Control fraud as an explanation for white-collar crime waves: The case of the savings and loan debacle

W. BLACK
Lyndon B. Johnson School of Public Affairs, University of Texas, Austin, P.O. Box 78713, Austin, USA (e-mail: b.black@mail.utexas.edu)

Introduction: Control frauds and the S&L debacle

Economists and white-collar criminologists tend to come from opposite ends of the political spectrum, so it should not be a surprise that their views on the relative importance of white-collar crime in general and the role of white-collar crime in the savings and loan debacle of the 1980s should be polar. Economists tend to view fraud as being of marginal importance in general, and “distracts” policy makers trying to prevent future crises.1

One scholar who specializes in law and economics, Professor Daniel Fischel of the University of Chicago’s School of Law, has written articles and books that reflect the conventional wisdom of many economists about these subjects. The title of his 1995 book, Payback: The Conspiracy to Destroy Michael Milken and His Financial Revolution, conveys both the thesis and the polemical style of the argument. While Payback deals primarily with Milken and the investment banking firm he became synonymous with, Drexel, Burnham & Lambert, it also discusses the S&L debacle at some length and argues that, as with Milken, the government sought to grossly exaggerate the role of fraud in the debacle.

In the course of Payback, Fischel asks the question that this article is intended to answer:

Why was there a sudden simultaneous explosion of fraud and criminality at savings and loans across the country? Did a new generation of morally depraved thrift operators just coincidentally appear at the same time.2

Professor Fischel intended these questions to be rhetorical and sarcastic, he believed they exposed the fact that: “The government’s simple fraud and insider-abuse explanation for the thrift crisis defied common sense (Id).”

This article answers Professor Fischel’s questions. There was a sudden explosion of criminality because a series of factors came together to create a
new S&L environment that was nearly optimal for fraud by controlling persons ("control fraud"). The entry of a substantial number of new controlling persons into the S&L industry who were seeking opportunities to commit control fraud was not coincidental, but the product of this optimal environment. Key elements of the new environment were regulatory and economic changes that made entry into the S&L industry far easier, and made S&Ls chartered by states that had undergone radical deregulation nearly ideal vehicles for ponzi schemes. Most S&Ls, however, were not ideal fraud vehicles, and the vast majority of traditional S&Ls that did not engage in changes of control did not engage in fraud. This explains why the explosion of fraud did not occur "across the country.” Instead, fraud was concentrated in the states in which deregulation and lax supervision combined to make S&Ls more attractive vehicles for control fraud.

And, yes, the new entrants that acquired S&Ls in order to loot them were “morally depraved.” I term such entrants “opportunistic” control frauds. Another variety of control fraud helped produce the debacle, those who reacted to the imminent failure of their S&Ls by engaging in fraud. I use the term “reactive” to distinguish such frauds. The wave of control fraud in the S&L debacle occurred, as do “rogue” waves in the ocean, when the crest of these two waves came together and amplified into a financial tsunami.

I do not defend “the government’s . . . simple fraud . . . explanation” because that is a strawman characterization. There is no single “government” explanation of the S&L debacle. Indeed, the early conventional wisdom, defined most starkly by economists (including many who were in the government), was that fraud made a trivial contribution to the overall crisis. I am one of several scholars to challenge that conventional wisdom.

I demonstrate here that economic theory’s core assumptions of rationality, constrained optimization, and self-interest are fully consistent with my theory of control fraud and predict periodic waves of white-collar crime. Indeed, I show that Fischel’s efforts to rehabilitate those who engaged in control fraud force him into repeated inconsistencies with the very economic theories he purports to champion. The central irony to Fischel's question is that the facts he presents answer his own question. Fischel is blind to the implications of these facts because they do not support his ideological beliefs and the case he wishes to present of a rapacious and mendacious government engaged in a witch hunt against S&L owners.

This article has four parts. First, I explain why opportunistic and reactive control frauds can be rational. Second, I show why some environments can be vastly more attractive for opportunistic or control fraud. Third, I show why the environment can become attractive simultaneously for both variants of control fraud – which can produce a wave of control fraud. I also show that