POLICY ESSAY

MORTGAGE ORIGINATION FRAUD

Diagnostics of white-collar crime prevention

John Braithwaite
Australian National University

Well-Placed Specificity of Regulatory Analysis

Nguyen and Pontell's (2010, this issue) article makes a strong case that white-collar crime played an important role in the origins of the global financial crisis; specifically, in waves of mortgage origination fraud. Particularly telling is the 2006 Federal Financial Crimes Enforcement Network (FinCEN) report of a 1,411% increase in mortgage-related suspicious activity reports between 1997 and 2005, 66% of which involved material misrepresentation or false documents. Then another 44% increase was reported between 2005 and 2006. The BasePoint Analytics (2007) analysis of 3 million loans, which indicated that 70% of early payment defaults had fraudulent misrepresentations on their original loan applications, was another early warning signal that the mortgage issue was a crime problem. These data also demonstrated that it was a consequential problem, as the loans with fraudulent misrepresentations were five times as likely to go into default. The Federal Bureau of Investigation began issuing public warnings in 2004, claiming that it was seeing a spike in mortgage fraud cases in the mid-2000s (Black, 2009).

Even earlier than that, a more abstract early warning drew on the lessons of the history of the savings and loans debacle from Nguyen and Pontell and fellow scholars such as Bill Black (Black, 2005; Black, Calavita and Pontell, 1995; Calavita, Tillman, and Pontell, 1997; Tillman and Pontell, 1995). Of course, other layers of causation were found in the structures of the derivatives market, the bonus culture on Wall Street, the captured ratings agencies that failed to do their job, the structural imbalances of American indebtedness to China to pay for Chinese exports to the United States, and the defective quantitative risk models applied by the financial industry (Braithwaite, 2009; Johnson, 2009; Krugman, 2008; O'Brien, 2009; Partnoy, 2003).

Yet Nguyen and Pontell's (2010) emphasis on the proximate causes in mortgage fraud is well placed for two reasons. First, many other layers of causation are extremely hard to fix and

Direct correspondence to John Braithwaite, RegNet, Research School of Pacific and Asian Studies, ANU College of Asia and the Pacific, The Australian National University, Canberra, ACT 0200 Australia (e-mail: john.braithwaite@anu.edu.au).

© 2010 American Society of Criminology

to prevent from becoming structural causes of the next crisis. Something like the Volcker plan to regulate bank trading in derivatives, for example, is not hard for other nations to do but is politically fraught in the United States because of the enormous political power and economic interests of Wall Street finance oligarchs. Comparatively, preventing financial misrepresentation in loan applications is an easier regulatory challenge. It is one even developing economies mostly manage reasonably well, so it is one the United States should be able to master.

Second, in retrospect, it is now clear that this was not a global financial crisis; recession only came to those economies that bought bad American housing loans. Most nations had no financial crisis; all they had was a temporary reduction in economic growth, largely driven by reduced exports to the United States. At the time of this writing, there is some risk of a double dip North Atlantic recession as a result of several southern European nations badly managing the extent of their stimulus spending before and after the 2008 recession. Most of the world's population that lives in Asia did not go into recession; Asian economic growth attenuated during the "global financial crisis" but continued throughout at a much higher level than the United States had experienced in the years before the crisis. A few nations like Iceland, the United Kingdom, and Ireland had such disproportionate exposure through the derivatives market to U.S. housing mortgages that they suffered a bigger crisis than the United States. But most of the world's population had a much lesser crisis than the United States and could help pull the United States back out of recession in a way that had not been possible in the 1930s. The main reasons were that their financial regulators did not allow the kind of crime that the United States had allowed in its housing mortgage market, nor had most non-U.S. financial regulators allowed their banks to buy a lot of exposure to it. Many less sophisticated regulators in lesser nations than the United States served their people well by saying to their banks, "We don't understand a lot of this derivatives trading, so we are going to restrict your ability to expose the nation to it." Such nations were even less affected by the last savings and loans debacle (in the 1980s) than by the 2008–2009 crash. This is the second reason why Nguyen and Pontell's (2010) attention to white-collar crime in the U.S. mortgage market as a cause is a well-placed emphasis: Even countries that suffered from other factors in the causation of the "global financial crisis" avoided recession as long as they avoided bad U.S. housing loans.

