Book Reviews

Bad History, Worse Policy: How a False Narrative about the Financial Crisis Led to the Dodd-Frank Act

By Peter J. Wallison

Reviewed by John Tamny

Related Links:

•Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (January 2011): http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

•*Causes of the Recent Financial and Economic Crisis: Hearing Before the Financial Crisis Inquiry Commission* (2010) (statement of Ben S. Bernanke, Chairman, Federal Reserve): http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm

On June 8, 2011, in an exchange with Fed Chairman Ben Bernanke about the federal government's response to the financial crisis, JPMorgan Chase Chairman Jamie 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." Thankfully the wait for just such a book has been 18 months.

For readers of the *Wall Street Journal*'s editorial page, one of their most insightful and regular contributors is American Enterprise Institute (AEI) fellow Peter Wallison. A prolific writer on matters financial, Wallison's op-eds have long been a must read. This was particularly true amid the financial crisis.

Happily for those seeking a very comprehensive account of what happened during the aforementioned crisis, along with the governmental errors before and after, Wallison has recently published *Bad History, Worse Policy: How a False Narrative About the Financial Crisis Led to the Dodd-Frank Act*. Anyone desiring a strong understanding of how the recessionary rush to housing occurred should buy Wallison's book. Jamie Dimon would surely be pleased, but perhaps also worried.

Wallison doesn't mince words. Throughout the book he makes plain that the driver of the eventual meltdown was "government housing policy" whereby government sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac, affordable housing legislation from Congress, and tax incentives fostered an excess of housing consumption that would never have occurred in a free market. But for those who might presume his account is a partisan one, they needn't worry. As Wallison asserts early on, "The Bush administration was at least as culpable as the Clinton administration when it came to setting the stage for the eventual crisis." To read the book is to even conclude that the Bush administration was the bigger miscreant of the two. More on that later.

Wallison's purpose in the book, which is mostly a collection of research reports he wrote on housing and banking from 2004 to 2012, is to change the popular narrative about what happened. As he notes, "Winners write the history," and with President Obama's ascendance to the White House in 2009, a narrative about what occurred has taken hold that deregulation, or a lack of proper supervision of private sector banks, caused the crack-up on the way to passage of the 2010 Dodd-Frank Act. As Wallison puts it about Dodd-Frank, "nearly every provision can be traced back to a corresponding provision in the left's narrative. Thus, if the narrative is wrong, the act is wrong." Wallison ably corrects a great deal of misinformation, but as of this writing, it's too soon to tell if his dissenting narrative will reverse what he terms "the most troubling—maybe even destructive—single piece of financial legislation ever adopted."

Considering the American rush into housing, Wallison notes that the nature of the surge which took on new force around 2001 was disturbing. He observes:

> from 2001 to 2006, the share of all mortgage originations that were made up of conventional mortgages (that is, the thirty-year fixed-rate mortgage that had always been the mainstay of the U.S. mortgage market) fell from 57.1 percent in 2001 to 33.1 percent in the fourth quarter of 2006. Correspondingly, subprime loans (those made to borrowers with blemished credit) rose from 7.2 percent to 18.8 percent, and Alt-A loans (those made to speculative buyers or without the usual underwriting standards) rose from 2.5 percent to 13.9 percent.

To explain this profound change in the kinds of mortgages issued, and it will be argued later that the explanation wasn't totally complete in this reviewer's eyes, Wallison points to legislation like the Community Reinvestment Act, along with an expanded mandate for the GSEs whose activities are prominently documented throughout the book.

Wallison was hardly a newby when it came to skepticism of Fannie Mae and Freddie Mac. Almost from the time that he arrived at AEI in 1999, Wallison staged numerous symposiums (seventeen from 1999-2005) on these quasi-market institutions. The problem, as he notes early on, is that Fannie and Freddie were experts in the political game and had Congress in their pockets for their mission of making housing more affordable for all Americans. The GSEs never acknowledged what little impact the liquidity they provided had on interest rates, not to mention that their massive borrowing probably erased any impact to begin with.

Very importantly in light of the false "de-regulation" narrative that continues to this day, Wallison points out that "the fact that they were regulated at all was a strong signal to the markets that the government was aware of its implicit obligations [assuming either ever went bust] and would stand

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by them." Private banks too were and are heavily regulated, and it's fair to suggest that counterparties of banks presumed much the same. Needless to say, the two GSEs had run up liabilities of more than $5 trillion; a number that would have been impossible for either to achieve in a market not distorted by the federal government's footprint.

