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How Dodd-Frank Damaged Community Banks and Hurt Small Businesses

CENTER OF THE
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FORUM SERIES

PETER WALLISON

WITH A RESPONSE FROM REP. TOM EMMER

On May 4, 2016, Peter Wallison spoke at the second of Center of the American Experiment's quarterly 2016 lunch forums. His topic was "How Dodd-Frank Damaged Community Banks and Hurt Small Businesses." Peter Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute, where he specializes in research relating to banking, insurance, and securities regulation. A former general counsel of the U.S. Treasury Department, Mr. Wallison is the author of *Hiding In Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again*. Congressman Tom Emmer, who has sponsored legislation that would rein in Dodd-Frank, also appeared and spoke about the unintended consequences of that law.

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HOW DODD-FRANK DAMAGED COMMUNITY BANKS AND HURT SMALL BUSINESSES

PETER WALLISON
WITH A RESPONSE FROM REP. TOM EMMER
AND INTRODUCTION BY JOHN HINDERAKER

Although I was asked to speak about the Dodd-Frank Act, I'll first discuss what caused the financial crisis. It's impossible to fully understand what's wrong with the Dodd-Frank Act unless you understand why the financial crisis happened. The Act only makes sense when you understand that it came about because of an inaccurate interpretation of the 2008 financial crisis. Let me start with that, and then I'll proceed to a discussion of Dodd-Frank and its effect on the U.S. economy.

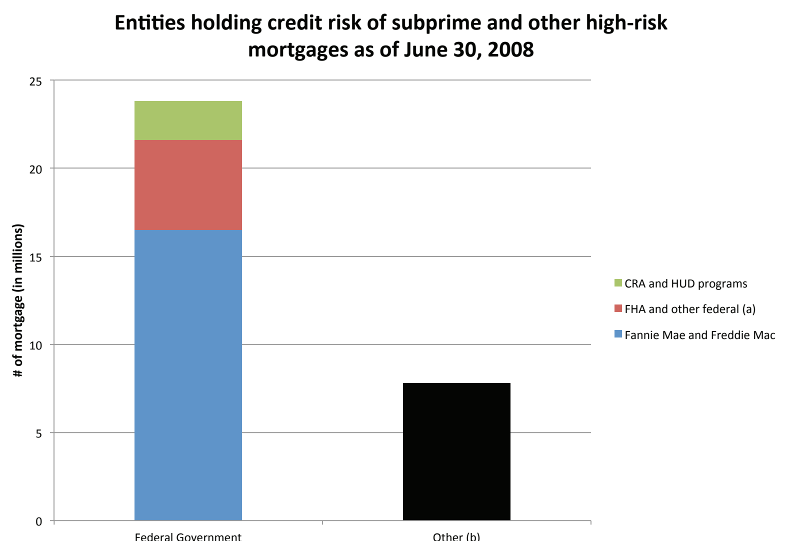
What we have all heard about the financial crisis is that it was caused by a mortgage meltdown. A very large number of subprime and other low-quality mortgages were in our financial system, and when they failed, the crisis resulted. The interesting thing is that there is very little discussion about why all of those very bad mortgages were in the financial system to begin with.

What you see on **Figure A** shows all of the subprime and other risky mortgages that were in the U.S. financial system just before the financial crisis. In 2008, there were 31 million such mortgages out of a total of 55 million mortgages in the United States.

Let's take a look at what those 31 million are composed of. On the left side of the graph, the blue portion represents the mortgages held or guaranteed by Fannie Mae and Freddie Mac, two government-sponsored enterprises that were chartered and backed by the government. They didn't make mortgages, but they bought them from originators such as banks and other mortgage originators. In that way, they made mortgages liquid assets. They held or had guaranteed about two thirds of the total of 31 million mortgages on the left side of the graph.

The red represents the Federal Housing Administration, which is a federal government agency that insures mortgages mostly for borrowers who can't meet ordinary underwriting standards. The green above that represents other government

Figure A



(a) "FHA and other federal" includes VA, Dept. of Agriculture, FHLBs, and others
(b) "Other" includes subprime and Alt-A private MBS issued by Countrywide and Wall Street

agencies such as the Veterans Administration and the Farm Credit Administration. All of them participate a little bit in the mortgage business.

