To: Joint Committee of Inquiry into the Banking Crisis
From: William K. Black
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Oral Testimony of William K. Black

Introduction

Thank you for the invitation to assist Ireland as you face among the most important questions Ireland and many other nations must answer correctly if we are to put a stop to our recurrent, intensifying financial crises. I am William K. Black and I come to you wearing four disciplinary and three institutional "hats." My primary appointment is in economics with a joint appointment in law at the University of Missouri-Kansas City. I am a white-collar criminologist and a former senior financial regulator. My research specialties include elite white-collar crime and corruption, regulation, and financial crises. I am the Distinguished Scholar in Residence for Financial Regulation at the University of Minnesota's Law School. I am a professor at the Instituto de Altos Estudios Nacionales es la Universidad de Posgrado del Estado in Quito, Ecuador. My testimony, of course, is solely my personal views rather than the official position of any of these universities.

There is Nothing More Expensive than Failed Banking Regulation

There is nothing a nation does in the domestic sphere that is more expensive than ineffective regulation. Bankers cause bank losses. Bank regulators can reduce bank losses dramatically and prevent the hyper-inflation of the bubble and the resultant financial crisis. Bank regulators do not require super powers to succeed. They do not have to be able to foresee the crisis or even realize that there is a bubble to succeed.

The Three Maladies

To prevent the most common and severe form of bank crises, bank regulators need to understand, and act vigorously and promptly to stop, three maladies – the "recipe," indefensible loan underwriting (leading to "adverse selection"), and the Gresham's dynamic. Each of those maladies is profoundly harmful, so acting promptly and vigorously to stem them is highly desirable. Acting to block these three maladies unambiguously aids honest bankers' banks and their shareholders, creditors, and customers. Each of these maladies had been in the relevant literature for decades prior to the Irish bank crisis.

A Caution on Interpreting my Use of the Word "CEO"

For reasons solely of brevity, I use the term "CEO" rather than the phrase "the persons controlling the bank." When I use the term "CEO" I am NOT referring to any individual who may have held that title at a particular Irish bank at a particular time. I am using the term generically and collectively to mean whatever officials exerted control over the strategic decisions of the non-Irish banks. **I do not refer in my testimony to any Irish bank CEOs.**

My testimony does *not* directly address the *causes* of the *current* Irish banking crisis.
My testimony focusses on what causes the worst and the most common banking crises in other nations. Those factors are also the most likely to cause *future* severe banking crises in Ireland and other nations. Preventing and minimizing future banking crises is my focus.

Countering "Criminogenic" Environments

Bank regulators who understood these three maladies have demonstrated the ability to regulate effectively and prevent systemic financial crises. They have figured out what policies make an environment "criminogenic." A criminogenic environment is one in which the incentive structures are so perverse that they produce widespread crime. The primary means by which bank CEOs create these perverse incentives is through compensation, retention, and promotion systems. Irish bank regulators can learn to identify and counter these perverse incentives, preventing and limiting the three maladies in the future and holding even elite individuals personally accountable for their misconduct in future failures.

My description of the need to counter these perverse incentives that make the three maladies widespread is not the only function of good bank regulators, but it is the *paramount function*. Preventing future criminogenic environment in banking would not simply accomplish the paramount function of banking regulators, but also greatly reduce the frequency and severity of future abuses by bankers such as the massive sales of inappropriate financial products to customers. The same type of perverse compensation/reward systems that produce the three maladies also produce endemic product sale abuses by bankers.

The Terrible Cost of Not Understanding the Concept of "Looting"

George Akerlof (Nobel Laureate in Economics, 2001) and Paul Romer chose to end their famous article entitled "Looting: The Economic Underworld of Bankruptcy for Profit" with this paragraph in order to emphasize the reason for the deregulatory failure and how to prevent future financial disasters.

> "Neither the public nor economists foresaw that the [S&L deregulations] of the 1980s were bound to produce looting. Nor, unaware of the concept, could they have known how serious it would be. Thus the regulators in the field who understood what was happening from the beginning found lukewarm support, at best, for their cause. Now we know better. If we learn from experience, history need not repeat itself" (1993: 60).