Wallison also notes the often "thuggish" bearing of Fannie and Freddie. Indeed, when he told a colleague that in his new role at AEI he would be investigating the two GSEs, the colleague asked who would start his car each morning. Upon arrival at AEI, Wallison was on the board of MGIC, the largest private mortgage insurer. But once his investigations began he had to step down from MGIC's board thanks to the mortgage insurer being frozen out of business by Fannie. The chairman of MGIC was told, "Fannie only wants to deal with its friends, and with Peter Wallison on your board we can't regard MGIC a friend."

As for Fannie's eventual implosion whereby the federal government put it into conservatorship, Wallison's expertise with the GSE put him in a unique position to predict what eventually came about. As of 2004 Fannie Mae had a low P/E ratio relative to others in its space, and at the time Wallison wrote that "investors have built into Fannie's stock price an enormous risk premium, perhaps anticipating that there will be some event—probably government action—that will seriously diminish the company's value." Yes there was.

Looked at in terms of U.S. economic health more broadly, it cannot be stressed enough that the purchase of a home, quite unlike an investment in a public or private company, is consumption as opposed to investment. Classical School thinkers from Adam Smith to John Stuart Mill knew this well, but this was largely misunderstood during the housing boom by both Democrats desperate to make housing affordable for everyone, and Republicans (right up to George W. Bush) eager to foster what they termed an "ownership society."

Missed by both sides was that the rush into housing signaled something seriously wrong with the economy (which this reviewer wrote about for *National Review Online* in 2006[1]). A purchase of a house doesn't make one more productive, it doesn't lead to software or other commercial innovations that drive economic efficiency, nor does it open foreign markets. Housing on its best day is a consumptive sink of wealth, and when housing was all the rage in the earlier part of the new Millennium, the fact that it was made it apparent that consumption of housing was detracting from investment in the productive parts of the economy.

Combine the above with a 425 basis point increase in the Fed funds rate beginning in 2004, and some sort of economic and banking crack-up was, at least in retrospect, inevitable. Traditional banks, investment banks, and the GSEs were hit in two ways: a weakening economy made mortgages more difficult to service and the hike in rates gradually eroded the value of the mortgage securities on the books of financial institutions—then when housing prices simply stopped rising in 2007, the trouble began. No longer able to refinance mortgages on houses they couldn't afford, but initially made affordable by governmental distortion of the housing market, mortgage holders began to default, and in some cases they simply "walked" ("without recourse" loans made this somewhat easy) from homes the underlying mortgages of which no longer made sense to pay.

Readers are well aware of what happened next in the form of bank failures, bailouts, and what is now termed a "financial crisis." What's so valuable about Wallison's account is that he brings understanding to an occurrence that is still largely misunderstood.

Most notable in this regard is his commentary about "interconnectedness." Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson used the latter to justify their bailout of Bear Stearns' counterparties; their contention that if Bear had been allowed to fail without government backstop, it would have created a "domino effect" across financial institutions with exposure to the investment bank. In short, "systemic risk" made the bailout essential.

Wallison easily discredits the above notion. Indeed, as he notes throughout the book, Lehman Brothers was a much larger financial institution than Bear, yet when it failed the alleged "contagion" only spread to the Reserve Primary Fund, a money market entity, which subsequently "broke the buck."

Importantly, even the Reserve Primary Fund's failure probably could have been avoided. As Wallison makes plain, the mistaken bailout of Bear Stearns created an expectation in the marketplace that the much larger Lehman would eventually be saved too. The Reserve Fund had a great deal of exposure to Lehman debt, but absent the aforementioned expectation created by federal officials, it would have long before shed its exposure to Lehman.

To this day market commentators talk about Lehman's failure as the cause of the financial crisis, but Wallison makes it more than apparent that the 'crisis' aspect of Lehman did not have to be. In truth, and as Wallison notes, the bailout of Bear was the "original sin" that occurred under false pretenses. If instead Bear is allowed to go bankrupt free of government meddling, Lehman is forced to quickly find a buyer for itself. Put very plainly, Lehman's eventual implosion was only a major market event because the Bush administration and the Bernanke Fed created the impression in the marketplace that it would be saved too. As for the narrative claiming that no banks can be allowed to fail in light of the presumed "domino effect," once again, and even with all the uncertainty created by a Bush administration that lacked a coherent policy, the Reserve Primary Fund's breaking the buck was the only failure-inducing result of Lehman's decline.

Regarding the credit default swaps (CDSs) that still have so many in the financial commentariate up in arms, Wallison's explanation of them is worth the price of the book alone. Indeed, he soberly explains throughout that CDSs could not have caused the 'crisis' as so many presume. A CDS is simply the way that the owner of company A's debt hedges against default. Assuming default, the debt owner is insured. If these innocuous instruments of finance didn't exist, they'd have to be invented so that companies would be able to raise more debt.