The chart shows immediately where the problem is, because if the column on the left is correct—and I believe it is—it represents 76 percent of all of the bad mortgages in the financial system in 2008. That means one thing: the government created demand for those subprime and other risky mortgages, because the government had bought or insured them.

In other words, what we usually hear about the financial crisis—that it was caused by too much risk-taking by the private financial system—is wrong. It was not the private sector financial system that was the source of the demand for these mortgages. Sure, banks and other originators made the mortgages, but they made them because Fannie and Freddie were saying, in effect: "We need those mortgages, and if you make them, we will buy them from you."

AFFORDABLE HOUSING GOALS

Why did Fannie and Freddie want these mortgages? The answer is the affordable housing goals. **Figure B** provides information about the affordable housing goals, which were adopted by Congress in 1992 and were intended to force Fannie Mae and Freddie Mac to provide more mortgage credit to borrowers at or below median income in the places where they lived. At that point, Fannie and Freddie were—and still are—the biggest buyers of mortgages in the U.S. housing finance system. Because of that dominance, they set the mortgage underwriting standards for the entire market. And they would only buy prime mortgages.

What is a prime mortgage? At that time, and even today, a prime mortgage is generally one in which the borrowers have a good credit rating, about a 660 or better in the FICO scoring system; they make a 10- to 20-percent down payment; and after the mortgage is closed, the borrowers' debt-to-income ratio, DTI, is not more than 38 percent. That is, all of a borrower's contracted obligations are not more than 38 percent of the borrower's income.

That's what Fannie and Freddie considered a prime mortgage in 1992. But in 1992, there were complaints that these mortgage standards were freezing out low-income borrowers. In other words, low-income borrowers did not have access to the housing finance system, because they couldn't meet prime mortgage standards when they tried to get a mortgage loan.

The affordable housing goals sought to address this problem by requiring Fannie and Freddie, when they bought mortgages from banks or other originators to meet a quota of mortgages to low or moderate income borrowers. Initially, 30 percent of the mortgages, in any year, had to have been made to people who were at or below the median income in the places where they lived.

The Department of Housing and Urban Development was given authority to administer these goals, and they raised these quotas over time. If you look at **Figure B**, you can see these increases—not only for those who were at or below median income, but also for minorities and very low income borrowers (80 or 60% of median income). By 2008, as you can see, 56 percent of all the mortgages that Fannie and Freddie bought had to be made to people who were at or below the median income.

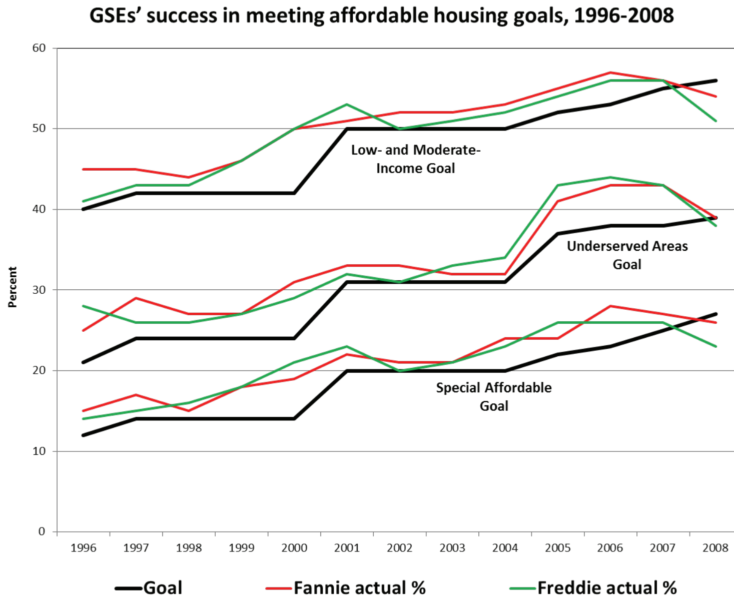
If 50 or 56 percent of all the mortgages you buy have to be made to borrowers below median income, it is going to be very difficult to find prime mortgages, and that is what happened. At some point, Fannie and Freddie could no longer find all the prime mortgages they needed in order to meet the affordable housing goals; therefore, over time, they began to reduce their underwriting standards. By 1997, only a few years after the goals started to rise, they were accepting mortgages with a 3-percent down payment. By the year 2000 they were accepting mortgages with no down payment at all. In other words, mortgage underwriting standards began to decline, not only for low and moderate income borrowers but for all mortgage borrowers.