The key words in this paragraph are "concept" and "unaware." Akerlof and Romer were unduly kind to economists in this passage. First, economists who studied banking knew that, historically, elite insider fraud and abuse had long been the leading cause of the most expensive banking failures. Second, economists did not provide "lukewarm support" to "the [S&L] regulators in on the field" who understood the looting "from the beginning." Economists were our most virulent opponents in trying to stop the elite looters. Third, economists did not "learn from [the S&L] experience." They doubled-down on their unrestricted support for the elite bank CEOs.

Failing to understand a critical risk concept (or excluding the concept from public policy formulation through cognitive dissonance) makes it impossible for regulators to take any deliberate safeguards against that critical risk. Ignorance of key risks also leads to regulatory complacency. This is particularly true when the concept that the regulators do not know exists (1) represents the paramount cause of catastrophic individual bank failures, (2) is increasingly likely, due to modern executive compensation, to produce a Gresham's dynamic that can hyper-inflate financial bubbles and spark systemic banking crises, and (3) initially produces exceptional (albeit fictional) *reported* banking income.

The bank regulator who is unaware of the concept of looting, therefore, creates a regulatory philosophy based on the *implicit* presumption that "accounting control fraud" does not exist. Implicit assumptions pose unique dangers. Because we do not know that we have made them, we never test their validity. When bank regulators implicitly assume out of existence the paramount risk to banks, the banking system, the public, the economy, and the Treasury they make real the great warning. The great warning is that it isn't the things we don't know that cause disasters – it's the things we do know, but aren't true. The bank regulators "knew" that the elite bankers were the solution rather than the problem. They could not have made a worse assumption.

Malady #1: The "Recipe's" Four "Ingredients" for a Lender (or Loan Purchaser)

1. Grow like crazy
2. By making (buying) vast amounts of toxic loans at a premium *nominal* yield
3. While employing extreme leverage, and
4. Providing only grotesquely inadequate loss reserves (Allowance for Loan and Lease Losses – ALLL)

The Recipe Produces Three "Sure Things"

1. The firm will promptly report record profits
2. The firm's executives will promptly be made wealthy by executive compensation
3. The firm will suffer catastrophic losses

Malady #2: The Evisceration of Effective Underwriting

In order to make massive amounts of bad loans the worst bankers have to gut the bank underwriting rules and suborn the supposed "controls." We have known for centuries that this will produce "adverse selection" and cause the loans to have a "negative expected value" at the time they are made. (In plain English, this means that the bank will lose money. The banker maximizes his income by causing the bank to make terrible loans.

Malady #3: The "Gresham's" Dynamic

George Akerlof used the metaphor to Gresham's law in his 1970 article on markets for "lemons," a variety of "control fraud" in which the seller uses his asymmetrical information advantage as to the quality of the goods or services being sold to deceive the buyer. Akerlof was made a Nobel Laureate in Economics in 2001, with the award citing particularly his article on "lemons" (a U.S. term for a car with severe defects).

> [D]ishonest dealings tend to drive honest dealings out of the market. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence (Akerlof 1970).

Akerlof's key observation was that market forces became perverse when dishonest officers use the firm's seemingly legitimacy to defraud the firm's customers and gain a competitive advantage over honest rival firms.

The National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE) that our Congress and President appointed to study the causes of the savings and loans (S&L) debacle found that the bank officers leading the accounting control fraud epidemic deliberately created a Gresham's dynamic to suborn audit professionals.

> [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).

The officers controlling the S&Ls used the same means to extort appraisers to inflate the appraised value of the collateral. The report of the Financial Crisis Inquiry Commission (FCIC) appointed by Congress to study the causes of our most recent crisis shows that the lenders reprised the same fraud scheme.

> From 2000 to 2007, a coalition of appraisal organizations … delivered to Washington officials a public petition; signed by 11,000 appraisers…. [I]t charged that lenders were pressuring appraisers to place artificially high prices on properties [and] "blacklisting honest appraisers" and instead assigning business only to appraisers who would hit the desired price targets (FCIC 2011: 18).

