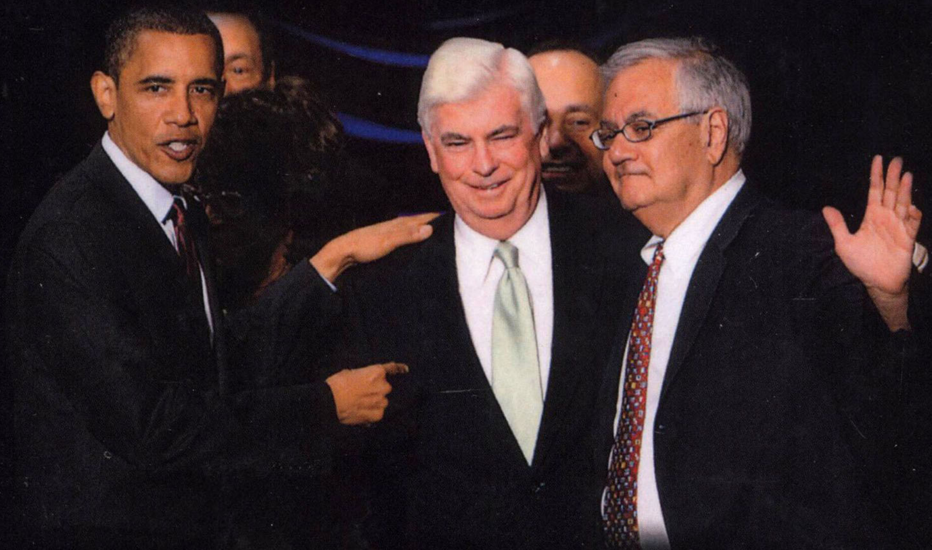
Bad History, Worse Policy

How a False Narrative about the Financial Crisis Led to the Dodd-Frank Act



PETER J. WALLISON

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Bad History, Worse Policy

Preface

The winners write the history, so a contemporary and contrary view is essential. With their victory in the elections of 2012, Barack Obama and the Democrats put themselves in a position to cement the Dodd-Frank Act into law. As this is written, more than two years after the act was passed, fewer than half of all the regulations required by the act had been finalized, but the election provided the Obama administration with four more years in which to get the job done. Sadly, the result will be much slower growth for the U.S. economy and a decline in the significance of the U.S. financial industry—formerly the world leader—in the global economy.

At some point in the future, scholars will wonder why the United States tied its own hands and limited its economic growth in the early 2000s. They will look back at the period after the second World War and note that until the second decade of the 21st century the United States led the world in innovation and economic growth, with startling advances particularly evident in the living standards of the middle class. Then, in 2008, there was a financial crisis, and in 2010 the Dodd-Frank Act, a financial reform law; after that, the wheels of the U.S. economy just turned more slowly.

I hope this book, made possible by a generous grant from the Templeton Foundation, will help future scholars sort it all out—that it will be seen as a chronicle of why and how the U.S. crushed the life out of one of its most successful industries, impeded the growth of its economy and hobbled improvement in the lives of its own citizens. It is made up principally of 30 essays, beginning in 2004 and extending through 2012, in which I chronicled the underlying causes of the crisis and how the left developed a false narrative both to deny the government's role in the crisis and to provide a foundation for legislation that would place the U.S. financial system under the government's control. These essays, called *Financial Services Outlooks,*

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are included in substantially the form in which they were originally published by the American Enterprise Institute.

I have tried to provide some context for these essays with accompanying commentary that places them in the political and economic background that existed at the time they were written. If, in retrospect, there are errors in the essays, I thought it best to leave them uncorrected, as evidence of what was known, or what I thought, at a particular time. Similarly, as I was writing the commentary, regulations were being proposed, modified and in some cases issued in final form; these changes could not be incorporated into the book before its publication in early 2013.

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Introduction: Obamacare for the Financial System

The Great Depression persuaded the public that private enterprise was a fundamentally unstable system, that the Depression represented a failure of free market capitalism, that the government had to step in. . . . The widespread acceptance of these views sparked the enormous growth in the power of government . . . that is still going on. We now know, as many economists knew then, that . . . the truth about the Depression was very different. The Depression was produced, or at the very least, made far worse by perverse monetary policies followed by the U.S. authorities. . . . Far from being a failure of free market capitalism, the Depression was a failure of government. Unfortunately, that failure did not end with the Great Depression. . . . In practice, just as during the Depression, far from promoting stability, the government has itself been the major single source of instability.

