ON THE MONEY

A chance for a modern Pecora Commission to right Wall Street's wrongs

Barry Ritholtz
ON INVESTING

What shall we make of this surprise pronouncement in President Obama's State of the Union address? A belated investigation has been launched into the role of fraud in the financial crisis.

This much is clear: Despite rampant illegalities, bank fraud and countless cases of perjury, the response to date — at the federal level and from most, but not all, states — has been underwhelming, cowardly even. A few principled holdouts — the attorneys general of Delaware, New York, Nevada and California — refuse to rubber-stamp a pre-investigation settlement with banks, but that's all. Despite chances to bring crooks to justice, there has been little action.

So, here we are, four years after the great financial collapse, three years after the recovery began and in the last year of Obama's term — and the president has finally decided to investigate the role of fraud in the great global financial crisis. Hence, this new task force — the unit of Mortgage Origination and Securitization Abuses — begins behind the curve. The statute of limitations is, in many cases, close to elapsing.

Even so, do not dismiss the investigation out of hand because of the timing: History informs us that a serious investigation can begin four years after the fact. Recall that Ferdinand Pecora was the fourth chief counsel for the Senate committee that investigated the Wall Street crash of 1929 and subsequent Depression. He was appointed in 1932 and received broad investigatory powers in 1933. His report ran thousands of pages. Thanks in large part to Pecora's findings, Congress passed the Glass-Steagall Banking Act, which separated commercial and investment banking; the Securities Act of 1933, which established penalties for filing false information about stock offerings; and the Securities Exchange Act, which created the Securities and Exchange Commission to regulate the stock exchanges. Nearly 50 years of financial stability followed.

The personality in charge can make all the difference. In an encouraging sign, Obama appointed to the task force New York Attorney General Eric Schneiderman, one of the few attorneys general not railroaded into a premature settlement with banks of the robo-signing-foreclosure scandal.

1933 ASSOCIATED PRESS FILE PHOTO

As counsel to a Senate committee that investigated the crash of 1929, Ferdinand Pecora, left, accomplished much, though he wasn't appointed until 1932. Also shown are J.P. Morgan, smiling at right, and Sen. Carter Glass, in hat at center, a principal sponsor of the Glass-Steagall Act.

Critics have derided the task force as little more than election maneuvering. The politics are obvious: Both Occupy Wall Street and the tea party were very unhappy with the bank bailouts; they seem even less happy with the lack of prosecution.

It's fair to ask: Is this new task force a meaningless exercise?

It is too soon to tell, of course. Like good poker players, we can look for "tells" that signal whether this will be a farce or a serious player. We'll find clues in the structural setup of the office as well as the areas it investigates.

In the setup of the office, four aspects are crucial:

- Does the office have subpoena power (as the New York attorney general's office has through the Martin Act)?
- Are there going to be public hearings (preferably in the Senate)?
- Will the commission have a significant budget?
- Will it be a forum for whistleblowers and crowdsourcing?

Without such powers, the office would be a farce, helping to shield banks from the fallout of their wrongdoings.

What the office investigates will also reveal how serious this is. Both pre- and post-crisis topics should be investigated, including:

