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Ten Years of Evidence: Was Fraud a Force in the Financial Crisis?

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Abstract

This article takes stock of ten years of academic research by synthesizing the large literature regarding the various players in RMBS securitization at the center of the U.S. housing and financial crisis. Underwriting banks facilitated wide-scale mortgage fraud by knowingly misreporting key loan characteristics underlying mortgage-backed securities. Under the cover of complexity, credit rating agencies catered to investment banks by issuing increasingly inflated ratings on both RMBS and CDOs. Originators who engaged in mortgage fraud gained market share as did CDO managers who catered to underwriters by accepting the lowest-quality MBS collateral. Appraisal targeting and inflated appraisals were the norm. RMBS and CDO prices indicate that the marginal AAA investor was unaware of pervasive mortgage fraud and rating inflation, but these factors were strongly related to future deal performance. The supply of fraudulent credit was not uniform, but clustered in certain geographic regions and zip codes. As these dubious originators extended credit to those who could not afford the loans, the credit expansion led to house price booms and subsequent crashes in these zip codes. Overall, there is substantial evidence that conflicts of interest, misreporting, and fraud were focal features of the financial crisis.

Keywords: Fraud, Financial Crisis, Conflicts of Interest

JEL Classification: G01, G21, G24, G18

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