By 1997, about 37 percent of the people who were getting subprime or other low-quality mortgages—that is, people who were actually getting mortgages without prime underwriting standards—could have afforded a prime mortgage but didn't actually want them.

It is actually an advantage not to have to make a large down payment—or any down payment—for a loan on a house. There are lots of reasons for that, but the biggest one is that you can then buy a bigger house. That was what happened. You can see in **Figure C** that between about 1997 and 2007, we had a gigantic bubble – the biggest we've ever had.

Why did lower underwriting standards lead to a bubble? Let's assume a person has $10,000 to buy a house. That means that if the underwriting standard

Figure B



requires a 10 percent down payment, a buyer can afford a $100,000 house. However, if the underwriting standards turns out to be 5 percent, then the same person can buy a $200,000 house. That means there is much more money chasing homes and you have an inflation of home prices. It also means that this same person who would originally borrow $90,000 to buy the house is now borrowing $190,000. He is a weaker borrower because he now has more debt.

That is how the reduction in underwriting standards, pushed by the government principally through Fannie Mae and Freddie Mac and the affordable housing goals, gradually built a gigantic bubble in the housing market.

When the bubble finally began to deflate in 2007, people who had overextended themselves were unable to refinance their mortgages. Market prices were no longer going up. An unprecedented number of mortgages began to default in 2007 and 2008, and when this occurred many financial firms that held these mortgages began to look unstable or insolvent because they had to write down the value of their mortgage holdings.

In March 2008, a Wall Street firm by the name of Bear Stearns, which was heavily invested in the housing finance market (this was not an insured commercial but what was known as an investment bank) was in financial trouble. It was facing continuing losses.

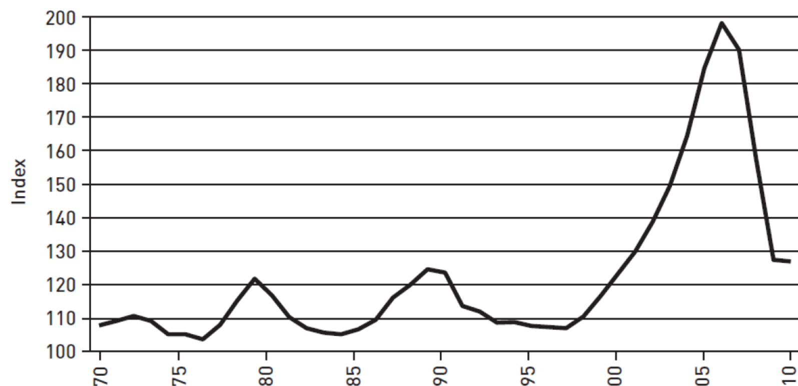
At this point, government officials made a major mistake: They bailed out Bear Stearns. This was done with about $29 billion from the Federal Reserve to help J.P. Morgan Chase to buy Bear Stearns. In other words, they bailed out the creditors of Bear Stearns.

This was as big a mistake as the affordable housing goals themselves, because it changed the way people looked at the future. First of all, the creditors of these financial institutions, who had been very worried about their financial health, now thought, "Hmm, if we just hang on and not sell our debt at a loss, the government will come in and bail us out." Many people who didn't have to sell just held on to whatever investment they had in these large financial institutions such as banks.

The rescue of Bear Stearns also sent a signal to the managers of many of these banks and other financial firms. They concluded: "If our creditors are not worried because they think they are going to be bailed out, why should we raise more equity in order to give them confidence in our financial condition?" As a result of that view, much less equity was raised during this period. This is all called moral hazard: people doing things they shouldn't do, or not doing

Figure C

Real home prices from 1970 to 2010 per the Shiller home price index



Source: Data from Robert Shiller.

things that they should do, because they think the government is going to help them out.

As a result, by September 2008—this is the famous date when the financial crisis is said to have begun—a large Wall Street firm called Lehman Brothers got into trouble. It was much larger than Bear Stearns, so most people thought it would be rescued, but to the surprise of everyone in the market, the government—in another huge error—allowed Lehman Brothers to fail.

In other words, it reversed the policy that had caused everyone to believe that things were going to be stabilized by government action. The shock of the government's illogical and unexpected failure to act was what caused the financial crisis. Investors, already concerned about the health of these larger firms now wanted cash. Liquidity dried up. That was the financial crisis.

