THE NATIONAL INTEREST

Dodd-Frank: Money Never Sleeps

By: Christopher Whalen - November 1, 2013

President Obama and Congress continue to wrestle with competing ideas to fix America's housing crisis, ranging from abolishing Fannie Mae and Freddie Mac to introducing new regulations for repairing the rickety mortgage-financing system years after it crashed. To understand the enduring nature of today's housing-system mess, it is not really necessary to do much more than to look backward. To look, that is, at the careers of two former prominent politicians, each of whom has played an integral role in American finance in recent decades.

The first is former Connecticut senator Chris Dodd; the other is former Massachusetts representative Barney Frank. Both men have a lot in common. Both are Democrats. Both were influential members of their chambers' banking and financial-services panels (they chaired their respective committees when Congress passed the Dodd-Frank financial-reform law in July 2010). Both personified the cozy tripartite relationship involving big banks, big housing and big government. And both pooh-poohed the skeptics and stoutly defended Fannie Mae and Freddie Mac—long after many experts were warning that those huge government-sponsored enterprises (GSEs) had overextended themselves in the frothy U.S. housing market before the crash.

When it came to listening to dissenting voices, Frank was a bully and proud of it. During one subcommittee hearing, when Congressional Budget Office director Robert Reischauer expressed concerns about taxpayer liabilities if Fannie and Freddie encountered financial difficulty, Frank responded so vehemently that the subcommittee chairman, the gentlemanly Texan Henry B. Gonzalez, admonished him to stop badgering the witness. His propinquity to Fannie Mae was manifest when the company hired his domestic partner upon his graduation from business school at Dartmouth and in the $75,000 that Fannie donated to a Boston nonprofit group cofounded by Frank's mother. As Gretchen Morgenson and Joshua Rosner observe in their 2011 book, *Reckless Endangerment*, "Frank was a perpetual protector of Fannie, and those in his orbit were rewarded by the company."

And what about Dodd? He, too, defended Fannie and Freddie, denying that they were in serious financial straits even after Treasury Secretary Hank Paulson sought to augment capital and regulatory requirements for the GSEs as part of a bailout package. Dodd promoted legislation to assist troubled subprime-mortgage lenders such as California-based Countrywide Financial when they faced collapse after the housing bubble burst. It later turned out that he had accepted below-market mortgage rates from Countrywide for refinancing his Washington and Connecticut homes. The Senate Ethics Committee

concluded that, while Dodd had not knowingly pursued special treatment, he should have investigated the matter when he discovered that Countrywide had placed him in a special category of customers.

Mark Calabria, director of financial-regulation studies at the Cato Institute, wrote in 2010 that nothing in the Dodd-Frank legislation ended the huge intervention by the U.S. government in the mortgage market. Nor would it help avoid the next crisis. He wrote:

Perhaps it should come as no surprise that Sen. Christopher Dodd and Rep. Barney Frank, the bill's primary authors, would fail to end the numerous government distortions of our financial and mortgage markets that led to the crisis. Both have been either architects or supporters of those distortions. One might as well ask the fox to build the henhouse.

So should it really come as a surprise to anyone that the Dodd-Frank bill, which was supposed to prevent a recurrence of the housing crisis, is riddled with problems that Congress continues to attempt to remedy? Three years after its passage, the bill increasingly resembles a new Washington Monument—to folly and hubris. Even its supporters acknowledge its shortcomings. Writing in the *Wall Street Journal*, for example, Alan S. Blinder, a former vice chairman of the Federal Reserve, noted, "The Dodd-Frank Act is taking on water fast." The consequences for banks and the economy could be dire. Yet it needs to be said that most of the critics of the law, including Blinder, would address concerns about it with yet more regulation.

