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The Bust-Out

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What the Mafia can teach us about corporate fraud.

 [100320_TBM_mob.jpg](#) [1]

On a rainy day in New York last week, a man named [William Black](#) [2] stood in front of a roomful of fellow law professors trying to sum up in a minute what had gone wrong with financial regulation over the last two decades. Actually, Black didn't have even a minute. His breathless spiel had (obviously as usual) already gone over its allotted period, leaving Black with just enough time to toss at his audience a number that encapsulated how slipshod and generally crazy-making federal efforts at dealing with fraud in the financial markets had become.

The number that Black practically shouted out was the grand total of mortgage and securities fraud related convictions the government had managed to secure in the wake of the financial crisis. It was *zero*. With that startling statistic Black sat down, politely if impatiently waited for the other panelists to finish their brief speeches, and immediately ran off to catch a flight back to Kansas City, trailing a half-open umbrella and a jumble of bags.

Last week, in *TBM's* roundtable about Michael Lewis' book [The Big Short](#) [3], [I wrote](#) [4] about how Wall Street and its financial models were blind to the reality of what was happening in the real world with the no-doc, no-asset, no-nothing loans that drove the subprime mortgage industry. Black explores the other side of the coin: How that same kind of oblivion befogged the work of regulators, who came to believe that fraud rarely happens, doesn't really matter, and wasn't worth pursuing.

Check out this *Magnum Photos* gallery on [mafiosi](#) [5].

How can that be? The work of Bill Black—who spent a decade as a federal bank regulator—is about how bad economic theory has given people whose jobs should be understanding fraud a screwy sense of how fraud works in the real world. One way of seeing this, as Black describes in a terrific article, is to think about the mob “bust-out.”

The bust-out is what happens when the mob moves in to take control of a business that's heavily indebted to a loan shark. As Black tells it, why the heck a mobster would ever want to take over a bar or liquor store in this way is incomprehensible to a classical economist. Why take over the business when you're already getting every cent of profit and more in your weekly vig?

Except that in the real world, things don't work that way, explains Black, a professor at the University of

Missouri-Kansas City. The reason to take over the business is to loot it 1,000 ways to Sunday, from buying vast amounts of liquor on credit to, ultimately, torching the place for the insurance money. Prosecutors and mobsters know this. Economists who think the mob operates like a bank that happens to charge high interest rates miss it.

The problem here is that none of the ugly realities of how a business can be stripped of everything valuable make their way into the economic and regulatory theories that have been ascendant for the last two decades. How did we get to this point? Well, here's a story:

Back in the early days of the savings and loan crisis, Bill Black was involved in the efforts of bank regulators to close down two savings and loans, Lincoln Savings—the bank run by [Charles Keating](#) [6], later to become the poster boy for the S&L crisis—and CenTrust Savings. The two S&Ls held massive portfolios of junk bonds issued by the (now long-defunct) investment bank Drexel Burnham Lambert, then the junk bond kings. Black and other regulators believed that Lincoln's and CenTrust's junk bonds and bad loans were a disaster in the making.

To help make the case for their financial stability, Lincoln and CenTrust went to a consulting company called Lexecon, created by [Daniel Fischel](#) [7], a University of Chicago Law School professor and one of the preeminent authorities on the economics of regulation. Lexecon reported that Lincoln and CenTrust were extremely unlikely to fail, and in the (nearly impossible) case that they did, a failure would cost the bank insurance program less than a penny for every \$1,000 of deposits.

Lincoln and CenTrust did fail—in the case of Lincoln, at a cost to the government of \$3 billion. Daniel Fischel went on to become dean of the University of Chicago Law School. Not long after the Lincoln and CenTrust debacle, Fischel (who defended Keating and his patron Michael Milken in a 1995 book) and his fellow Chicagoan Frank Easterbrook went on to publish [The Economic Structure of Corporate Law](#) [8], the standard text on the intersection of law and economics.