Don't get me wrong. My point here is not that the government *should* have bailed out Lehman but rather that it *shouldn't* have bailed out Bear Stearns. If the government had not bailed out Bear Stearns, then much more equity would have been raised by many other firms. We wouldn't have had the kind of destruction that occurred in September when Lehman Brothers failed. The market now thought the world was coming to an end, because no one had any idea of who was safe and who was not safe; who held the bad mortgages and who was not holding the bad mortgages. All those things were unknowns, and investors hate unknowns.

What happened then was something that no academic, no regulator, no one in the financial markets had ever seen. Banks, the largest banks in the United States, refused to lend to one another even overnight, because they were all hoarding cash. That is what frightened many people in Washington into believing that some drastic action had to be taken.

That is the story of the financial crisis. What we know about it is that it was caused by the government in two ways: The affordable housing goals, which caused the housing crash; then the blunders of the Treasury Department and the Fed in 2008 in first rescuing Bear Stearns but then allowing Lehman Brothers to fail.

Why is it important to understand the causes of the financial crisis? First, as in medicine, the wrong diagnosis produces the wrong prescription and, in some cases, not only is the disease not eliminated but the remedy chosen causes harm. That is what is happening today in the financial world.

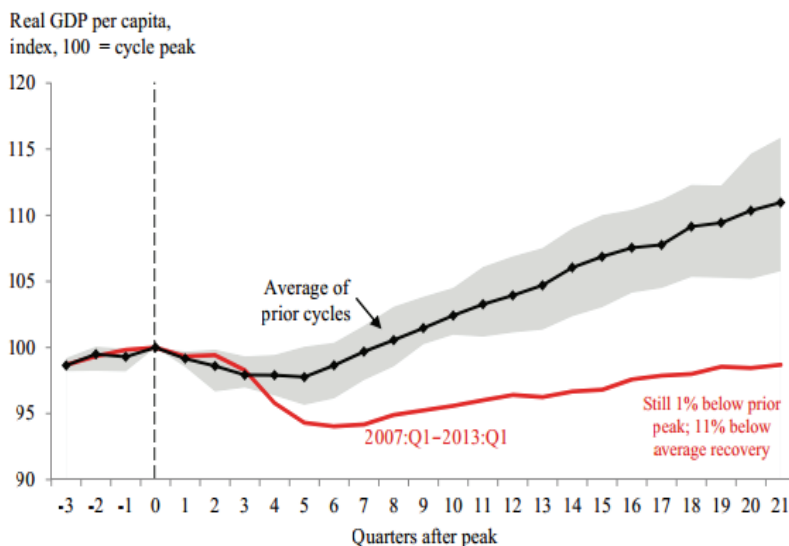
When the financial crisis was blamed on risk-taking, greed, and lack of sufficient regulation of the private sector, the result was the Dodd-Frank Act, which I will now discuss in some detail. This is the most restrictive financial regulatory legislation adopted by the government since the New Deal.

THE DODD-FRANK ACT

The results of this very restrictive legislation are reasonably plain. **Figure D** shows the recovery from the financial crisis and the ensuing 2009 recession compared to other recoveries in the past. The black line is the average of all past recoveries from financial crises, and the red line down at the bottom shows this latest recovery. This is no surprise to anyone who has been in the business world, because you have seen a very slow recovery.

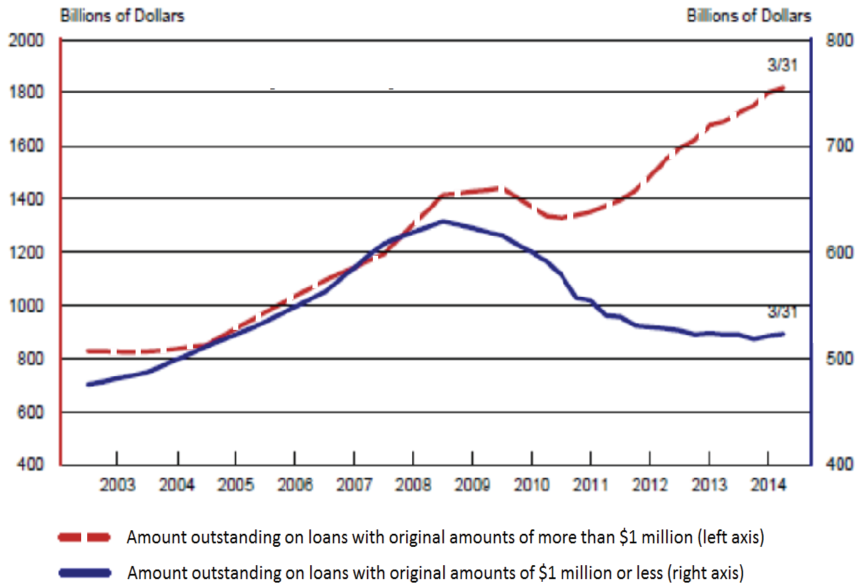
Why is it so slow? There are a couple of ways to approach this. There was a recent article in the *Wall Street Journal* by a famous economist at the University of Chicago, John Cochrane, who said the reason we're having this slow recovery is that there is too much