—Milton Friedman, *A Monetary History of the United States*

The 2008 financial crisis was the most serious shock to the U.S. economy since the Great Depression. It triggered a lengthy recession, deepened a painful housing market collapse, and set the stage for massive taxpayer bailouts. Perhaps most serious, the 2008 crisis triggered a view—never far below the surface on the left—that capitalism itself was at fault. Wall Street greed, private sector irresponsibility, and regulatory failure quickly became the heart of the narrative pushed by the left and embraced by the Obama administration and the mainstream media. This narrative helped

to shackle public opinion behind the Dodd-Frank Act (DFA),[1] a modern analog of New Deal legislation like the National Industrial Recovery Act and the Agricultural Adjustment Act, both of which were eventually declared unconstitutional.

Instead of a thorough study of the causes of the financial crisis, we got the left's perennial prescription for the economy's ills—more government controls. Like its health care twin, popularly known as Obamacare, the DFA leaves the financial system nominally in private hands but subjects it to so many controls that it will no longer be able to function independently of the government. In this book, I will attempt to show how this was brought about through the development, propagation, and acceptance of false narratives—first about the government sponsored enterprises (GSEs) the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and then about the financial crisis itself.

The DFA is yet another example of the aphorism that the speed and scale of a government prescription is directly proportional to the vapidity of its diagnosis. In effect, the most serious U.S. financial crisis in at least eighty years has never been thoroughly investigated, nor its causes fully debated. From the moment in the 2008 presidential debates that President Obama called it the result of "Republican deregulation," no serious consideration was given by his administration or the Democratic Congress to the real causes of the financial crisis. Together, in the DFA, they enacted far-reaching legislation that will likely hobble one of the most successful industries this country has ever produced, and they will have done it on the basis of nothing more substantive than a half-baked political slogan.

A challenge to this dominant narrative is now emerging. During the 2011 and 2012 Republican presidential debates, almost all the candidates—including the eventual victor, Mitt Romney—argued that the 2008 financial crisis was caused by U.S. government housing policy. Republicans in Congress have also introduced legislation to repeal the act in its entirety. These efforts are not necessarily driven solely by ideological considerations. There is strong evidence that the DFA has impeded recovery from the

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (July 21, 2010).

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recession that followed the financial crisis. Enacted in July 2010, the act started the gross domestic product (GDP)—including both the housing and manufacturing sectors—on a downward track from which it never fully recovered. Before the DFA, average GDP growth had been 2.5 percent. After, through the third quarter of 2012, it was 2 percent.

These results illustrate the underlying rationale for an exchange between Jamie Dimon, the chairman of JPMorgan Chase, the largest U.S. bank, and Fed chief Ben Bernanke on June 8, 2011: Dimon said, "I have a great fear that someone's going to write a book in 10 or 20 years and the book is going to talk about the things we did in the middle of the crisis that actually slowed down the recovery. . . . Has anyone bothered to study the cumulative effect of all these [regulations]? . . . Is this holding us back [from creating jobs] at this point?"[2] Bernanke's reply was candid: "Has anybody done a comprehensive analysis of the impact [of new regulations] on credit? I can't pretend that anybody really has. You know, it's just too complicated. We don't really have the quantitative tools to do that."[3]

Narratives and Policy

If government housing policy—and not lack of regulation—caused the financial crisis, more and tighter regulation as embodied in the DFA would be the wrong policy response. It will unnecessarily increase costs for the private sector and reduce economic growth and jobs. Instead, one would repeal Dodd-Frank, change government housing policy, and then evaluate whether any additional regulation is necessary.

These were ideas I had been pressing for many years through the *Financial Services Outlook* essays that form the heart of this book. Between 2004 and 2012, I had written more than seventy essays on the regulation of financial services. From these, with a generous grant to AEI from the John Templeton Foundation, I selected twenty-nine *Outlooks* that covered important aspects of three related topics Fannie Mae and Freddie Mac, the financial crisis of 2008, and the Dodd-Frank Act.

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2. Quoted in Canfield and Associates, *GSE Report*, July 1, 2011, 1.
3. Ibid.

In reviewing these essays, I found that they reflect a common theme: the power of ideas—shaped into a narrative or description of an event—to affect public policy. Until 2004, when both GSEs were found to have manipulated their accounting, they were thought to be politically powerful but well managed and essentially harmless toilers in the housing finance vineyard. This image—the product of a well-tended narrative about their benign and helpful role in housing finance—protected them from serious challenge. After the financial crisis, despite a strong case that the government's housing finance policies were the principal cause of the breakdown, the left succeeded in constructing a counternarrative in which "unbridled free markets" were the principal culprits. This narrative was accepted uncritically by the media and became the conventional explanation for the crisis. With no other ideas admitted into the public square, the DFA was the inevitable result.