Many other analyses of the "global financial crisis," originating from New York and London, have been focused far too sweepingly on the general pathologies of the nature of contemporary capitalism, conceiving the Anglo-American North Atlantic as global capitalism instead of part of it, and have been insufficiently focused on specific failures of U.S. financial regulation. That specificity of focus is a strength of Nguyen and Pontell's (2010) article.

Neglect of Preventionism in White-Collar Crime Research

Popular discourse on crime in the media and in politics is overly preoccupied with imprisonment of the guilty as a remedy for crime. Evidence-based criminology suggests that more prison time is rarely the most cost-effective way to reduce crime. One way in which criminology is a superior discourse to media and political discourse on crime is that it directs the attention of

policy makers to a great variety of preventive programs, some of which are bound to be more effective and cheaper than building more prisons. This virtue is manifest across the volumes of *Criminology & Public Policy*. Criminological discourse on white-collar crime insufficiently shares this virtue of the mother discipline. Too much white-collar crime literature identifies the failure to punish sufficiently as the only form of prevention failure worthy of analysis. Admittedly, white-collar crime is more under-deterred than other forms of crime, and reasons persist for thinking deterrence can be more effective with it (Braithwaite and Geis, 1982). Equally, white-collar crime suffers more under-investment in prevention and preventive policing than other forms of crime, and reasons also persist for believing that this policy can be more effective than with common crime (Braithwaite and Geis, 1982). Thankfully, this article (Nguyen and Pontell, 2010) and the earlier work from the University of California, Irvine has been focused admirably on the measures required to prevent another crisis. The tragedy is that regulators have been deaf to their message for so long.

The white-collar crime comparativist is bound to ask the question of whether other countries that have not had the U.S. problems of widespread mortgage fraud have averted this issue by filling their prisons with brokers and bankers. It does not seem likely, although a global comparative study of this kind of enforcement has not been done. In many, perhaps most, domains of enforcement against white-collar crime, the United States is the most punitive enforcer, with other Anglo-Saxon economies—particularly Australia—being next in punitiveness, and with continental European and Asian economies being much less punitive (e.g., Coffee's [2007] data on securities enforcement).

Regulation in less sophisticated economies than the United States works in an old-fashioned way of kicking the tires when the wheels seem to be falling off with unusual frequency in a particular sector. So, if something such as a wave of loan defaults is occurring in a particular place or at a particular bank, then old-fashioned regulators in less sophisticated markets are less likely than their U.S. counterparts to use quantitative risk models to try to understand what is going on. They are more likely to go out and talk to mortgage brokers and bankers at what might turn out to be mortgage-fraud hot spots. If they find mortgage fraud, then such old-fashioned regulators rarely call in a prosecutor. They often mutter darkly about the responsibilities that come with having a banking license (see Grabosky and Braithwaite [1986] on the gentle manners of old-fashioned financial regulators in Australia). One denizen of Australia's Reserve Bank in the 1980s called it "regulation by raised eyebrows." An example of responsibilities about which such old-fashioned regulators would mutter darkly is ensuring that mortgage documents are not riddled with misrepresentation.

Like those in Australia, old-fashioned financial regulators in many countries little touched by the global financial crisis were "benign big guns." In countries like Indonesia, they moved from being captives of crony capitalism to being benign big guns after the Asian financial crisis of 1997. Benign big-gun regulators have enormous powers to take over banks, increase the reserves they are required to hold, limit their derivatives trading, and suspend or impose conditions on licenses that, in most nations, were born of the experience of the 1930s Depression.