When cheaters gain a competitive advantage, market forces become perverse because of the Gresham's dynamic. As S&L regulators, we were familiar with Akerlof's "lemons" paper, but like virtually all students of economics our professors presented the article solely as a key development of the theory of "asymmetrical information." Our professors had never mentioned the word "fraud" though as one can read in the quotation above Akerlof made clear he was talking about "dishonest dealings." Once we reread the "lemons" article after discussions with the appraisers (the term in the U.S. for the professionals that value real estate) we understood what Akerlof was saying about fraud. Our incorporation of the Gresham's dynamic into the lessons we had drawn as to how fraud could become epidemic proved to be one of the most useful insights.

It took me 20 years after the S&L debacle to learn that a famous non-economist had described the Gresham's dynamic centuries before Akerlof's article. This acute observer was Irish.

> The Lilliputians look upon fraud as a greater crime than theft. For, they allege, care and vigilance, with a very common understanding, can protect a man's goods from thieves, but honesty hath no fence against superior cunning. . . . [W]here fraud is permitted or connived at, or hath no law to punish it, the honest dealer is always undone, and the knave gets the advantage (Swift, J., *Gulliver's Travels* (1726)).

On February 3, 2015, the U.S. Department of Justice (DOJ) announced a settlement of well over $1 billion with the credit rating agency, S&P. DOJ's civil complaint alleged that S&P engaged in fraud by inflating credit ratings on toxic housing derivatives in order to keep the business of the issuers of those derivatives (who generated a successful Gresham's dynamic by setting the credit rating agencies in competition with each other for laxity.

The Implications of the Three Maladies

These looting strategy creates a serious risk of hyper-inflating a financial bubble. The recipe is easy to copy, and because it maximizes bonuses and raises it creates a Gresham's dynamic that pressures honest bankers to adopt their competitors' strategy of looting.

While a bubble is inflating, it is easy to hide bad loans and their losses by refinancing the bad loans. The saying in the trade is: "a rolling loans gathers no loss."

The lending practices that optimize the CEOs' "sure things" and the nature of the "sure things" mean that the worst failures-in-waiting will follow a characteristic pattern that competent regulators can identify early while the bankers are still reporting that the bank has record profits. They have to gut underwriting, which competent examiners will spot very quickly. They will make loans that are exceptionally risky, but they will report for many years low levels of default and loss upon default because they (or others bankers) will refinance the bad loans. A lender that makes highly risky loans (e.g., commercial real estate loans) and maximizes its risk of loss by gutting underwriting.

It is indefensible folly for regulators to rely on self-regulation, outside auditors, credit rating agencies, reported record bank income or reported capital, bankers' concern for reputation, "efficient markets," or "private market discipline." The recipe is mathematically guaranteed to produce high earnings. "Capital" is simply an accounting residual: Assets – Liabilities = Capital. The fraud and abuse schemes I have described function by massively overstating asset values (indeed, as I explained, the banks' bad loans are actually net liabilities). On average, every new bad loan causes the bank's losses to grow. If the worst bankers inflate their asset values and/or understate their liabilities (both of which they do routinely) capital will be inflated enormously. Because they report extreme profits it is easy for them to borrow until the collapse is imminent. Governmental regulators are the only "controls" that fraudulent or abusive bank CEO cannot hire and fire. This is why they seek to create a regulatory race to the bottom – another form of a Gresham's dynamic.

You asked me to comment on capital regulation. Banks need considerably increased capital and that will only happen if capital requirements are increased substantially after Basel II ruined capital requirements for the largest banks and their unreliable models. I do not believe any of the purported horrors of increased capital requirements for banks. I stress that increased capital requirements are a necessary, but not a sufficient change. The accounting fraud schemes I have described and that pose the gravest risks commonly lead to deeply insolvent banks reporting through financial statements blessed by a top tier audit firm that they are highly profitable and exceed all capital requirements. Capital is simply an accounting residual, not a pot of actual money. We cannot simply rely on increased capital requirements to prevent our recurrent, intensifying financial crises.