Accordingly, this book emphasizes the importance of narratives in shaping public policy. Before policies and laws can be changed, the narrative that gave rise to the existing policies must be challenged or shown to be wrongly founded or outdated. Obviously, this is not a new insight; it's always been clear that ideas have consequences. But in the case of the Dodd-Frank Act, it is possible to discern a clear line from the narrative about the GSEs, through the initial ideologically tinged narrative about the causes of the financial crisis, to the principal terms of the act. In order to repeal the act, then, it is necessary to show that its policy rationale—the underlying narrative—is false. That is the purpose of this book.

When I joined AEI in 1999, I had already decided that my first project would be to explore the role of Fannie Mae and Freddie Mac in the U.S. housing finance system. I'd had this idea in mind since my years as general counsel of the Treasury, when I'd first encountered these obscure but immensely powerful Washington institutions. In 1999 I knew relatively little about the two GSEs, but enough to recognize that they represented a peculiar and troubling business model—shareholder-owned private firms that were listed on the New York Stock Exchange, thinly capitalized, highly profitable, and the beneficiaries of what was then described by outside observers as "implicit" government backing. The companies denied that they had any such government support, implicit or otherwise, and of course the government—often through the Treasury Department—issued the

same denial. But the markets refused to believe it and continued to provide Fannie and Freddie with rates on their debt securities that were better than AAA and only slightly higher than what Treasury itself was required to pay.

This structure worried me. It was not clear how their risk-taking could be controlled if creditors—the only group that doesn't benefit from risk-taking—have no incentive to care whether the two firms are taking risks. In other words, how could there be any form of market discipline if the credit markets were assured that they would be reimbursed by Uncle Sam if one or both of the GSEs were to fail? Here, undoubtedly, was the clearest and most troubling case of moral hazard in the U.S. financial system. Even government deposit insurance covers only a specified amount of bank deposits; Fannie and Freddie had accumulated liabilities of more than $5 trillion, and all of these obligations were implicitly on the government's books. If the markets were correct about the nature of this government backing, the taxpayers were eventually going to face substantial costs.

Fannie and Freddie were regulated, to be sure, but I am skeptical in general about the efficacy of regulation. Government employees, as diligent as they may be, simply do not have the incentives to be tough and thorough in supervising complex financial institutions. And if these incentives are absent, regulation itself creates moral hazard by providing an illusory sense that an objective third party is controlling a regulated firm's risk-taking. Indeed, the fact that they were regulated at all was a strong signal to the markets that the government was aware of its implicit obligations and would stand by them. Under these circumstances, weak regulation was the worst of all possible worlds, and the regulatory structure for the GSEs in 1999 was notoriously weak. For example, their regulator, the Office of Federal Housing Enterprises Oversight (OFHEO), did not even have the ability to increase their capital as their risks increased; their capital level had been set by statute at an appallingly low level—2.5 percent on their mortgage assets and forty-five basis points on their guarantees of mortgage-backed securities (MBS). Accordingly, my objective—as outlined in chapter 1—was to raise public awareness of the risks associated with these two firms in the hope that this would spur congressional action for tighter and more comprehensive regulation.

There is some irony associated with my view of the GSEs' potential risks for taxpayers; during the time I was studying the GSEs, I was largely unaware of the nature and scope of the risks they were actually taking.

This was not because of my own limitations as an analyst—limitations I readily admit—but because the same lack of disclosure that characterized the GSEs' financial statements also extended to their activities in buying and securitizing mortgages. Although their fraudulent accounting awakened Congress, the White House, and Fed chairman Alan Greenspan to the dangers they might potentially pose to the financial system and the taxpayers, by late 2004 few people had yet realized that the GSEs were also buying hundreds of billions of dollars of subprime and other low-quality mortgages in order to meet the affordable housing goals that had been imposed on them by Congress in 1992. It wasn't until shortly before they became insolvent and were taken over by their regulator—acting as a conservator—that the data began to come out in understandable form. These data made clear for the first time the poor quality of the mortgages the GSEs had been acquiring. It showed not only why they had become insolvent but why their activity was a primary element in the government housing policies that ultimately caused the 2008 financial crisis.

