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THE CASE FOR REPEALING DODD-FRANK

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The 2008 financial crisis was a major event, equivalent in its initial scope—if not its duration—to the Great Depression of the 1930s. At the time, many commentators said that we were witnessing a crisis of capitalism, proof that the free market system was inherently unstable. Government officials who participated in efforts to mitigate its effects claim that their actions prevented a complete meltdown of the world's financial system, an idea that has found acceptance among academic and other observers, particularly the media. These views culminated in the enactment of the Dodd-Frank Act that is founded on the notion that the financial system is inherently unstable and must be controlled by government regulation.

We will never know, of course, what would have happened if these emergency actions had not been taken, but it is possible to gain an understanding of why they were considered necessary—that is, the causes of the crisis.

Why is it important at this point to examine the causes of the crisis? After all, it was five years ago, and Congress and financial regulators have acted, or are acting, to prevent a recurrence. Even if we can't pinpoint the exact cause of the crisis, some will argue that the new regulations now being put in place under Dodd-Frank will make a repetition unlikely. Perhaps. But these new regulations have almost certainly slowed economic growth and the recovery from the post-crisis recession, and they will continue to do so in the future. If regulations this pervasive were really necessary to prevent a recurrence of the financial crisis, then we might be facing a legitimate trade-off in which we are obliged to sacrifice economic freedom and growth for the sake of financial stability. But if the crisis did not stem from a lack of regulation, we have needlessly restricted what most Americans want for themselves and their children.

It is not at all clear that what happened in 2008 was the result of insufficient regulation or an economic system that is inherently unstable. On the contrary, there is compelling evidence that the financial crisis was the result of the government's own housing policies. These in turn, as we will see, were based on an idea—still popular on the political left—that underwriting standards in housing finance are discriminatory and unnecessary. In today's vernacular, it's called "opening the credit box." These policies, as I will describe them, were what caused the insolvency of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, and ultimately the financial crisis. They are driven ideologically by the left, but the political muscle in Washington is supplied by what we should call the Government Mortgage Complex—the realtors, the homebuilders, and the banks—for whom freely available government-backed mortgage money is a source of great profit.

The Federal Housing Administration, or FHA, established in 1934, was authorized to insure mortgages up to 100 percent, but it required a 20 percent down payment and operated with very few delinquencies for 25 years. However, in the serious recession of 1957, Congress loosened these standards to stimulate the growth of housing, moving down payments to three percent between 1957 and 1961. Predictably, this resulted in a boom in FHA insured mortgages and a bust in the late '60s. The pattern keeps recurring, and no one seems to remember the earlier mistakes. We loosen mortgage standards, there's a bubble, and then there's a crash. Other than the taxpayers, who have to cover the government's losses, most of the people who are hurt are those who bought in the bubble years, and found—when the bubble deflated—that they couldn't afford their homes.

Exactly this happened in the period leading up to the 2008 financial crisis, again as a result of the government's housing policies. Only this time, as I'll describe, the government's policies were so pervasive and were pursued with such vigor by two administrations that they caused a financial crisis as well as the usual cyclical housing market collapse.

Congress planted the seeds of the crisis in 1992, with the enactment of what were called "affordable housing" goals for Fannie Mae and Freddie Mac. Before 1992, these two firms dominated the housing finance market, especially after the federal savings and loan industry—another government mistake—had collapsed in the late 1980s. Fannie and Freddie's role, as initially envisioned and as it developed until 1992, was to conduct what were called secondary market operations, to create a liquid market in mortgages. They were prohibited from making loans themselves, but they were authorized to buy mortgages from banks and other lenders. Their purchases provided cash for lenders and thus encouraged home ownership by making more funds available for more mortgages. Although Fannie and Freddie were shareholder-owned, they were chartered by Congress and granted numerous government privileges. For example, they were exempt from state and local taxes and from SEC regulations. The president appointed a minority of the members of their boards of directors, and they had a $2.25 billion line of credit at the

Treasury. As a result, market participants believed that Fannie and Freddie were government-backed, and would be rescued by the government if they ever encountered financial difficulties.

This widely assumed government support enabled these GSEs to borrow at rates only slightly higher than the U.S. Treasury itself, and with these low-cost funds they were able to drive all competition out of the secondary mortgage market for middle-class mortgages—about 70 percent of the $11 trillion housing finance market. Between 1991 and 2003, Fannie and Freddie's market share increased from 28 to 46 percent. From this dominant position, they were able to set the underwriting standards for the market as a whole; few mortgage lenders would make middle-class mortgages that could not be sold to Fannie or Freddie.