The Dodd-Frank law puts new obstacles to getting credit in front of businesses and consumers, while leaving the riskiest parts of the big banks untouched. The law imposes partial limits on bank trading for their own accounts through legislation known as the Volcker Rule—a rule that, as the *Wall Street Journal* noted, "languishes unfinished and unenforced, mired in policy tangles and infighting among five separate agencies whose job is to produce the fine print." It currently fails fully to curtail commercial-bank securities activities or separate banks from securities dealers, as was done by the Glass-Steagall provisions of the Banking Act of 1933. Even today, despite Dodd-Frank, the basic business model of Wall Street, which helped foment the crisis, remains largely intact. And the same federal regulators who so badly botched things in the years leading up to the crisis are still in charge. Worse, investors in mortgage securities—many of whom were victimized by lending fraud and questionable mortgage bundling that occurred further upstream—have been penalized repeatedly and forced to foot the bill for cleaning up the mess, including foreclosure settlements with the states and litigation between banks and federal housing agencies. Meanwhile, gubernatorial aspirants such as attorneys general Eric Schneiderman of New York and Kamala Harris of California have fattened their electoral war chests by exploiting, in the name of consumer protection, the ongoing settlement process with large banks. If American consumers used their homes as ATMs prior to the crisis, aspiring governors like Harris use banks and private investors as a source of ready campaign cash.

Given the cozy relationships reflected in Dodd's and Frank's ties to Fannie Mae and Freddie Mac, it isn't surprising that Congress didn't directly address the root cause of the crisis. The obvious conclusion is that we need to reform Congress and its corrupt relationship with the housing industry. As one veteran counsel in the House said in an interview for this article: "Congress got in bed with the housing-

industrial complex decades ago. Guess who got screwed?" The roots of this prolonged affair go back decades, to the beginning of Washington's involvement in the housing sector. It was veteran Capitol Hill analyst Robert Feinberg who originally called it the "housing-industrial complex," in a nod to Dwight Eisenhower's warning about the military-industrial complex. The former appears as impermeable to true reform as the latter. For the subprime crisis was the inevitable outcome of this housing-industrial complex and its years-long push for a government-supported bull market in residential real estate built upon public finance.

The watchdogs and regulators who were supposed to protect the country from financial harm, Morgenson and Rosner note, were actually complicit in the actions that led to the implosion of the American economy. The watchdogs, in other words, didn't do much watching, and the regulators didn't regulate. From the mid-1990s onward, the Federal Reserve, the Treasury Department and other regulators, along with various federal housing agencies, all acted as facilitators for acts of securities fraud and malfeasance by the largest banks that rivaled the worst excesses of the Roaring Twenties. These same regulators, led by former treasury secretaries Timothy Geithner, Hank Paulson and Lawrence Summers, then told Congress and the American people that we could not prosecute the responsible individuals for fear of "systemic risk." To date there have been just a handful of minor fraud prosecutions involving mortgage securities issued by the largest banks. Dodd-Frank does not address the issue of financial fraud, much less the festering political issues behind the subprime crisis.

It was Congress that nearly precipitated the collapse of the economy by systematically dismantling Glass-Steagall's separation of banking and securities underwriting. Glass-Steagall imposed clear and simple prohibitions on what banks could and could not do in just five brief sections of the Banking Act, comprising just thirty-seven pages. Such simple prescriptions didn't require any huge new enforcement bureaucracy. Dodd-Frank, by contrast, is a mess. It takes up 2,319 pages and imposes expansive and highly detailed rules on nearly every aspect of financial-institution management.

The new layers of government regulation imposed on the financial-services industry include a new Consumer Financial Protection Bureau (CFPB) to protect Americans from the predations of large banks. Another is the creation of the Financial Stability Oversight Council to manage the risk of sudden liquidation of large, troubled financial companies. Hundreds of new restrictions also are imposed on hedge funds and ratings agencies, adding mind-numbing new layers of regulatory bureaucracy to these businesses. One result of this raft of intrusive regulations and legal strictures is that nearly a third of all Americans have essentially been frozen out from buying a home.

Meanwhile, although Dodd-Frank's statement of intent brims with promises, the law lacks powerful provisions that might help to prevent another financial crisis. For example, former Democratic senator Ted Kaufman of Delaware says that the "orderly liquidation authority" established by Dodd-Frank is a paper tiger. At a Washington conference this May, he said that Dodd-Frank cannot handle the liquidation of insolvent financial institutions and hence can't end the practice of government bailouts of large banks. Curtailing the bailouts was of course a primary goal of Dodd-Frank. Thomas Hoenig, former president of the Federal Reserve Bank of Kansas City and now vice chairman of the Federal Deposit Insurance Corporation, told the House Financial Services Committee that the biggest banks are

“woefully undercapitalized” within a “very vulnerable financial system.” SEC commissioner Daniel Gallagher blasted the Dodd-Frank law in January. “It’s a perfect example,” he said, “of not letting a good crisis go to waste. . . . The act is a model of the new paradigm of legislation: a good concept, in this case regulatory reform, overwhelmed by a grab bag of wish list items.”