The very large, unrecognized, credit losses are also likely to cause a liquidity crisis at the bank when the bubble bursts. The losses under the recipe, particularly in the case of a hyper-inflated bubble, are likely to be so large that market-makers fail.

The bad lending practices means that the regulators must intervene – vigorously – and very quickly or the losses will surge (but not be recognized for accounting purposes) and the bubble. The regulators must go (as we did in 1984 in the S&L debacle) to an emergency operations basis. The longer the worst banks remain in business, the worse the harm they will create, and losses at the worst banks typically grow more than linearly, sometimes super-exponentially.
The bank regulators must not rely on conventional econometric tests and modelling of regulatory decisions. The three "sure things" and the Gresham's dynamic mean that as long as the bubble (or appraisal fraud) is expanding the loan activities that best aid accounting fraud will display the strongest positive correlation with higher reported bank profits.

Modeling. We realized during the S&L debacle based on our understanding of these accounting fraud implications that that the economic models used to quantify various financial risks were unreliable because they systematically and severely understated risk in the presence of accounting control fraud. We also realized the key implications of greatly understating the risk of financial assets: the risk/pricing models must dramatically overvalue assets (and, therefore, the bank's capital) and the models create false complacency. The problem was more basic, and far larger than what is now famous as the "black swan" problem – the failure to realize that the most extreme portions of the risk "distribution" (the "tail(s)" that would produce the greatest losses) were substantially "fatter" than assumed under a "normal" distribution. The real problem is that all such statistical techniques rely on their being a true, fixed risk "distribution." In statistical jargon, however, there is no true "exogenous" risk distribution. Our regulatory and governance policies (e.g., the virtual elimination of partnerships run by "general partners" with "joint and several liability" for all the partnership's debts – a characteristic that often created highly prudent decisions), and bank managerial decisions that create a Gresham's dynamic can prove so "criminogenic" that fraud becomes epidemic, even the norm as it did in Libor, Forex, liar's loans, appraisals, and many other banking areas in the United States and the UK.

In such circumstances, the huge risk of catastrophic bank and customer losses due to frauds and abuses led by the banks' CEOs are no longer relegated to the highly infrequent "tails" of the distribution – they fall within the central tendency. This is why we are suffering recurrent, intensifying financial crises.

The Recipe Attacks the Achilles' "Heel" of Principles-Based Regulation

Bank CEOs inherently pose the greatest risk of catastrophic losses to "their" banks – the very people that principles-based regulation presumes are exemplary.

Accounting is the bad banker's "weapon of choice." The primary CEO scheme that causes massive losses to "his" bank involves deliberately making massive amounts of bad loans that will harm the bank but enrich the CEO and create the enormous reported profits that block such regulators from acting.

Making massive amounts of bad loans creates record, albeit fictional, reported accounting income – and huge amounts of real losses that will only be recognized years later.
Bad bankers can cause the bank to enter and concentrate on lending involving assets whose values are opaque and set by experts that the CEO can suborn.

The international accounting standards, purportedly "principles-based" are so unprincipled in their actual interpretation by the bankers and their audit partners that they have created the "perfect crime" by banning what must be required – the *current* provision of loss reserves for the losses sure to be caused by gutting underwriting and suborning the external "controls." Note that the stated "principle" underlying this rule is to prevent CEOs from engaging in accounting fraud by creating "cookie jar" loss reserves. This anti-fraud "principle," however is destroyed by the bankers' interpretation of the anti-fraud principle as creating a much larger, guaranteed fraud by not establishing the loss reserves that would reflect the economic reality that making bad loans through terrible underwriting creates a "net liability" rather than an "asset." This unprincipled perversion of an anti-accounting fraud "principle" into a pro-fraud rule was scandalous, but the fact that the "principle" has not been fixed six years after the abuses were known to be legion explains why competent regulators cannot rely solely on financial accounting principles.
The lending practices that optimize the CEOs' "sure things" and the nature of the "sure things" mean that the worst failures-in-waiting will follow a characteristic pattern that competent regulators can identify early while the bankers are still reporting that the bank has record profits. They have to gut underwriting, which competent examiners will spot very quickly. They will make loans that are exceptionally risky, but they will report for many years low levels of default and loss upon default because they (or others bankers) will refinance the bad loans. A lender that makes highly risky loans (e.g., commercial real estate loans) and maximizes its risk of loss by gutting underwriting.

