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Don’t close the lid on bank fraud

By John Gapper
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The news this week that Eric Schneiderman, the New York attorney-general has launched yet another inquiry into Wall Street’s role in the mortgage crisis will no doubt be greeted with groans at investment banks. Four years – and multiple investigations – after the meltdown started at two Bear Stearns hedge funds, isn’t it time to move on?

I think not, for there is still work to be done. With the exceptions of Bernard Madoff and Raj Rajaratnam, no senior Wall Street executive has faced criminal charges, although some in the industry – whether at the top or in the middle – probably broke the law. Such criminality may be hard to pin down after all this time, but it is worth the effort.

There is an element of grandstanding in Mr Schneiderman’s foray – Eliot Spitzer, the former New York attorney-general, parlayed his crackdown after the internet bubble into becoming governor (before his downfall). Wall Street remains unpopular after the bail-out and politicians see opportunity there.

But it is right to expect Wall Street to face justice for any criminal acts – or civil offences – and little evidence that it has reached the executive suite. A criminal inquiry into the conduct of Angelo Mozilo, former head of Countrywide, was dropped earlier this year. Other Wall Street chief executives such as Richard Fuld, the former head of Lehman Brothers, have not faced even civil charges.

Matt Taibbi, the muckraking journalist, asserts in Rolling Stone this month that executives at Goldman Sachs, the bank he famously compared to a “vampire squid”,

should face criminal charges for “gross, bald-faced fraud”. He argues that Goldman not only fooled clients by offloading on to them mortgage securities it wanted to shed in 2007 but later its executives lied to a Senate committee.

The call for senior executives to face trial was countered on Bloomberg last week by Roger Lowenstein, the financial author. He wrote that “the yearning to pin the crisis on a handful of criminals” was a distraction from its true cause and that “people who contribute to a financial collapse aren’t guilty of a crime absent specific violations that make them so”.

Mr Taibbi is a showman and he does not make his case against Goldman stick – however badly the bank acted at the height of the mortgage crisis, the evidence so far that it criminally defrauded its clients or perjured itself is weak. Lloyd Blankfein, its chief executive, was being obtuse in his evidence to the Senate by denying that it had a “big short” on mortgages, but that is not a crime. Yet, although his rhetoric against Goldman is overblown, Mr Taibbi is correct on the broader principle that criminal inquiries should continue to be pursued against Wall Street. Mr Lowenstein’s willingness to write off the mortgage bubble as being due to professionals acting “badly or unwisely” rather than criminally is premature.

Mr Lowenstein attributes the wish for Wall Street prosecutions to what Richard Hofstadter, the historian, once called “the paranoid style” in US politics – or in this case markets. This “spawned a rhetoric that tilted every question toward conspiracy, so that random or unfortunate events were seen to compose a ‘baffling pattern’”, Mr Lowenstein writes.

A lot of the behaviour as the housing bubble inflated between 2005 and 2008 was indeed not criminality but the age-old willingness of people to fool themselves that asset prices would keep on rising indefinitely. That led to a rush to sell mortgages to anyone willing to take them, and to profit by securitising and trading them. One does not have to be paranoid, however, to think that this spilt over not only into breaches of regulations but also into crimes. At the sharp end, mortgage brokers bent the rules to get subprime borrowers to sign “liars’ loan” documents, encouraged by the insatiable demand from Wall Street banks for mortgage securities.

It is easier to pin down fraud at the bottom of this chain that at the top. The only senior mortgage banker so far to be convicted of a crime is Lee Farkas, the former head of a small mortgage lender, who was convicted in Virginia of fraud and conspiracy last month for writing fictitious loans to obtain cash collateral.

That is pretty black and white (black, in fact) and easy for a jury to understand. When one gets to the heights of the valuation and packaging of securitised assets that were deliberately complex in order to increase the fees for building and trading them, finding proof of wrongdoing is tougher.

Lehman Brothers, for example, was accused by David Einhorn, the hedge fund manager, of overstating the value of its balance sheet in the lead-up to its collapse in 2008. The court-appointed examiner last year reached different values for Lehman’s mortgage and property assets but said there was sufficient ambiguity that it did not amount to fraud.

What is clear is that, both on the way up and in the panic on the way down, many banks valued and traded such assets for their own purposes and did their best to hunt out gullible buyers. The Senate inquiry report quotes a Goldman executive

exulting that “I think I found a white elephant, flying pig and unicorn all at once” on finding an investor that would buy one of its collateralised debt obligations.

It beggars belief that somewhere on Wall Street, in the last days of the mortgage bubble, crimes were not committed. They are still worth finding.