Figure D



NOTE: The gray area indicates the range of major recessions since 1960, excluding the short 1980 recession.
SOURCES: Bureau of Economic Analysis; Census Bureau; authors' calculations.

Figure E



for about 20 percent of the new employment in any year.

If the problem is low lending by small banks, then we should be able to see a difference between small business growth and the business of larger institutions that have access to the capital markets.

In **Figure E**, the red line reflects loans of more than $1 million, with the amount outstanding growing substantially. The blue line shows the loans that are less than $1 million, and those would be loans to smaller companies. As you can see, they have declined substantially since 2009.

Figure F shows the same phenomenon in a different way. The red line shows loans by large banks, and the blue line shows loans by small banks.

In **Figure G**, the blue line shows bank lending for all businesses. The green line shows mostly the securities markets. Larger institutions registered with the SEC can issue debt, and they are financed largely through the issuance of bonds, notes, and commercial paper. With the blue line, you can see that banks are gradually declining as a source of credit for business.

What we see in the data is that the largest companies, the ones defined, for example, as big firms which have more than 500 employees, are able

regulation, and regulation is suppressing risk-taking. I believe that it true, but what I would like to do is try to get into somewhat more detail about exactly how this new Dodd-Frank regulation is causing a much, much slower recovery than might have been predicted.

I believe the data shows that Dodd-Frank has imposed substantial new compliance costs on financial institutions, particularly small banks. The data on this is pretty clear; small banks are not lending at the rate that they used to. New community banks are not being formed. We used to have about 100 new banks starting every year; now we have about three, and in some years we've had one.

Thus, there is a huge disparity now between the health of the small-bank sector before the financial crisis and today.

If the small-bank sector is not lending, then small business is not getting the credit it needs, and among small business, there is one particularly susceptible organization or group of organizations, namely startups. These are the people who are starting new businesses. They are responsible, according to much the data that I've seen,

Figure F

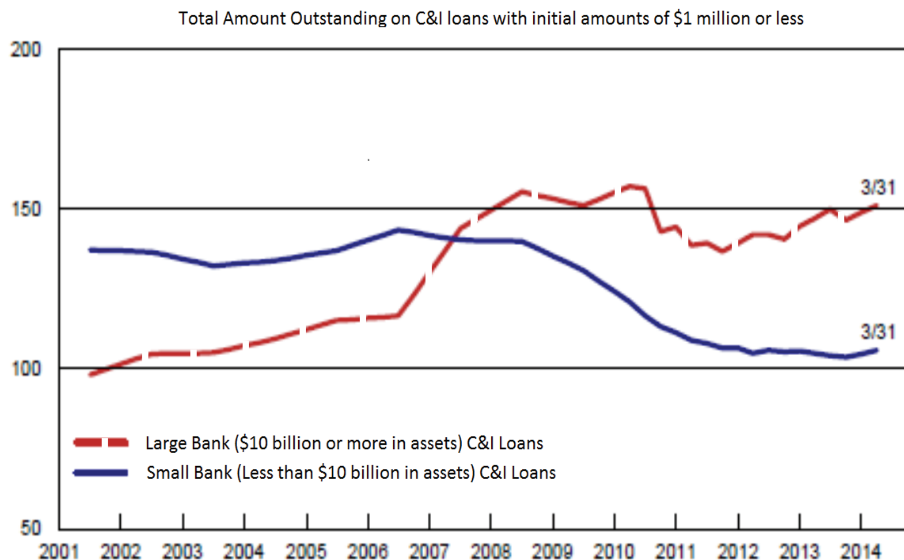
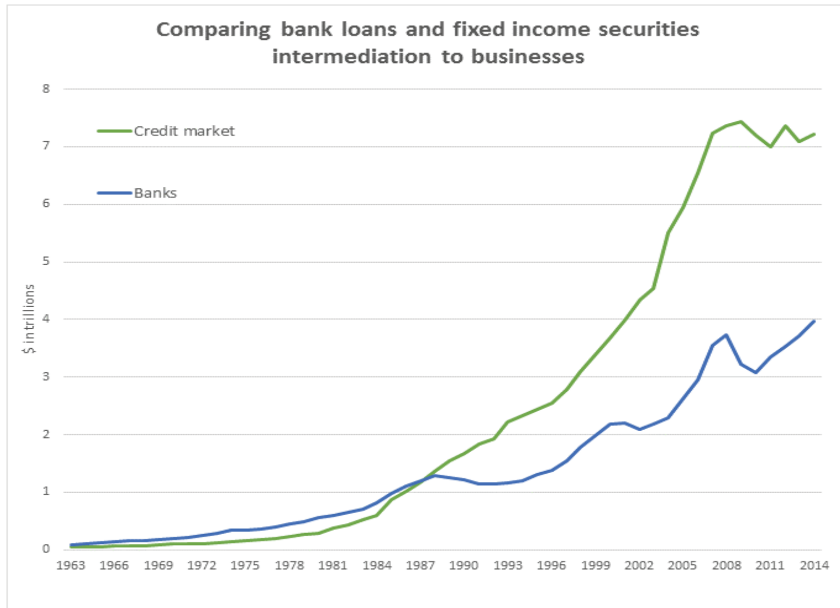