There is a sequel to all of this. In July 2009, I was appointed by John Boehner, then the House minority leader, as a member of the Financial Crisis Inquiry Commission (FCIC), a congressionally appointed ten-member group (six Democrats and four Republicans) that was to investigate the causes of the financial crisis and report to Congress, the president and the American people. Ultimately, for the reasons outlined below, I dissented from the commission's majority report.[4] In my dissent, I pointed out that by 2008, because of government housing policies, almost half of all mortgages in the United States were subprime or otherwise weak and that the vast majority of these mortgages were on the books of government agencies like Fannie and Freddie. The FCIC majority ignored these numbers. Nevertheless, in December 2011, the SEC sued some of the top officers of Fannie and Freddie during the period prior to their insolvency, alleging that they had failed to disclose the full scope of their purchases of subprime and other low-quality mortgages. The SEC had been able to conduct a thorough investigation of the books and records of the GSEs and had obtained nonprosecution agreements in which both firms admitted that

4. Peter J. Wallison, "Dissent from the Majority Report of the Financial Crisis Inquiry Commission," 23–28, http://www.aei.org/files/2011/01/26/Wallisondissent.pdf.

they had acquired and not disclosed the mortgages that ultimately caused their insolvency. These agreements showed that there were actually more subprime and low-quality mortgages on their books in 2008 than I had reported in my dissent.

Because Fannie and Freddie were hiding their subprime credit risks, I and others—including Alan Greenspan and economists at the Fed—were focused on the interest rate risk associated with their portfolios of mortgages and mortgage-backed securities. Together, the GSEs held mortgages and MBS with a value of more than $1.5 trillion. Their statutory capital was extremely thin, only 2.5 percent of their assets, and they were carrying these instruments with borrowed funds. If interest rates should rise above the rate on the funds they had borrowed, they would begin to suffer cash and accounting losses on the value of the instruments themselves. For example, if the GSEs were earning 5 percent on the mortgages in their portfolios but were required to pay 6 percent for the funds necessary to carry these portfolios, they would sustain significant losses. Because they were so thinly capitalized, it would not take long for them to become insolvent. In addition, their assets would have to be written down, causing a further decline in capital. These losses, in turn, could trigger much higher funding costs, eventually requiring the government either to come to their rescue or close them down. Ultimately, of course, it was their credit risk-taking and not their interest rate risk-taking that did them in. Their shares fell sharply in value in the summer of 2008, when investors realized that the unprecedented number of mortgage delinquencies and defaults would affect their profitability, even if the government protected their creditors.

This raises the legitimate question of whether it was the GSE form itself or government housing policy that caused the failure of these two firms and ultimately the financial crisis. The answer is: both. If it had not been for the GSE form, which allowed Fannie and Freddie to operate with the implicit backing of the U.S. government, they could never have grown as large as they did and could never have had such outsized influence on the U.S. housing market. In addition, it was the moral hazard associated with this implicit government backing—the belief in the credit markets that the government would never allow Fannie or Freddie to fail—that allowed them to operate without anyone's scrutiny. The fact is that no investor that was buying their securities—either their debt securities or

the MBS they had guaranteed—cared what risks they were taking. In the end, everyone was confident that Uncle Sam would stand behind them, a confidence that was fully borne out. This enabled the U.S. Department of Housing and Urban Development (HUD) to raise the affordable housing goals over time—substantially increasing their risk-taking—without engendering any significant concern in the credit markets. To the extent that financial analysts were looking at Fannie and Freddie, they were equity analysts, who probably believed the narrative that Fannie and Freddie only bought prime mortgages. Even if housing prices stopped rising, they reasoned, the high quality of the GSEs' portfolios would keep them from suffering debilitating losses.

The Narrative on Fannie Mae and Freddie Mac

There was little support for tighter and more comprehensive regulation of Fannie and Freddie when I joined AEI in 1999. To the extent that they were known at all, the GSEs were seen as largely benign facilitators of an efficient housing market, and their soft-focus advertising emphasized their contributions to the American dream of homeownership. Americans generally thought of the U.S. housing finance system as efficient and effective, and the politicians who supported it called it "the envy of the world." Few Americans—or lawmakers for that matter—knew that the U.S. mortgage interest rates and homeownership rates were somewhere in the middle of the pack for developed countries, even though only the United States directly subsidized housing finance, allowed refinancing without penalty, and in many states allowed "nonrecourse" mortgages in which homeowners had no liability on the mortgage note beyond whatever value the lender received on foreclosure. With all this misplaced satisfaction, it was difficult for Congressman Richard Baker—then the head of the House subcommittee with jurisdiction over the GSEs—to find cosponsors for tougher regulation of the GSEs, even among Republicans.

Between 1999 and 2005, I sponsored seventeen AEI public conferences about the GSEs and the risks they posed to the taxpayers. But apart from raising interest in the GSEs in the Washington policy community, my efforts seemed to produce no significant additional support for regulatory legislation. During much of this period, when Alan Greenspan was asked in

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