Just as the Sarbanes-Oxley law sidestepped the securities fraud perpetrated by Enron and WorldCom, and instead focused on corporate governance, Dodd-Frank also deliberately misses the point. Washington’s grab-bag habits stem from the fact that few members of Congress have the time, let alone the inclination, to study finance, much less the intricacies of a bill such as Dodd-Frank. When it comes to designing legislation, members and their staffs ultimately are led around by the nose by big-bank lobbyists who finance reelection campaigns—or not. But the most telling point about Dodd-Frank is that even with thousands of provisions it does not address the root of the crisis—namely, the government’s intimate involvement in housing finance.

That involvement goes back to the Great Depression and, before that, to progressive-era concepts that came to the fore in American politics during World War I and the presidency of Woodrow Wilson. In terms of the origins of the subprime crisis that led to the passage of the Dodd-Frank law, obviously housing is the main foundation. Government subsidy and promotion of home ownership by all Americans from the 1930s onward is the historic precursor of the collapse of the U.S. financial markets in the last decade. The failure of markets for private mortgage securities would start the avalanche that became known as the subprime crisis, but the entire U.S. mortgage market was built upon a financial and legal template that assumed a leading role for Uncle Sam.

Since the turn of the last century, American progressives have pushed for legal remedies to contain the worst tendencies of big business and the malefactors of wealth. A main goal of the progressive movement was purification of government by exposing corruption and undercutting political machines and bosses. The other notable tendency in Washington from World War I through the Great Depression was the creation of “parastatal” entities in Washington, modeled after 1920s European countries experimenting with fascism and Communism, especially Italy, Germany and the Soviet Union. The use of GSEs during World War I and the New Deal reinforced this model of a direct and continuing role for the federal government in the U.S. economy, a model that was effectively combined with the progressive urge to use the state as an agency for social good. GSEs such as the Reconstruction Finance Corporation (chartered by President Herbert Hoover, a Republican with progressive leanings) were explicitly modeled after European organizations.

This tendency to rely upon the state rather than private individuals for economic solutions very much underlies the U.S. approach to housing in the post–World War II era and reflects a broader philosophical conflict in the American body politic. It is worth noting that when Franklin Roosevelt commanded that Congress pass the Glass-Steagall laws, it was, of course, good politics to attack the big banks and Wall Street speculators, just as it is today. In 1936, the *Journal of Social Psychology* sought to survey latent authoritarian tendencies of the American populace. While the vast majority of respondents described themselves as antifascist, they also expressed support for fascist views so long as they were not identified as such, as renowned cultural historian Wolfgang Schivelbusch recounted in his 2006 book

Three New Deals. Even Walter Lippmann had declared during the early stages of the Great Depression that perhaps the time had arrived to roll up the Constitution and put it into abeyance. The grim economic realities of the Great Depression made Americans amenable to authoritarian views that would never have won majority support prior to World War I or during the Roaring Twenties.

After losing the 1932 election, Hoover identified housing as one of the more attractive areas for generating employment. Though he was highly critical of FDR's New Deal public-works programs and mildly critical of government providing cheap credit for private business, he supported the use of housing to create jobs. "The American people are always underhoused both in quantity and quality," Hoover declared in pressing his case for government support. Hoover, who had served as commerce secretary in both the Harding and Coolidge administrations (and as Wilson's Food Administration chief during World War I), was no ideologue when it came to the economy. Unfortunately, FDR and the Democrats in Congress ignored Hoover's proposal in 1933 to use the newly created Federal Home Loan Banks to discount mortgage loans, a proposal that "would have done more good than billions in tax money," Hoover wrote in his three-volume memoirs.

The New Dealers were not about to let a good crisis go to waste if they could leverage it to gain a firm grip on political and economic power, which is what they did. And it's fair to note that the Great Depression was so deep because of the flimsy condition of the mortgage-finance industry a century ago. Mortgage finance in the early 1930s was primitive and definitely not consumer friendly, providing a ready laboratory for progressive reform under FDR and the New Dealers. Banks did not typically provide mortgage loans, which instead were short-term instruments financed by title and insurance companies.