The Enormous Benefits of a Regulatory Focus on Underwriting

I explained above why focusing on loan underwriting was so useful to preventing and stemming the epidemics of accounting control fraud that drive our recurrent, intensifying financial crises. But the less obvious advantage is that early, vigorous regulatory intervention against pathetic underwriting is unambiguously beneficial to everyone (except corrupt bank officers) and poses no downside.

If we act very promptly as regulators against terrible underwriting we cannot know whether our failure to act would lead the bank to fail or cause a financial crisis. It is ludicrous to think any meaningful "benefit-cost analysis" could be conducted. If we act *extremely* quickly against terrible underwriting we cannot know whether the bank's CEO is leading an accounting control fraud. It takes time to figure out whether the bank's CEO is incompetent or acting fraudulently. The great thing is that for most purposes we do not have to know. When the bank's underwriting is terrible it will cause severe loan losses. We help the bank, the customers, and all honest bankers when we act immediately to stop horrible underwriting because we greatly reduce loan losses.

The matters you asked me to address include the assumption that there are inherent **"trade-offs between aggressive regulation and costs to the economy of excessive interference."** This single sentence contains four destructive anti-regulatory memes. This is an area where is vital to understand that it is impossible to evaluate a generality like "regulation" or "rule." It is a common error these days to start evaluating rules through the prism of "market failure."' The issue (irrationally) is no longer: will adopting the rule be an improvement? Unless there is something that a neoclassical economist considers a "market failure" we are not supposed to improve the world by adopting rules.

This is such a common lens that we now think of "market failure" barrier as if it were obviously sensible. Fortunately, classical economists never followed that test in the past. They believed that it was critical that the government establish – and enforce vigorously – a rule of law. Even intense critics of government like Ayn Rand and von Hayek explicitly argued that it was an important governmental responsibility in establishing an effective rule of law was to prevent fraud. The key disconnect is that even though the Parliament/Congress explicitly relies on us to adopt rules implementing their statutory acts in order to create an effective rule of law, it has become common to denounce such rules as if they were illegitimate as opposed to being essential to helping the legislature implement an effective rule of law.

Classical economists recognized that maintaining an effective rule of law was not merely helpful, but essential to allow honest business people to prosper. As to a broad category of rules (but certainly not all rules) there is no "trade-off" between "aggressive regulation" and "costs to the economy." The opposite is true – effective regulation is essential to *reducing* "costs to the economy." There are few things as costly as the breakdown in the rule of law. That is what has happened. That is why we observed such corrupt cultures of banking in the City of London, Wall Street, Greece, Cyprus, and Iceland. (I do not address Ireland's banking culture during the crisis.) Because the regulatory "race to the bottom" led to the widespread embrace of the three "de's," there was no effective rule of law for elite bankers in any of these nations. When the rule of law is rendered ineffective the damage caused to the public can be catastrophic.

I have explained why proper underwriting makes banks safer and more profitable and blocks the classic accounting control fraud scheme. There is no "tradeoff" with "the economy" when the regulators "aggressively" enforce competently designed underwriting rules. There is instead a win-win-win-win-win: the bank, its honest customers, its shareholders, its creditors, and the Treasury all benefit.

