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The Journal of Socio-Economics 34 (2005) 756–770

The Journal of Socio-Economics

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Control fraud, gambling for resurrection, and moral hazard: Accounting for white-collar crime in the savings and loan crisis☆

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Abstract

This paper reviews the relevant literature regarding the role of control fraud, or major frauds committed by controlling organizational insiders, in the savings and loan crisis. Using both economics and criminological concepts, it contrasts the claims made by "fraud minimalists" with those who saw fraud playing a significant role in the crisis. The paper concludes that the economics-based official history of the debacle that sees moral hazard and gambling for resurrection as responsible for major financial losses is not supported by the empirical data generated by criminological research.

JEL classification: (G) Financial economics; (N) Economic history; (K) Law and economics; (Z) Other special topics

Keywords: Control fraud; White-collar crime; Financial regulation

1. Introduction

The savings and loan crisis of the 1980s was one of the worst financial disasters of the 20th century, resulting in what were at the time, the largest financial losses in American

☆ Revised version of paper presented at the Conference on Corporate Governance and Control Fraud, LBJ School of Public Affairs, University of Texas at Austin, 28–29 April, 2003.

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doi:10.1016/j.socec.2005.07.025

history. By 1992, over 680 institutions around the country were insolvent, tens of thousands of criminal cases were referred to authorities, and the final resolution costs amounted to over $150 billion (Calavita et al., 1997). One of the more contentious issues that arose in the aftermath of the debacle was the role of fraud in producing these unprecedented losses. Numerous accounts of crime, especially expensive insider or control frauds, were brought to light in media accounts, government hearings and reports, and academic research. The debate continues as to the salience of white-collar crime in causing the size of the savings and loan crisis, relative to other structural economic factors related to regulation, deposit insurance, risk taking, managerial incompetence, and the like. The issue is still important, both nationally and globally, as it remains central to a comprehensive understanding of financial regulation and corporate governance upon which economic policies are ultimately based.

The notion that fraud was overblown (or even used as a “cover up” to government incompetence) in the savings and loan crisis is commonly heard in economics and finance quarters. Honest thrift owners who desperately gambled to save their institutions and failed in doing so, along with moral hazard created by a combination of faulty regulation and deposit insurance comprise, to a large degree, the official record of the savings and loan debacle (NCFIRRE, 1993).

Just as it would clearly be a mistake to assign too much weight to the role of fraud, it would also be a serious error to underestimate its prevalence. The major federally funded study on the savings and loan debacle and the response of the government contained a number of empirically supported findings regarding the nature and extent of fraud as well as other losses (Pontell et al., 1994a). First and foremost, it showed that crime and deliberate fraud were extensive in the thrift industry during the 1980s, thereby contributing to the collapse of hundreds of institutions and increasing the cost of the taxpayer bailout. This conclusion was supported by government hearings and data collected from numerous law enforcement and regulatory agencies. It also documented that the dramatic deregulation of the thrift industry in the early 1980s coupled with an increase in deposit insurance were key elements of a criminogenic industry environment that was clearly conducive to fraud. These two policy changes are repeatedly cited in almost all historical accounts as major factors that affected the ways in which thrifts could conduct business. In particular, the study notes that these changes in law increased the opportunities for fraud while decreasing the risks associated with fraud. It was also shown that thrift crimes typically involved networks of insiders, often in association with affiliated outsiders. Using primary statistical data, the research demonstrated how fraud was correlated with specific organizational characteristics at failed savings and loans. Institutions that were stock-owned, were less involved in the home mortgage market, and that undertook strategies that led to dramatic growth in assets – all of which were made possible by deregulation and increased deposit insurance – were the sites and vehicles for the most frequent, most costly, and most complex white-collar crimes.

Regarding the government’s response to the crisis, the research concluded that despite the urgency of this response and its unprecedented scale, its effectiveness was limited by the complex nature of these frauds, resource constraints, interagency coordination difficulties, and inherent structural dilemmas related to financial regulation. Despite this, a relatively high proportion of hundreds of defendants who were formally charged in major thrift cases