Figure G



to get credit through the securities markets, whereas those below 500 employees are reliant on banks, and the banks are making many fewer loans. An interesting study has been done by Goldman Sachs to show that the larger companies are recovering from the financial crisis and the ensuing recession at the normal rate we looked at before, while the smaller companies are dead in the water.

Start-ups are a key here, and that is where the problem really is focused. All small businesses are having some trouble getting credit, but the real problem is we are not starting new businesses just like we are not starting new banks. Why is that? It's because bank examiners have become much more critical of lending to people who don't have the things that bank examiners want to see. It is kind of a one-size-fits-all method of regulating. What bank examiners want to see is track records. They want to see audited financial statements. Those are things that start-ups can't provide. As a result, the start-up area is dead in the water and thus unable to stimulate the economy.

One of the great things about our economy is that it begins at the very lowest level and works its way up. We all know about starting a business in your garage and so forth, and those businesses become the Googles and the great businesses of the future. Well, those things are not happening anymore, because it has become very difficult for people to get the necessary credit.

That is a result of Dodd-Frank, because of the way it was described. At the time Dodd-Frank was adopted, the problem was said to be the private sector's greed and risk-taking, which, many contended, was insufficiently regulated. So, what did the regulators do? They became much tougher on the private lenders. They try to cut back on risk-taking. And they've been successful. Yet it is their success that has made economic growth much more difficult to achieve.

A new regulation has been proposed to require all deferred compensation, like bonuses, to be deferred for four years. If you earn a bonus this year, you don't actually see a substantial portion of it for four years, and then the company can claw that portion back if the decisions you made caused losses to the firm. This, of course, will be disastrous for lending. It will require people to think about whether they are going to have the bonus they are counting on to send the kids to college or buy the house; therefore, there will be fewer loans written, as people won't want to take the risk of making loan if the loan goes bad and causes them to lose a substantial amount of their bonus.

To summarize what happened, these new regulatory costs and restrictions have been imposed on small banks. This has increased compliance costs. Compliance officers have been hired instead of lending officers and others who facilitate growth, and we have reduced credit available for start-ups. Consequently, economic growth has slowed.

WHAT HAS DODD-FRANK DONE (OR NOT DONE)?

What can we say about Dodd-Frank? We now know in general, at least from my perspective, that Dodd-Frank has caused the slow recovery that we have all been experiencing. Yet there are many other things that Dodd-Frank has either done or not done.

First, all of you have heard about the problem of "too big to fail;" that is, there were certain firms that are said to be so big that the government has to step

in and bail them out—not allow them to fail. We've been told that Dodd-Frank has solved that problem. Untrue. Not even close.