Still, naysayers presumed them to be the cause of the crisis, but nothing could be further from the truth. As a CDS reveals by its very name, if a company defaults, the bondholder gains for being insured, while the insurer is out of the money. It is if anything zero sum, but even the insurer isn't completely out of the money for the bondholder having made insurance payments right up to any default. Wallison notes that AIG didn't run into trouble for its exposure to CDSs, rather its troubles stemmed from "selling protection against others' losses, but unlike other market participants it never hedged its bets by buying protection for itself." What if AIG had been allowed to go bankrupt? Well, those it sold insurance to would simply have gone to another insurer to buy the protection theoretically no longer provided by AIG.

More broadly, Wallison reminds the reader of the genius of much maligned CDSs in two important ways. For one, they provide a precious market assessment of the financial health of companies whose debt is insured by outside investors against default. Even better, Wallison reminds the reader that "[u]ntil CDSs became available, it was not possible to sell short—to speculate against the prices of debt securities—in a debt market." The latter can't be stressed enough. In equity markets, the role of short sellers is beautiful for moderating overexcitement about a specific equity, and infusing stock prices with less frothy views. The creation of CDSs offered the same to debt markets, and considering that there was no 'crisis' absent the federal government's bailout of Bear Stearns, it should be said that the existence of CDSs will make future market shocks less, not more likely.

As for the de-regulation narrative that has taken hold on the way to the Dodd-Frank Act, Wallison reminds the reader that "the current crisis was caused by regulated banks." More important, he notes that "regulation is simply not effective in preventing risk-taking and failure." This reviewer would put it more bluntly than did Wallison: to presume that regulations over banks would work is to believe that those who couldn't get jobs on Wall Street or in finance would have the skills to oversee the individuals who did. Regulation is a brutally fatal conceit.

Thinking about the above in light of Dodd-Frank legislation that allows federal officials to take over 'Too Big To Fail' financial institutions seen as troubled, not to mention the power handed to the Fed in the same legislation that asks it to regulate for the 'crises' that haven't yet revealed themselves, both are logically doomed to fail. Indeed, John Paulson and others didn't earn billions when mortgages went south because investors and regulators saw what he did, instead he earned billions *precisely because* so few understood the troubles brewing. If regulators had the skill to do what they're empowered to, rather than spending time watching over banks, they'd instead be earning billions in the private sector for having a hotline to the future that even the best investors (recently Paulson's funds have experienced cash outflows as his returns have underperformed) don't claim to have. Regulation is an arrogant falsehood, and if we want to fix banks, the only way to do it is lack of regulation whereby their failures are their own.

As for the popular view that Glass-Steagall's repeal led to irresponsible banking practices, Wallison easily destroys this nonsensical myth. He points out that even post-repeal traditional banks are still prohibited "from underwriting or dealing in securities." What got the banks in trouble? Loans, and exposure to mortgage securities, but as Wallison helpfully reminds the reader, Glass-Steagall never prohibited "banks from buying and selling whole loans." In short, what took certain banks down was already allowed before Glass-Steagall was partially repealed.

Considering the book in a more broad sense, it's very repetitive, but that's meant as a huge compliment. That subjects are regularly revisited means that particularly for a reader somewhat new to the concepts within, by the end of the book the understanding of various subjects will be that much greater.

As for disagreements, about mark-to-market (MTM) accounting, Wallison asserts that the aforementioned accounting rules "may have been as destructive as the mortgage meltdown itself. As mortgage losses continued, there were very few buyers in the market for PMBS, so market prices were almost entirely distress prices, but it seemed that accountants were still requiring write-downs in the value of these assets." Fair enough, but if a market is frozen, that's the market, and at times at least with some assets, it's probably wishful thinking that any frozen market will clear. Shouldn't asset prices reflect this?

Further on, he decries MTM for being "procyclical." In other words, it tends to exacerbate current financial trends, whatever they are. But isn't that the point too? Assuming a bank has a great deal of exposure to an asset class in trouble, wouldn't we want substantial write-downs as a way of making sure that the troubled bank ceases sending even more good money after bad? Isn't this particularly true in light of what Wallison and this reviewer deem the "moral hazard" that is the FDIC?

A reponse to the above might be that tight credit would exacerbate a recession—but isn't that the point of recessions, for banks to tighten credit so that no more of it is destroyed on bad ideas? Furthermore, as of 2008 banks only accounted for roughly 20% of corporate lending, so wouldn't non-bank credit substitutes fill the breech until things normalize?

After that, Wallison seems to accept that financial institutions were in trouble no matter the accounting system in place. As he acknowledges about Bear Stearns, "doubts about the quality of the firm's assets—and hence its long-term solvency—was the ultimate cause of its collapse." In short, investors frequently mark to market no matter the accounting systems in place, and in 2008 investors had lost faith in the balance sheets of some financial institutions.