- **MERS:** Mortgage Electronic Registration Systems was created by banks without any authority or enabling legislation. It allowed the rapid transfer of mortgages, avoiding state and county filing fees amounting to billions of dollars. Without MERS, it's hard to imagine that the massive volume of mortgage securitizations could have occurred. How were lenders able to circumvent mortgage filings with town and county registrars? Did they engage in illegalities? How many billions of dollars do they owe in fees for transferred notes? And what percentage of MERS assignments were fraudulent, made for entities that did not exist?
- **Origination fraud:** Why did lenders accept "stated income" loans? Why did they abandon traditional standards? Michael White, a Countrywide subprime unit employee, called this "origination fraud," observing, "Eliminate the verification of income for a mortgage borrower, and you eliminate your ability to predict the likelihood of repayment or default."
- **RMBS:** Wall Street's securitized mortgage pools (residential mortgage-backed securities) contained a broad variety of flaws, some so egregious that they amounted to fraud. In plain English, we're talking about bad paperwork and misrepresented pools of mortgages to borrowers whose debts were significantly understated and whose median incomes and credit scores were significantly overstated.
- **Insurance fraud:** Look at a bank tactic in which legitimate home insurance is canceled and new insurance provided at a substantially higher fee through a subsidiary or affiliate of the bank mortgage holder. This extra expense in some cases led to foreclosures.
- **"Pyramid" servicing fees:** An illegal practice in which current payments are applied to past late fees, generating more late fees and additional interest owed and creating a delinquency where none existed. This tactic also led to foreclosures that were probably unlawful.
- **Lost mortgage notes:** How is it possible that the most important part of the mortgage contract — the promissory note — was consistently lost or misplaced by banks? It is unfathomable to anyone who has ever handled documents. At best, it's gross incompetence. At worst, it's willful document destruction during litigation.
- **Document fraud for sale:** There were many examples of alleged document fraud, but the one crying out for investigation involves Lender Processing Services' DOCX subsidiary. The firm seems to have been selling fabricated documents for a fee to lawyers and banks. Indeed, Lender Processing Services, which processes nearly half of all U.S. foreclosures, could require a separate investigation.
- **False affidavits, perjury (robo-signing):** We do not know who ordered the robo-signing of foreclosure documents, the false notarizations, fraudulent written statements to courts and perjury. This should be easy to investigate, like flipping a nickel-bag dealer to get to the drug kingpin. Astoundingly, this easy-to-investigate felony (via notarized perjurious statements submitted to foreclosure courts) has yet to be prosecuted.
- **Foreclosure mills, process servers:** Law firms engaged in rampant fraud that corrupted the foreclosure process. If found guilty, those folks should be disbarred and jailed. Same for the "sewer service" process servers who threw away legally required notices to delinquent homeowners.
- **Soldiers and Sailors Relief Act:** Federal law protects active-duty service members from foreclosure and eviction. I find violation of this law reprehensible. If it were up to me, I would let the Special Forces — Navy Seals and Army Green Berets — handle this as they see fit.

Even with criminal statutes of limitations elapsing, we can achieve some measure of justice against the crisis wrongdoers. Lawyers can be disbarred and corporate insiders banned from serving in publicly held firms again. CEOs and CFOs can be fired. A significant investigation, with subpoena powers, a real budget and public hearings would go a long way toward restoring public confidence.

Schneiderman has an opportunity to create a legacy for himself that lasts far beyond the next election cycle. If he lacks the tools to do so, he should demand them or resign in protest.

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STEVEN PEARLSTEIN

What Washington lacks? Entrepreneurial culture.

PEARLSTEIN FROM G1

Before he became a congressional candidate, John Delaney, a successful local banker and financier, put together two reports under the banner of Blueprint Maryland that give a concise and compelling account of the challenges facing not just Maryland but the wider region, as well (*www.blueprint-maryland.org*). Maryland, it turns out, is no less dependent on federal spending than Virginia and the District. The report does a good job of drawing the link between high costs and sprawl.

Delaney also makes a convincing case that the region has an opportunity to participate in the national manufacturing revival by better leveraging the Port of Baltimore, particularly now that a widened Panama Canal will change the economics of transporting goods from Asia to the East Coast.

Transportation, warehousing and manufacturing can provide jobs for lower-skilled workers not just in Baltimore but in Prince George's County and the District, as well. This needs to be a regional priority — the Washington-Baltimore region, that is, which is the way we need to start thinking about things, putting aside rivalries.

What distinguishes the work of Blueprint Maryland, like that of the 2030 Group in Virginia, another "ad hoc" business group, is that it is candid and critical about our weaknesses in ways that the boosters of the Board of Trade and government officials are not.

There was pushback from those who thought I overlooked their work when making the sweeping generalization that Washington didn't really have much of a commercial tech culture or ecosystem.

Jon Aberman wrote about his Founders Group, a network of serial entrepreneurs who mentor young ones, and the enthusiastic response to the state chapters of Startup America that AOL's Steve Case is spearheading. Brent Solomon, of the Reznick Group, reported that he's helping start a chapter of Keiretsu, a network of angel investors.

These efforts, however worthy, look to me to be more aspirational than real. No doubt there are plenty of people starting businesses in the region and investors putting money behind them, and God love them for it. But the evidence is that, outside the robust government contracting sector, these initiatives haven't had much of an impact on the Washington economy.