The real danger, if there is a danger at all, comes from the very largest banks in our financial system. There are four trillion-dollar banks that have about $6 trillion in assets. Then there are many others that are below that but quite large. Those banks—I'm talking here about banks and not bank holding companies—are the indeed "too-big-to-fail." If one of them were to fail, we could have a serious crisis. Dodd-Frank leaves this problem to the FDIC, the Federal Deposit Insurance Corporation, to resolve. But the FDIC doesn't have anything close to the resources necessary to resolve a failing trillion-dollar bank. In other words, in the one area where there is a danger from failing financial firms, Dodd-Frank does nothing. If one of those very large banks should fail, they will have to be bailed out by the taxpayers. So we are exactly where we were before Dodd-Frank.

Another unresolved issue is mortgage lending. As you know, mortgages were the major cause of the decline in assets for all these financial institutions, because so many bad mortgages were put into the financial system by the affordable housing goals. What has Dodd-Frank done about mortgages? The answer is: nothing. The only way Dodd-Frank addressed the whole mortgage issue was to require something they called a "qualified residential mortgage," which had to be a very high-quality mortgage with a down payment of at least 20 percent.

The framers of Dodd-Frank thought that might have improved the quality of outstanding mortgages, but the Obama Administration would not accept it. The regulators were told by the Obama administration to eliminate that idea, and they did it by eliminating every element of a prime mortgage and substituting instead a requirement that the lender bears the risk of making a mortgage that the borrower does not have the resources to repay. Since that regulation was adopted, many banks have left the business of making mortgages and many potential homeowners have found it impossible to get a mortgage loan.

Many more loans are now being made by nonbank intermediaries of various kinds, and it turns out they disappear after a period of time, so you can't recover whatever losses are caused to the financial system by what they have done.

WHAT ELSE HAS DODD-FRANK DONE OR NOT DONE?

It has set up something called a Consumer Financial Protection Bureau (CFPB). The Bureau has authority over all financial relationships with consumers. The law here says that you can be civilly liable if you make a loan that is abusive, but what is an "abusive" loan? It's not defined by statute. The CFPB has said "We won't define it by regulation. Instead, we will define it over time by prosecuting people, and eventually people will get the message of what an abusive loan is." That also is reducing consumer credit substantially, which is another reason why the economy is moving slowly.

In addition, the CFPB is being challenged on constitutional grounds, because it is headed by a single administrator who can't be removed from office by the President, and it is funded by the Federal Reserve, which has no control over the agency but is still required by statute to provide it with the funds to operate.

There is also something called "The Volcker Rule." The Volcker Rule prohibits banks and their affiliates, such as companies that are subsidiaries of the same bank holding company, from engaging in trading debt securities for their own accounts. This was something banks had always done before. By buying and selling debt securities they kept these markets liquid. Without banks in the market, there is less liquidity.

Dodd-Frank does allow banks to make markets in securities, but it is so difficult to tell the difference between proprietary trading—which is prohibited—and making markets—which is permitted, that many banks have simply withdrawn from the market rather than be faced with the danger of violating a regulation.

Recently the president of the New York Fed admitted that it looks like these regulations actually may be reducing liquidity in the market. If liquidity in the market has been reduced, then we are going to be in very serious trouble at some point when, for whatever reason, people want to sell their securities. There won't be the liquidity available to sell the securities, and a kind of panic will result. That's another result of the Dodd-Frank Act.

Dodd-Frank also gave the Fed the power to regulate the holding companies and S&Ls. That would not ordinarily be a major problem. After all, S&Ls were a small group of lenders after the crisis they experienced in the late 1980s. It turns out, however, that many

of the holding companies of S&Ls are insurance companies, so the Fed is now the regulator of a large proportion of the major insurance companies in the United States. The Fed's policies are very restrictive, reflecting a belief that it was a lack of regulation that caused the financial crisis. Thus, we now have a very restrictive federal government agency in charge of the insurance business, too.

Finally, Dodd-Frank has imposed new regulations on derivatives. Almost all derivatives now have to be cleared through clearinghouses. This means that clearinghouses will be taking a lot more risk. There is, then, a fear that they will become too big to fail because of all the new powers the government has given them.

So the Dodd-Frank solution is that the Fed can open its discount window to the clearinghouses, just like that window is open to the banks. So the government is backing yet *more* of our economy. Of course, if the economy is backed by the government, financial institutions will take more risks, because their creditors—who get no benefits from risk-taking—will not worry about their financial condition; they will believe that the government will bail them out—and it probably will. That virtually ensures they will eventually have some kind of large market failure, like another financial crisis—again caused by the government's policies.