Importantly, none of what's written here should be taken as an endorsement from this reviewer of MTM. To me, it's a bad idea not because of the problems it created for banks in 2008, but because banks should in a perfect, non-regulated world be able to individually choose their accounting methods. If so, investors in the marketplace would decide the best way to mark the value of assets, as opposed to valuation in a one-size-fits-all manner.

But probably the biggest problem with the book wasn't so much what was said (it can't be stressed enough what a useful book Wallison has written), but what was omitted. Wallison writes early on that "[f]ew 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.*"[2]

Put very simply, even though the U.S. subsidized homeownership in ways quite unlike developed countries around the world, there was still a global rush to housing. It would be willful blindness to deny Wallison's main point of the book that "government housing policy" generated rising housing demand, but as evidenced by the global nature of the housing run-up along with an eventual global financial crisis, housing boomed in parts of the world where Fannie and Freddie equivalents did not exist, where interest rates weren't set at 1% for quite some time, and where tax subsidies like the mortgage interest deduction quite simply did not exist. It's possible this reviewer missed it, but Wallison didn't seem to account very well for this oddity.

In that case, I'll fill in what I deem the blanks. Beginning in 2001, a long decline in the gold value of the dollar began. Somewhat mocked by modern intellectuals, gold is still worthy as a measure of value with great constancy. If this is doubted, consider that an ounce of the yellow metal bought 15 barrels of oil in 1971 at $35/ounce, and today it buys a little north of 16 barrels at $1,600 an ounce. In 1981 at $480/ounce, gold bought 15 barrels at $35.

When U.S. monetary authorities devalue the dollar, it's always and everywhere a global event. So while currencies from the pound, to the euro, to the Canadian dollar, to the Aussie dollar increased substantially against the greenback in 2001, in gold terms all fell substantially. When money loses value as it did on a global basis beginning in 2001, there began to occur what Austrian School economists refer to as a "flight to the real." Put more plainly, falling currency values led to a rush into hard assets least vulnerable to currency devaluation: think housing, land, rare stamps, art, etc. Of note, there's a historical basis for this presumption.

As Adam Fergusson wrote in *When Money Dies*, his classic account of the collapse of the mark in post-WWI Germany, amid the mark's decline, investors safeguarded their dwindling wealth through the purchase of assets that "would maintain their value: houses, real estate, manufactured goods, raw materials, and so forth."

Moving to the 1970s when the dollar was in freefall, "housing emerged as the most dynamic sector" according to Allen Matusow's account of monetary folly within the Nixon administration, *Nixon's Economy*. Turning to the second half of the 1970s amid further dollar weakness, William Greider wrote in *Secrets of the Temple* that the economy of the Carter years "particularly benefited the broad middle class of families that owned their homes." Writing about the late '70s rush to housing amid a falling dollar in his classic book, *Wealth and Poverty*, George Gilder wrote, "What happened was that citizens speculated on their homes . . . Not only did their houses tend to rise in value about 20 percent faster than the price index, but with their small equity exposure they could gain higher percentage returns than all but the most phenomenally lucky shareholders." Shades of the '2000s?

Crossing the pond to England in the 1970s, the Brits tragically followed our devaluationist path with their pound, and as David Smith wrote in *The Rise and Fall of Monetarism*, the sector which investors "chose above all others was property development." As a Bank of England quarterly bulletin in June of 1978 revealed about the '70s, "There was no other general area of economic activity which seemed to offer as good a prospective rate of return to an entrepreneur as property development."

These various quotes are offered up to hopefully fill the hole in the story of what caused the rush to housing. That government housing policies played a role is impossible to argue with. But there was something more to it as evidenced by a housing boom that was global. Falling currency values have historically fostered price-driven housing booms, and so a weakness in Wallison's book is that he didn't delve into the monetary aspects (not interest rates, but the dollar's value specifically against foreign currencies and gold) of what occurred. Subsidies matter, but ultimately loans were for a time easy to make on houses precisely because they kept rising in price.

Still, the two main areas of disagreement should not be construed as a negative comment about Wallison's excellent book. *Bad History, Worse Policy* is an essential read that will bring light to readers eager to understand what happened, where previously there was darkness. Readers will be enthralled, and for the amazing information and analysis within, this is a book that they'll always keep handy. It's that good.

Endnotes

1 John Tamny, *Blame the Media for Bush's Low Economic Ratings?*, National Review (June 12, 2006), http://www.nationalreview.com/articles/217906/blame-media-bushs-low-economic-ratings/john-tamny.

2 (Emphasis Added).