REAL CLEAR POLITICS

# Financial Crisis Reforms Missed the Mark

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The events of September 2008, including the government rescue of Fannie Mae, Freddie Mac and AIG, along with the failure of Lehman Brothers, will go down as some of the most important in American economic history. Unfortunately, the five years since have been a wasted window of opportunity to address the structural flaws in our financial system.

Don't get me wrong, a lot has been done. Sadly, most of it has been useless or outright harmful. The hours put into financial reform should not be our measure of success, but rather the effectiveness of those reforms and their actual relationship to the causes of the financial crisis. By this measure, it is clear that the Dodd-Frank Act went off track. The Act's 16 titles and hundreds of pages bear little resemblance to the actual drivers of the crisis.

The narrative behind Dodd-Frank goes like this: predatory mortgage lending drove defaults, which crashed house prices (undermining the value of mortgage- backed securities), which ultimately triggered a run outside the commercial banking system (in entities like Lehman or the money market mutual funds), which caused panic because regulators lacked the tools to resolve these non-banks in the same fashion as banks.

The problem is that this narrative has more holes than Swiss cheese. First, the change in house prices preceded defaults. So unless mortgage defaults caused some Star Trek-style backward ripple in time, it should be clear that the driver of defaults was the decline in house prices.

This decline followed the inevitable increase in interest rates by the Federal Reserve in reaction to a heating economy. Rate changes directly impact housing prices by impacting both affordability and the discounting applied to valuing any asset.

So what did tip America's economy into crisis? A property bubble. The bubble was driven by loose credit, which burst when credit tightened, and resulted in a market finally out of buyers willing to believe that house prices only go up.

If the problem was a bubble, what has been done to avoid another one? Essentially nothing. In fact, watching the Federal Reserve, it would be easy to conclude it is trying to create new bubbles.

Bubbles rarely occur in markets without some restrictions on supply. That is why the housing boom was concentrated in California, which had significant regulatory barriers to quickly increasing new housing supply. Florida, Arizona and Nevada had similar regulatory obstacles. These regulatory wedges between demand and supply drove the housing crisis, and they have only gotten worse, suggesting the next housing boom and bust could be bigger than the last.

Not truly addressing this problem is one of Dodd-Frank's greatest failures. While it has instituted some restrictions on mortgage terms, they're not the ones that really matter. The federal government's own studies show the primary drivers of default are borrower equity and borrower credit. Yet Dodd-Frank obsesses about loan terms like "prepayment penalties" or "documentation" when their impact on default is negligible.

Worse, by making minor technical violations a bar to foreclosure, Dodd-Frank guarantees the level of defaults will actually be higher next time the housing market goes bust.

Our national obsession with homeownership also has not changed, at least not in Washington. When regulators had the opportunity to impose down payment requirements, they punted. Why? Because requiring down payments for taxpayer-backed loans would limit homeownership to only those who could afford it.

To look beyond housing, we've also been told that Dodd-Frank ended "too-big-to-fail." The truth is far from that. Instead, Dodd-Frank simply gave regulators more power over who to rescue or who to let fail. Remember that regulators had the tools in September 2008 to avoid any taxpayer losses from Fannie Mae and Freddie Mac but chose not to use them. Given Citibank is just as large, and more complex, than Freddie Mac, does anyone seriously believe the federal government would let Citibank fail?

The fundamental flaw in the reform efforts of the past five years has been excessive reliance on giving more discretionary power to the same regulators who failed last time. Markets aren't perfect, but neither is government. The primary goal of financial reform should have been to better align the incentives of market participants and regulators.

Instead of forcing creditors to monitor those entities to which they lend, we've entrenched too-big-to-fail, ultimately reducing the level of private regulation. We are left ever more dependent on government bureaucrats who never lose their job regardless of what they miss or how many banks fail on their watch.

With extending such perverse incentive, Dodd-Frank will not avoid future crises, but will rather make them both more severe and more frequent.

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