From the New Deal onward, the market for home mortgages was dominated by federal housing agencies such as the Home Owners' Loan Corporation (HOLC) and the Federal Housing Administration (FHA). The HOLC had the power to restructure existing home loans, while the FHA provided a guarantee for investors to encourage them to hold mortgages. From the mid-1930s, the government provided a guarantee to investors willing to invest in mortgage paper, thereby creating a marketplace that otherwise would not have existed. Their key innovation was to change the structure of the mortgage from what was essentially a short-term demand note into a long-term (typically twenty-year) fixed-rate, self-amortizing debt instrument.

Once the immediate emergency of the Depression was met, however, the federal apparatus created around housing continued to operate and perform a role that the private sector would not. The HOLC was dissolved and the FHA remained as guarantor. Fannie Mae was created to facilitate a secondary mortgage market. Owing to laws passed during the Depression and several earlier landmark Supreme Court decisions, the private sector was not yet prepared to underwrite twenty-year fixed-rate mortgages without a guarantee. The FHA provided surety for private investors, and Fannie Mae helped banks fund term loans. But the key point is that by embracing a government-intervention model similar to those of European nations such as Germany and Denmark, Roosevelt fundamentally altered both home financing and the country's political economy. FDR effectively replaced traditional private lending with publicly supported risk-pooling, rendering home loans more affordable but also injecting a large

public subsidy—as well as the same type of cronyism and political corruption one now sees in the European Union's largely nationalized banking sector.

During and after World War II, the U.S. government provided subsidized loan guarantees to returning soldiers, creating a new entitlement for housing that would eventually grow into a more general federal subsidy for much of the middle class. In 1944, a Veterans Affairs loan program was added to the Veterans Bill of Rights. By 1948, Fannie Mae was buying VA loans and adding greatly to credit availability. In 1968, Fannie Mae was split in two, creating Ginnie Mae to continue underwriting government-guaranteed mortgages while Fannie Mae was "privatized."

An August 1968 memo from Housing Secretary Joseph Califano to President Lyndon Johnson outlines the budget savings from the Fannie Mae privatization. Even as the Johnson White House planned the privatization, though, Fannie Mae was pursuing an ambitious effort to promote greater home ownership. "It will probably save some $200 million in the budget by having the private corporation, rather than the public Fannie Mae, sell bonds in September," Califano told the president. Little did the secretary know that four decades later, a pseudoprivate Fannie Mae would nearly bring about a collapse of the U.S. financial markets.

Congress created Freddie Mac in 1970 to securitize mortgages originated by savings and loans. Only then did the private sector begin to think about getting into housing finance in a serious way, without a federal guarantee for the credit risk on the mortgage. Indeed, from the 1970s onward, a procession of federal subsidies and initiatives increased the federal support for the U.S. housing sector. In 1987, Congress passed tax rules for "Real Estate Mortgage Investment Conduits," which gave Fannie and Freddie an effective monopoly over the market for residential mortgage-backed securities. The fact of this legal monopoly opened the door for the GSEs to underwrite and sell toxic loans to investors under the benign label of "short-term government securities."

In the forty years since Freddie's creation, the U.S. housing market has gone through dramatic boom-and-bust cycles. In 2006, the private sector was underwriting a significant portion of the overall mortgage market, but today private mortgage lending has almost disappeared. Virtually all of the $1.5 trillion in residential mortgages that will be underwritten in 2013 will carry a federal guarantee. Private mortgage-backed securities will probably total no more than $50 billion this year, down from hundreds of billions annually before the crisis. The last decade may mark a peak for private financing for mortgages—and for home ownership—that may not be reached again.

U.S. home-mortgage rates, although up slightly since midyear, remain extremely low. The current rates advertised by private banks and lenders reflect a subsidy of several percentage points above where a hypothetical private market investor would lend. And Dodd-Frank leaves the federal monopoly on mortgage finance virtually untouched.

