of the largest criminal enterprises in the world, and instead of being shut down, it is the entity that is (a) constantly given bailout treatment and (b) is allowed to grow. I mean, the idea of allowing it to merge with Commerzbank is crazy and (c) it delays all effective regulatory restrictions, because Angela Merkel says the EU can't adopt these really strict Basel rules because Deutsche Bank would fail them. And so the world's system of increasing capital was disrupted for the sole benefit of Commerzbank and Deutsche Bank. This is nuts.

ZR: Bill, let's pick up this conversation in the future and talk about solutions. Unfortunately we have run out of time. Thank you so much for joining us today.

BB: Thank you.

ZR: And thank you guys for joining us today. Don't forget to subscribe to our YouTube channel and to donate, because if you don't we won't be able to produce independent and non-profit news and analysis. My name is Zain Raza. See you guys next time.

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