There remains a strong belief in the entrepreneurial community that the only thing preventing a commercial tech cluster from taking off in this region is the lack of funding.

Gary Knott, a former National Institutes of Health researcher, tells of his frustration in getting venture backing to commercialize the mathematical-modeling software he and his colleagues created for the government. And entrepreneur Bob Nelson noted that the Washington region was only ninth in the nation in venture investing, down from third in the late '90s during the dot-com boom. Aberman has documented that when Washington's entrepreneurial companies are sold or go public, the proceeds are less likely to be recycled back into new ventures here.

While funding can be a problem, my hunch is that it is not the key problem. In today's financial world, money has a way of finding worthy projects. Rather, what Washington suffers from is the lack of an entrepreneurial culture.

Dennis Whittle is an old friend who left the World Bank more than a decade ago to start up a Web site linking global donors to worthy development projects. Dennis recalled how lonely it felt during the early years with nobody to talk to other than Case, Ted Leonsis and Mario Marino, the three horsemen of the region's entrepreneurial community.

"In Palo Alto, even people who didn't fund us always asked, 'What if,' whereas nearly everyone on the East Coast had a hundred reasons why [our idea] wouldn't work," Whittle wrote. "I would at times almost despair when I landed at Dulles."

A similar sentiment comes from Shari Loessberg, who commutes from Washington to her job at Massachusetts Institute of Technology, where she teaches entrepreneurship and venture capital. Loessberg says New York, Istanbul and Sao Paolo have shown it is possible for cities to develop to an entrepreneurial business culture, but she doesn't see it in Washington, where "the narcotic of getting one big government contract numbs and deadens the ambitions of promising startups."

I got a bit of pushback to suggesting that Washington take a page from Mayor Michael Bloomberg's playbook in New York and offer land and money to lure a world-class graduate research university in science and engineering. Some folks at the University of Maryland wrote to suggest we already had a world-class contender in College Park.

They may well be right. A belated review of the various rankings suggests that, indeed, Maryland's campus is in the top 20 of all universities, and probably higher. If that's not world class, it comes awfully close. Maryland has been inching up in the standings for 20 years, thanks in part to lots of federal grants and contracts and collaboration with federal labs. It competes for top faculty and graduate students with the likes of University of California at Berkeley and University of Michigan.

Even its top officials, however, acknowledge that where Maryland falls short is in turning world-class students and teachers and research into world-class companies. Like Johns Hopkins up the road in Baltimore, Maryland's success in winning federal research funding, and winning jobs for its graduates with the government and contractors, has meant that it never developed the entrepreneurial, risk-taking culture of schools like MIT and Stanford.

Patrick O'Shea, the new vice president for research, is working to correct this, starting with new incentives for faculty and the development of a technology park.

So would it help or hurt Maryland's efforts if the District could persuade Stanford or Carnegie Mellon to open a research campus and company incubator on Poplar Point? Tell me this: Does it help or hurt MIT that Harvard is located a mile up the river in Cambridge?

Steve Winnick took issue with my declaration that the enclosed shopping mall is dead. Too many mall owners are milking tenants for every dollar they can, forcing weaker stores to close and stronger retailers to find better landlords, as Winnick did by moving his clothing store to Tysons Corner from Montgomery Mall.

Winnick certainly has a point — the real estate business has done a bang-up job of sapping the creativity and vitality from the retail sector. If he checks, however, I think he'll find that even the better mall operators are looking to convert to town centers and other formats.

Sharon Bulova, head of the board of supervisors in Fairfax County, took exception to my suggestion that she and her colleagues lend their support to a plan to relocate the FBI headquarters to a campus in Prince George's County. Fairfax would be "remiss," she wrote, if it did not pursue its own bid for a federal parcel in Springfield.

Remiss?

There's little doubt that even without the FBI, the private markets will find a productive, tax-generating use for the land in Springfield. By contrast, the FBI site would serve as a much-needed catalyst in Prince George's County, where land near the Metro and the Beltway has sat undeveloped for years.

What would be "remiss," to my mind, would be for an affluent Fairfax County to be so piggy about winning every last job and every last dollar of tax revenue that it cannot see its own long-term interest in developing the economy of the entire region in a more fair and balanced manner.

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