Over time, these two GSEs had learned from experience what underwriting standards kept delinquencies and defaults low. These required down payments of 10 to 20 percent, good credit histories for borrowers, and low debt-to-income ratios after the mortgage was closed. These were the foundational elements of what was called a prime loan or a traditional mortgage, and they contributed to a stable mortgage market through the 1970s and most of the 1980s, with mortgage defaults generally under one percent in normal times and only slightly higher in rough economic waters. Despite these strict credit standards, the homeownership rate in the United States remained relatively high, hovering around 64 percent for the 30 years between 1964 and 1994.

In a sense, government backing of the GSEs and their market domination was their undoing. Community activists had kept the two firms in their sights for many years, arguing that Fannie and Freddie's underwriting standards were so tight that they were keeping many low- and moderate-income families from buying homes. The fact that the GSEs had government support gave Congress a basis for intervention, and in 1992 Congress directed the GSEs to meet a quota of loans to low- and middle-income borrowers when they acquired mortgages. The initial quota was 30 percent: In any year, at least 30 percent of the loans Fannie and Freddie acquired must have been made to low- and moderate-income borrowers—defined as borrowers at or below the median income level in their communities. Although 30 percent was not a difficult goal, the Department of Housing and Urban Development (HUD) was given authority to increase the goals, and Congress cleared the way for far more ambitious requirements by suggesting in the legislation that down payments could be reduced below five percent without seriously impairing mortgage quality. In succeeding years, HUD raised the goal, with many intermediate steps, to 42 percent in 1996, 50 percent in 2000, and 56 percent in 2008.

In order to meet these ever-increasing goals, Fannie and Freddie had to reduce their underwriting standards. In fact that was explicitly HUD's purpose, as many statements by the department at the time made clear. As early as 1995, the GSEs were buying mortgages with three percent down payments, and by 2000 Fannie and Freddie were accepting loans with zero down payments. At the same time, they were also compromising other underwriting standards, such as borrower credit standards, in order to find the subprime and other non-traditional mortgages they needed to meet the affordable housing goals.

These new easy credit terms spread far beyond the low-income borrowers that the loosened standards were intended to help. Mortgage lending is a competitive business; once Fannie and Freddie started to reduce their underwriting standards, many borrowers who could have afforded prime mortgages sought the easier terms now available so they could buy larger homes with smaller down payments. Thus, home buyers above the median income were gaining leverage through lower down payments, and loans to them were decreasing in quality. In many cases, these homeowners were withdrawing cash from the equity in their homes through cash-out refinancing as home prices went up and interest rates declined in the mid-2000s. By 2007, 37 percent of loans with down payments of three percent went to borrowers with incomes above the median.

As a result of the gradual deterioration in loan quality over the preceding 16 years, by 2008, just before the crisis, 56 percent of all mortgages in the U.S.—32 million loans—were subprime or otherwise low quality. Of this 32 million, 76 percent were on the books of government agencies or institutions like the GSEs that were controlled by government policies. This shows incontrovertibly where the demand for these mortgages originated.

With all the new buyers entering the market because of the affordable housing goals, housing prices began to rise. By 2000, the developing bubble was already larger than any bubble in U.S. history, and it kept growing until 2007, when—at nine times the size of any previous bubble—it finally topped out and housing prices began to fall.

Housing bubbles tend to suppress delinquencies and defaults while the bubble is growing. This happens because as prices rise, it becomes possible for borrowers who are having difficulty meeting their mortgage obligations to refinance or sell the home for more than the principal amount of the mortgage. In these conditions, potential investors in mortgages or in mortgage-backed securities receive a strong affirmative signal; they see high-yielding mortgages—loans that reflect the riskiness of lending to a borrower with a weak credit history—but the expected delinquencies and defaults have not occurred. They come to think, "This time it's different"—that the risks of investing in subprime or other weak mortgages are not as great as they'd thought. Housing bubbles are also pro-cyclical. When they are growing, they feed on themselves, as buyers bid up prices so they won't lose a home they want. Appraisals, based on comparable homes, keep pace with rising prices. And loans keep pace with appraisals, until home prices get so high that buyers can't afford them no matter how lenient the terms of the mortgage. But when bubbles begin to deflate, the process reverses. It then becomes impossible to refinance or sell a home when the mortgage is larger than the home's appraised value. Financial losses cause creditors to pull back and tighten lending standards, recessions frequently occur, and would-be purchasers can't get financing. Sadly, many are likely to have lost their jobs in the recession while being unable to move where jobs are more plentiful, because they couldn't sell their homes without paying off the mortgage balances. In these circumstances, many homeowners are tempted to walk away from the mortgage, knowing that in most states the lender has recourse only to the home itself.

With the largest housing bubble in history deflating in 2007, and more than half of all mortgages made to borrowers who had weak credit or little equity in their homes, the number of delinquencies and defaults in 2008 was unprecedented. One immediate effect was the collapse of the market for mortgage-backed securities that were issued by banks, investment banks, and subprime lenders, and held by banks, financial institutions, and other investors around the world. These were known as private label securities or private mortgage-backed securities, to distinguish them from mortgage-backed securities issued by Fannie and Freddie. Investors, shocked by the sheer number of mortgage defaults that seemed to be underway, fled the market for private label securities; there were now no buyers, causing a sharp drop in market values for these securities.