Unfortunately, Dodd-Frank does not address the financial crisis at its core. Under the law, lenders are encouraged to originate "qualified mortgages." These low-risk loans include those backed by the FHA and the VA, conventional loans bought by Fannie Mae and Freddie Mac, and some "portfolio" loans, which are mortgages that lenders originate and then keep. But qualified mortgages exclude many of the

mortgage-loan options that have been available in the past. The terrible irony of Dodd-Frank is that it seeks to address the misdeeds of Washington and Wall Street by reducing the availability of credit for American consumers at both ends of the credit spectrum.

Blue-chip "jumbo" borrowers whose loans are too large for the agency market are discriminated against by Dodd-Frank, an illustration of the mindlessness of the reform legislation. And Dodd-Frank doesn't just affect borrowers at the top of the marketplace. The qualified-mortgage guidelines limit points and fees to 3 percent of the amount being financed and prohibit prepayment penalties that protect lenders from refinancing in the first three years of a loan. But such a stiff standard will lock many borrowers with weaker credit out of the market. That certainly won't expand local real-estate sales or maintain home values. Qualified mortgages, according to the CFPB, "generally require that the borrower's monthly debt, including the mortgage, isn't more than 43 percent of the borrower's monthly pre-tax income." Unfortunately, the 43 percent debt-to-income standard and other rules imposed by Dodd-Frank leave many potential home buyers without financing. Instead, American families will be locked into renting homes at a cumulative cost far above that required to buy the very same dwelling. Is this what Chris Dodd and Barney Frank mean when they talk about helping American families?

In a sign of the continuing agitation in Congress over the largest banks, Democratic senator Elizabeth Warren of Massachusetts and Arizona's Republican senator John McCain have introduced legislation to separate commercial and investment banking in the mold of the Depression-era Glass-Steagall law. The proposal is mostly a political exercise since the legislation has little chance of approval, but it is important because the political attraction of assailing the largest banks has not diminished even five years after the onset of the subprime crisis.

The most interesting thing about McCain-Warren is that it would complete the evolution only partly accomplished in Dodd-Frank by the Volcker Rule, named after former Federal Reserve chairman Paul Volcker, who pursued draconian anti-inflation policies in the late 1970s and early 1980s. Specifically, the McCain-Warren legislation would separate securities underwriting and trading from banking, and allow large dealers such as Merrill Lynch and Morgan Stanley to trade once again for their own account. The Volcker Rule's limits on trading activities of banks for their own account do not address the causes of the subprime crisis, but they do sequester bank capital from the financial markets, reducing liquidity in many types of debt and equity securities.

It is no small irony that the Volcker Rule could be the cause of the next financial crisis by limiting the ability of banks to provide liquidity to financial markets, as was the case this past June when Fed chairman Ben Bernanke began to signal an end to easy-money policies. Ultimately we need to either repeal the Volcker Rule or move forward with something like a Glass-Steagall-type legal separation of banking from investment activities to release this capital. In the latter case, "narrow banks" would function as depositories, lenders and fiduciaries, and they would become clients of the investment banks. The investment banks would need substantial balance sheets to operate outside the umbrella of "too big to fail." But this would be a big improvement over the current—and very dangerous—situation created by the half measure of the Volcker Rule within Dodd-Frank.

The fact that members of Congress such as Warren and McCain, among others, still feel the need to push for a separation of the securities and banking arms of the largest universal banks speaks volumes about the unfinished nature of the debate surrounding the Dodd-Frank legislation. Bashing the big banks remains good politics, even if chances of actually passing legislation to split up those banks are very thin. Besides, when members of Congress bash the big banks, the banks and their surrogates write ever more checks to fill campaign war chests.

In the next several years, the full negative impact of Dodd-Frank on the U.S. economy, and particularly its housing sector, will likely become apparent. Then the emphasis on higher capital in banks will be replaced by a desire for stronger growth and more jobs. One of the key targets for such counterreformation will be the CFPB, the Calvinist instrument of righteousness of Senator Warren, which has greatly reduced the availability of credit to American consumers. The intentions of Warren and others may be noble, but their efforts to regulate the U.S. financial markets are almost certainly doomed to failure. But even as Congress seeks to repair some of the deficiencies of the Dodd-Frank bill, it will surely remain oblivious to the real relationships between finance, markets and capital. If history, as Edward Gibbon recorded in *The Decline and Fall of the Roman Empire*, consists of the “crimes, follies, and misfortunes of mankind,” then the congressional record on financial regulation does little to dispel his gloomy verdict.