The word "aggressively" is obviously loaded. It has strongly negative connotations. "Aggressive" enforcement of rules is not objectionable because it imposes costs on businesses. It depends on the rule as I have explained. The "aggressive" enforcement of "win-win" rules could maximize net benefits "to the economy." The real issue depends on what you mean when you use the word "aggressive." If you mean "nasty," then we can all agree that even though nasty enforcement of the underwriting rules would greatly improve "the economy" compared to "weak" or "non" enforcement of the underwriting rules, we don't want regulators to be rude. Financial regulators must have a great deal of power if they are to be successful against the immense power of elite bankers. Great power can be abused in many harmful ways. One of the symptoms that indicates that a regulator is prone to abuse is that he acts rudely or abusively towards non-elite enforcement targets. The "cost" of "nasty" regulators is the cost arising from such potential abuses. The answer is to pick the right regulatory leaders, establish and constantly reinforce regulatory professionalism, and vigorous parliamentary oversight of the regulatory agency. I noted at the beginning the "Patriarca test." Patriarca's instructions to us when we were dealing with the most arrogant and damaging fraud, Charles Keating of Lincoln Savings infamy, was that we were always to act professionally and "cut square corners." The non-loaded word that describes how regulators should respond to dangerous wholesale violations of rules such as the underwriting rules is "vigorously."

Similarly, your phrase "excessive interference" is doubly loaded. By definition, anything "excessive" has to be "excessive" – bad. The word "interference" aptly reflects a highly destructive anti-regulatory meme that starts with a presumption that it is illegitimate for regulators to regulate. Bankers' actions, however, are treated as presumptively legitimate even after a crisis that has made clear that such actions were frequently fraudulent and abusive, in large part because of such anti-regulatory memes. The persistence of these reflexively anti-regulatory memes in these circumstances shows how durable and damaging such memes remain. When we vigorously act to end widespread horrific underwriting we are not "interfering" – we are doing are jobs. There is nothing "excessive" about regulators acting vigorously against horrific underwriting, but bank CEOs always simply our label our actions "excessive."

A strong, well-enforced "rule of law" consisting in of statutes and regulations is vital to the health of banking and the ability to block the "Gresham's" dynamic that is disastrous for honest bankers, bank shareholders, creditors, and customers, and the Treasury. Unless that rule of law is vigorously enforced, however, it isn't an effective rule of law.

I emphasize that not all rules fall in this category. Regulation is not made more effective simply by adopting more rules. We eliminated or streamlined many S&L rules we concluded did not make S&Ls healthier. It is essential to take a fine grained view, but a fine grained view that takes into account how rules may block a Gresham's dynamic and make the banking environment less criminogenic.

Consider How Depraved a "Race to the Bottom" is v. other Crimes

Blue collar criminals rarely have trade associations. Assume that there was a trade association of burglars and that it successfully lobbied the government to weaken the rule of law, make it far harder to arrest burglars, slash the number of police, and virtually cease prosecuting burglars for their crimes or even "clawing back" the proceeds of their crimes. That would obviously be insane.

What I am *Not* Saying

Let me stress what I am *not* saying. I am not saying that bank regulators can, or should, prevent all bank failures. I am not saying that the seven lending practices I identified are the sole or even the most common cause of bank failures. The lending practices I have discussed that we know how to counter are simply the most common cause of catastrophic bank failures and financial crises. I am not saying that they are the sole cause of catastrophic bank failures and financial crises. Indeed, I turn now to two other causes of catastrophic losses that occurred in the most recent crisis. That discussion demonstrates that important aspects of how regulators can identify and respond to lending crises are applicable in these other crises.

Banks Ripping off their Customers

Another source of potential enormous losses to banks is the *pervasive* defrauding and abusing the bank's customers. As with the five lending fraud characteristics I set out above, the senior bankers craft a criminogenic environment through shaping perverse compensation systems even for junior employees in order to generate a "Gresham's" dynamic. Anti-customer frauds and abuses involving the sale of financial products such as PPI and hedges to small business borrowers by bankers have never caused a material U.S. failure, much less a financial crisis in the United States. These abuses only reached catastrophic proportions in one highly developed nation – the United Kingdom – the nation that "won" the regulatory race to the bottom. We need to end the Gresham's dynamic and replace it with a race to integrity, competence, and vigor that will allow honest bankers to dominate banking.