This had a disastrous effect on financial institutions. Since 1994, they had been required to use what was called "fair value accounting" in setting the balance sheet value of their assets and liabilities. The most significant element of fair value accounting was the requirement that assets and liabilities be marked-to-market, meaning that the balance sheet value of assets and liabilities was to reflect their current market value instead of their amortized cost or other valuation methods.

Marking-to-market worked effectively as long as there was a market for the assets in question, but it was destructive when the market collapsed in 2007. With buyers pulling away, there were only distress-level prices for private mortgage-backed securities. Although there were alternative ways for assets to be valued in the absence of market prices, auditors—worried about their potential liability if they permitted their clients to overstate assets in the midst of the financial crisis—would not allow the use of these alternatives. Accordingly, financial firms were compelled to write down significant portions of their private mortgage-backed securities assets and take losses that substantially reduced their capital positions and created worrisome declines in earnings. When Lehman Brothers, a major investment bank, declared bankruptcy, a full-scale panic ensued in which financial institutions started to hoard cash. They wouldn't lend to one another, even overnight, for fear that they would not have immediate cash available when panicky investors or depositors came for it. This radical withdrawal of liquidity from the market was the financial crisis.

Thus, the crisis was not caused by insufficient regulation, let alone by an inherently unstable financial system. It was caused by government housing policies that forced the dominant factors in the trillion dollar housing market—Fannie Mae and Freddie Mac—to reduce their underwriting standards. These lax standards then spread to the wider market, creating an enormous bubble and a financial system in which well more than half of all mortgages were subprime or otherwise weak. When the bubble deflated, these mortgages failed in unprecedented numbers, driving down housing values and the values of mortgage-backed securities on the balance sheets of financial institutions. With these institutions looking unstable and possibly insolvent, a full-scale financial panic ensued when Lehman Brothers, a large financial firm, failed.

Given these facts, further regulation of the financial system through the Dodd-Frank Act was a disastrously wrong response. The vast new regulatory restrictions in the act have created uncertainty and sapped the appetite for risk-taking that had once made the U.S. financial system the largest and most successful in the world.

What, then, should have been done? The answer is a thorough reorientation of the U.S. housing finance system away from the kind of government control that makes it hostage to narrow political imperatives—that is, providing benefits to constituents—rather than responsive to the competition and efficiency imperatives of a market system. This does not mean that we should have no regulation. What it means is that we should have only regulation that is necessary when the self-correcting elements in a market system fail. We can see exactly that kind of failure in the effect of a bubble on housing prices. A bubble energizes itself by reducing defaults as prices rise. This sends the wrong signal to investors: Instead of increasing risk, they tend to see increasing opportunity. They know that in the past there have been painful bubble deflations in housing, but it is human nature to believe that "this time it's different." Requiring that only high quality mortgages are eligible for securitization would be the kind of limited regulatory intervention that addresses the real problem, not the smothering regulation in Dodd-Frank that depresses economic growth.

The Affordable Care Act, better known as ObamaCare, has received all the attention as the worst expression of the Obama presidency, but Dodd-Frank deserves a look. Just as ObamaCare was the wrong prescription for health care, Dodd-Frank was based on a faulty diagnosis of the financial crisis. Until that diagnosis is corrected—until it is made clear to the American people that the financial crisis was caused by the government rather than by deregulation or insufficient regulation—economic growth will be impeded. It follows that when the true causes of the financial crisis have been made clear, it will become possible to repeal Dodd-Frank.

This has happened before. During the 1930s, the dominant view was that the Depression was caused by excessive competition. It seems crackpot now, but the New Dealers thought that too much competition drove down prices, caused firms to fail, and thus increased unemployment. The Dodd-Frank of the time was the National Industrial

Recovery Act. Although it was eventually overturned by the Supreme Court, its purpose was to cartelize industry and limit competition so that businesses could raise their prices. It was only in the 1960s, when Milton Friedman and Anna Schwartz showed that the Depression was caused by the Federal Reserve's monetary policy, that national policies began to move away from regulation and toward competition. What followed was a flood of deregulation—of trucking, air travel, securities, and communications, among others—which has given us the Internet, affordable air travel for families instead of just business, securities transactions at a penny a share, and Fedex. Ironically, however, the regulation of banking increased, accounting for the problems of the industry today.

If the American people come to recognize that the financial crisis was caused by the housing policies of their own government—rather than insufficient regulation or the inherent instability of the U.S. financial system—Dodd-Frank will be seen as an illegitimate response to the crisis. Only then will it be possible to repeal or substantially modify this repressive law.

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