But these financial regulators almost never fire these big guns. Rather they "express concern," which often is enough to put a banker in fear that a big gun might be pointed at them. In other words, it is a policing accomplishment in which police officers not only do not lock anyone up, but also they do not so much as withdraw their guns from their holsters to point them at anyone. Nevertheless, it is bargaining for prevention in the shadow of a big gun. It is more the old-fashioned British bobby response of uttering "Ello, ello, ello, what's going on ere?" It is preventive regulatory patrol focused on what look like emerging hot spots (Braithwaite, 2009; Sherman, 1995). The aim is more to prevent the hot spots from getting worse than to punish the evidence of crime that already has been lured to the hot spot.

My intuition is that the United States should ask itself the question of whether it is that more old-fashioned method of kicking the tires and expressing concern at the center of the financial regulation in most other nations that has saved most of them from experiencing anything as bad as the savings and loans debacle of the 1980s or the mortgage fraud surge of the 2000s. In advance of fine-grained empirical research to explore such an intuition, its merit cannot be judged. Nevertheless, I am critical of the U.S. policy debate for having such an impoverished comparative imagination that such questions rarely are asked. U.S. policy debates tend to look within the United States for solutions, to U.S. policy innovation, and to policy transfer from one U.S. policy domain to another without even asking the obvious kinds of comparative questions raised here.

So, with banking crime, perhaps the first option for the U.S. criminologist to consider might not be: "What if we were to apply the same incarceration policy that we have applied so successfully with the War on Drugs, the War on Terror, and the War on Street Crime?" That is not to say that financial regulation in all nations, including the United States, does not need a stronger deterrent element than it currently has. It almost definitely does need more deterrent credibility. For responsive regulators, that would be just at the peak of a regulatory pyramid, where the preventive work that made the biggest difference to levels of financial crime would occur at the base of the pyramid. Yet, a benign big gun is more likely to be effective if it is fired occasionally and with telling effect.

Qualitative Empirical Insights

Not enough of the kind of research that Nguyen and Pontell (2010) have provided in their article exists to enhance our understanding of crime-facilitative environments (Shover and Hochstetler, 2006). Although derived from just 23 insiders of the subprime lending industry, the policy implications are suggestive. We learn that the lead in mortgage fraud tends to be taken by mortgage origination personnel rather than by borrowers (Black, 2008). This point is critical for understanding where to target prevention. We also learn about the most common forms misrepresentations takes. This knowledge helps inform the targeting of audit. We learn that "denial of victim" is a central technique of neutralization, which implies the potential for techniques of deneutralization that require perpetrator bank boards to face victims who so often

have lost their homes, their marriages, or worse. Restorative justice is another possibility (Braithwaite, 2009). Yet another insight suggests that the U.S. finance sector progressively has become less interested in risk management associated with housing loans and more interested in risk shifting, in slicing and dicing risk so that it can be spread around through derivatives. Nguyen and Pontell (2010) offer the telling policy implication here that rewards should not be based on how many loans an employee can squeeze out each month, but instead be based on loans that are performing. This suggestion indeed appears compatible with credible prevention.

One might be more cynical of some of the reforms Nguyen and Pontell (2010) commend in the 2009 Mortgage Reform and Anti-Predatory Lending Act. Requiring a good-faith determination regarding clients' reasonable abilities to repay loans will not suffice if inspectors never check to see that this determination happens or if they fail to insist on reform when it does not happen. Regulation based on risk models bears scant connection to such law. My hypothesis is that countries that have not had the mortgage fraud problems of the United States have not had more demanding laws; they have had more demanding policing. Preventive policing requires, as argued, kicking the tires and making life difficult for the firm in some way when the vehicle is defective. And it requires brokers, bankers, and ratings agencies to be convinced that the regulator will escalate its intervention into their businesses until they fix the problems. The North Atlantic regional financial crisis of 2008, as Nguyen and Pontell argue, did seem to be a case in which lure, inadequate oversight, and a supply of tempted insiders (Shover and Hochstetler, 2006) allowed crime to lead on to catastrophe. This is an example of an explanatory model that seems suitable in guiding the micro–macro empirical work that is needed to inform financial crime prevention policy. My methodological point is that financial crime prevention policy is best advanced by a more comparative method than prevails in American criminology.