Wait a second, how can a guy who was so utterly wrong in evaluating the economics of the S&L crisis come to be the go-to guy on regulatory theory? Fischel's theories were based on the premise that in the main markets were very good at evaluating the true worth of loans, bonds, and equities, and certainly better at it than regulators. On Fischel's view—a view that Black marvels at, given what the Chicago professor knew about the inner workings of Keating's bank—no fraud could grow too fast or get too big before the markets punished it.

This makes for a very neat economic theory, and a disaster in practice. In the Easterbrook-Fischel world of economic models—the world in which S&Ls don't fail and don't cost much money when they do—even the most cynical subprime lender acts in its own long-term self-interest. In Black's bust-out world, that's not the case at all.

In bust-out world (which means the real world), chief executives pump up their share price and dump as much of it as they can on the market before everyone else has figured out better. Investment banks pocket fees for underwriting bonds and then dump the losers on their captive investment funds. And what's left after it's done, by the time the market exacts its price, is the burnt shell from which every possible profit has been extracted.

At least two key differences with the current outlook emerge when you look at fraud in this way. The first is that while legitimate companies try to grow for as long as they can, frauds are not structured with the long-term in mind. They are built to fail—they tend to happen, as Black explains, at companies where the “wealth optimizing strategy” for those at the top is to loot the firm.

The people who run such companies know that they will eventually blow up. Their object is to get out with what they can before that happens. Decisions—like those of subprime lenders who handed out hundreds of billions in bad loans—that to neoclassical economists look merely misguided may actually be evidence that the folks who run it are getting ready to burn down the store.

The second difference that emerges in this view of fraud is that you just can't look at frauds in isolation. An economist looking at a bust-out scratches his head wondering why a loan shark would cut off his own best source of revenue or a bar owner would burn down his own business. But in real life there are lots of others involved—from liquor distributors to mob bosses to crooked insurance investigators—and lots of ways of hiding the profits.

If you need to see this to get how the bust-out works, it goes double for complicated financial frauds. You have to pay attention to who is really calling the shots and where the money lies. You can't look at the profits (or losses) of a subprime lender without also looking at the fees taken in by the investment banks that packaged the loans into bonds. You can't look at what happened. You can't look at a lender without also looking at the incentives paid to brokers to peddle junk mortgages.

Legitimate companies make profits and pay them out to shareholders or plow them back into the business. Frauds create huge losses for the public and hidden profits that are hard to find. And some of the biggest are designed for the chief executives to loot the company while being able to claim that he didn't know what was going on and take shelter under the claim that he just couldn't predict where the market would go. “You don't need to send out a memo telling your employees to make fraudulent deals,” says Black, who wrote a book called [The Best Way To Rob a Bank Is To Own One](#) [9]. “You can send the same message through your compensation system.”

None of this means that the entire financial crisis can be chalked down to fraud—though Black believes that much of it can. I've [written before](#) [10] about how what happened on and off Wall Street with the mortgage crisis was linked to a national delusion in which both ordinary people and those who should have known a lot better imagined that real-estate prices could keep going up forever. Yet as charitable as one might want to be, there is still the issue of that extraordinary statistic about the number of successful prosecutions in this crisis, that big fat zero.

To believe that none of the mortgage crisis was the result of fraud is just as mistaken as to believe that all of it was. And maybe more pernicious, because the lesson is that if a fraud is big enough, it will be ignored. The outlook for that changing soon is not promising. In the case, for instance, of [Angelo Mozilo](#) [11], the chief executive of Countrywide, once the country's biggest mortgage lender, and arguably the man who most defined the mortgage meltdown, the government is pursuing civil, not criminal, penalties. The rest of the world has figured out that the markets are not very good at self-policing.

The economists haven't caught up yet. Nor have the regulators and enforcement agencies. As Black pointed out to me, recently the FBI announced a new and unlikely partner in its efforts to fight mortgage fraud. It is the Mortgage Banker's Association, the trade group for the very industry that set the financial crisis in motion.

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