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AEI's Wallison Chases Bad Dodd-Frank Narrative

By: Robert Feinberg - February 21, 2013

On Tuesday, Peter Wallison of the American Enterprise Institute (AEI) hosted a presentation titled Bad History, Worse Policy: How a false narrative about the financial crisis led to the Dodd-Frank Act to unveil a book by the same title consisting of a compendium of his columns on the subject, plus some new material.

Readers were advised to begin at the back of the book, where the new material is located. The presentation was moderated by Alex Pollock of AEI and friendly comments were offered by Wayne Abernathy, an executive vice president of the American Bankers Association; John Allison, former CEO of BB&T Bank and current CEO of the Cato Institute; and Hester Peirce, former senior counsel to the Senate Banking Committee and currently a senior research fellow at the Mercatus Center of George Mason University.

The significance of the topic, and the reason it receives so much attention in these articles, is that the enactment of the Dodd-Frank Act in 2010, most of which has yet to be implemented and may never be implemented, did not resolve either the financial crisis or the debate over the appropriate policy to manage it as it slogs along through perhaps its fifth decade. That is why I refer to the events of 2008 as "the 2008 episode of the financial crisis," whereas the administration's narrative holds that the crisis that led to the bailout of the largest financial institutions arrived totally unforeseen, as though the biggest dog in the universe swept down and ate the homework of all of the Treasury officials and financial regulators.

Ironically, Wallison himself was a key official in the Reagan administration at a crucial point in the evolution of the crisis, as he served as general counsel to the Treasury and as White House counsel as Donald Regan occupied the posts of Treasury Secretary and White House chief of staff until he was ousted by First Lady Nancy Reagan after the Republicans lost control of the Senate in 1986.

Wallison's presentation, therefore, is best viewed in the context of a competition among narratives of the administration, industry trade associations, such as Abernathy's group, and the many scholars and commentators who have written on the subject, most recently Stanford's Anat Adnati and University of Bonn's Martin Hellwig, whose book "The Bankers' New Clothes: What's Wrong with Banking and What to Do About It" was presented and extensively discussed at a recent conference at George Washington University. Readers can decide which views to adopt or choose elements of the available narratives to construct their own versions of how the crisis developed and which policies to support. Significant resources continue to be spent on this debate, because the future of the financial system, the winners and losers in the ongoing bailouts, are at stake.

Nevertheless, one of Wallison's key charges is that there was not enough debate before Dodd-Frank was passed, that Congress rushed the bill through before investigating the causes of the events of 2008. Rather than an episode in an ongoing crisis, Wallison sees 2008 much as the administration does, as an unusual event that need not be repeated if appropriate policies are put in place.

Where he differs energetically with the administration is over whether the episode was caused by too little or too much regulation. Wallison argues that government policies — such as the affordable housing goals and Community Reinvestment Act, which demanded ever-looser underwriting of loans — made to borrowers who lacked the ability to repay their loans fueled a bubble in housing credit that burst in 2008. Now he protests that the administration is following its policy of "never letting a crisis go to waste" to tighten the regulation of the largest financial institutions.

Wallison asserts that this policy will damage the competitive posture of the industry and impair economic growth and job creation. He accuses the left of "squeezing the life out of the banking industry" and warns that the country "will pay a heavy price in lost economic growth."

Proponents of Dodd-Frank respond that this argument ignores the damage to the economy caused by reckless lending practices of banks and non-banks that took advantage of their status as "too big to fail," which allows them to borrow cheaply due to the assumption that the government stands behind them in the same manner as it backed Fannie Mae and Freddie Mac as so-called government-sponsored enterprises (GSEs).

When Allison was CEO of BB&T Bank, the bank received $3.1 billion in Troubled Asset Relief Program (TARP) money at the same time the outspoken objectivist railed against the program and protested that the bank wasted $250 million in taking the money. As a mere fellow traveler of Ayn Rand, call me skeptical, even cynical with regard to the claims by the recipients of TARP money, starting with former Treasury Secretary Hank Paulson, that the funds were going only to healthy banks.

So we're expected to believe that this program was put in place in 2008, allegedly to save the financial system, because the banks were so healthy. It may be fair to consider that some healthy banks were thrown into the program in order to conceal which banks were desperately insolvent, but the protests by banks in general, and the spectacle of calling the heads of the largest, perhaps weakest, banks to the Treasury and forcing them to accept enormous sums looked phony to me. I predicted it the moment Paulson was named Secretary the previous year.

Allison, who has written his own book on the crisis, also doesn't like fair value accounting, and one could get the impression that bankers don't like accounting and auditing much at all, because it is the one force that threatens to hold them accountable for how they run their banks. It is a task for the reader to sort out where Allison is wrong and where he may be right when he blames the government policy of over-investing in housing, which he points out is a consumption good, and the inverted yield curve under Federal Reserve Chairman Ben Bernanke, for making the government the principal source of financial instability.

Peirce made some useful observations about the current state of affairs by noting the difficulty in restarting the private securitization market, the trend under Dodd-Frank of increasing further the number of GSEs, and the fact that the rescue of large financial institutions is continuing behind the scenes. She challenged the characterization by the administration of the AIG bailout

as a result of excessive exposure to derivatives, charging instead that AIG was insolvent due to investments in mortgage securities by the insurance side of the business.

Abernathy concluded by criticizing “the continuing willingness (of the authorities) to allow the embers of the crisis to smolder rather than putting them out,” warning that a bubble persists in Treasury securities. He joined in the assault on mark-to-market accounting and questioned the need for stress tests of the largest banks. He offered a provocative analogy of Dodd-Frank to Obamacare, suggesting that both represent a large-scale takeover of an important industry by the federal government.

Most significant, perhaps, is the suggestion by Abernathy that Dodd-Frank is ripe for re-examination and that another reform process could soon begin. Perhaps this accounts for the energy that continues to be invested in the debate over the causes and consequences of the ongoing financial crisis.