References

BasePoint Analytics. 2007. *New Early Payment Default: Links to Fraud and Impact on Mortgage Lenders and Investment Banks*. White paper. Carlsbad, CA: BasePoint Analytics.

Black, William K. 2005. *The Best Way to Rob a Bank Is to Own One: How Corporate Executives and Politicians Looted the S&L Industry*. Austin: University of Texas Press.

Black, William K. 2008. *Why Greenspan & Bush's Regulatory Failures Allowed a "Criminogenic Environment."* Paper presented at the Levy Institute's Minsky Conference.

Black, William K. 2009. Bill Moyer's journal. *PBS.org*. Retrieved June 2, 2009 from pbs.org/moyers/journal/04032009/transcript1.html.

Black, William K., Kitty Calavita, and Henry N. Pontell. 1995. The savings and loan debacle in the 1980s: White-collar crime or risky business? *Law and Policy*, 17: 23–55.

Braithwaite, John. 2009. Restorative justice for banks through negative licensing. *British Journal of Criminology*, 49: 439–450.

Braithwaite, John and Gilbert Geis. 1982. On theory and action for corporate crime control. *Crime & Delinquency*, 28: 292–314.

Calavita, Kitty, Robert Tillman, and Henry N. Pontell. 1997. The savings and loan debacle, financial crime, and the state. *Annual Review of Sociology*, 23: 19–38.

Coffee, John C. 2007. *Law and the Market: The Impact of Enforcement*. Columbia Law and Economics Working Paper No. 304. Retrieved October 15, 2007 from ssrn.com/abstract=967482.

Grabosky, Peter and John Braithwaite. 1986. *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies*. Melbourne, Australia: Oxford University Press.

Johnson, Simon. 2009. The quiet coup. *The Atlantic*. Retrieved April 8, 2009 from theatlantic.com/doc/200905/imf-advice.

Krugman, Paul. 2008. *The Return of Depression Economics and the Crisis of 2008*. London, U.K.: Penguin Books.

Nguyen, Tomson H. and Henry N. Pontell. 2010. Mortgage origination fraud and the global economic crisis: A criminological analysis. *Criminology & Public Policy*. This issue.

O'Brien, Justin. 2009. *Engineering a Financial Bloodbath*. London, U.K.: Imperial College Press.

Partnoy, Frank. 2003. *Infectious Greed: How Deceit and Greed Corrupted the Financial Markets*. London, U.K.: Profile Books.

Sherman, Lawrence. 1995. Hot spots of crime and criminal careers of place. In (John E. Eck and David Weisburd, eds.), *Crime and Place: Crime Prevention Studies,* vol. 1. Monsey, NY: Criminal Justice Press.

Shover, Neal and Andy Hochstetler. 2006. *Choosing White-Collar Crime*. Cambridge, NY: Cambridge University Press.

Tillman, Robert and Henry N. Pontell. 1995. Organizations and fraud in the savings and loan industry. *Social Forces* 73: 1439–1463.

Statutes Cited

Mortgage Reform and Anti-Predatory Lending Act, H.R. 1728 (2009).

John Braithwaite is an Australian Research Council Federation Fellow and Founder of RegNet (the Regulatory Institutions Network) at the Australian National University. He is embarking on a 20-year comparative project called "Peacebuilding Compared" with Hilary Charlesworth, Valerie Braithwaite, and Kate Macfarlane. In the past, he has worked on a variety of areas of business regulation and on the crime problem. His best-known work is on the ideas of responsive regulation and restorative justice. Braithwaite has been active in social movement politics around these and other ideas for 40 years in Australia and internationally. His most recent book is *Regulatory Capitalism: How it Works, Ideas for Making It Work Better* (2008).