To sum up, the Dodd-Frank Act has put the federal government in substantial control of most of our financial system: large banks, small banks, nonbank financial institutions, housing, insurance, derivatives, mortgage policies, and consumer finance. It sounds like a lot, and it is. That is why we have such slow growth. We have all these new laws and regulations because of a mistaken diagnosis for the financial crisis. It wasn't caused by a lack of regulation; it was caused by the government's housing policies. To recover prosperity and growth, we have to understand this mistake and correct it with a repeal of these unnecessary regulations.

Cong. Tom Emmer: I'm on the Financial Services Committee in the U.S. House of Representatives. It is a committee that we like to refer to as working on the plumbing of this country's free market economy.

The FSOC, as we call the Financial Stability Oversight Counsel, was just one of the first pieces we started to go after to try and address some of the concerns Peter Wallison has mentioned.

I had to write down a couple of notes today because I saw [CAE Chairman] Ron Eibensteiner. Around Ron's office are pictures of all the different businesses that have started in a garage. It is one of the most impressive things, frankly, about the office. We look at this state, and we've got Medtronic that started in a garage, and look what it has become. Look across this country, whether it is Amazon, Disney, or Harley Davidson, you've got examples all over the country.

I think many of us in Congress understand the emergency we are faced with, because this is the crisis. You have a 1,000-page law that they put into place and created these things called the FSOC, the CFPB, the OFR. I really appreciate that Peter Wallison talked about the Consumer Financial Protection Bureau and the unaccountable bureaucracies that have been created in this agency.

Former U.S. Senator Rudy Boschwitz said to me when I was first elected and going to Washington that there are so many things a person can get involved with, but if I want to be productive—if I want to make a difference—then find something I can really work on. This is it! Look around Minnesota. What runs this state? What is responsible for all the innovation and the growth in the State of Minnesota? It is the ability to access capital so you can begin one of those garage-started businesses like the ones pictured in Ron Eibensteiner's office.

We need the big banks that Peter was talking about. We also need the small banks, because they are the backbone of our small communities. We need them all. This is where the farmer goes to finance his small business that isn't so small anymore. This is where the next creator of Medtronic or Amazon goes. They typically go to their local bankers. I asked a very successful gentleman last night, "What did you do when you started this great company? Did you just go see your dad and ask him for a few dollars?" He said, "Tom, my family didn't have any money."

Since the enactment of Dodd-Frank, in Minnesota alone, we have lost roughly a quarter of our community banks. This is a crisis.

An op-ed in the *Wall Street Journal* recently talked about how in this country we had private economic growth or GDP growth in this country of 3.5 percent from 1950 to 2000. Since 2000, it has been roughly 2 percent, and since the crash it has been less than 2 percent.

When we had that 3.5 percent growth, per capita income grew from $16,000 in 1952 to $49,000 in 2000. If we had struggled along with 2 percent growth during that same time period, that $16,000 would have been only $23,000. We must get past current partisanship and understand what made this country great. It is all about the free-market economy in the financial services industry.

What we're trying to do in accordance with Rudy Boschwitz's lesson is to identify first pieces. The FSOC legislation, the Financial Stability Oversight Council, as you heard was created under Dodd-Frank defines banks that are "too big to fail" and could cause our financial system to collapse. They are defined as having $50 billion is assets or more. Then they collect what they call assessments but which are, in fact, a tax that they collect to finance all these bureaucracies.

If you saw their budgets, it would make most of you upset. Budgets that are literally written on a piece of paper and sent over to the Fed with almost 50 percent listed as "Other," and we're talking about $100 million-plus. What are they doing? What are they using it for? What is the purpose?

We've started with these organizations. The bill we've passed on the House Floor—I will be very candid—is not going to get past U.S. Senator Elizabeth Warner yet, and Treasury Secretary Jack Lew doesn't like the bill, either. The point of the bill was to bring this unaccountable bureaucracy back within the supervision of Congress by subjecting it to the appropriations process. They would still get their money from the Fed the way it is set up right now. Yet they would be forced to come before congressional committees of jurisdiction and answer questions about what they are doing.

Right now, their funding is actually being used, in my opinion, for political purposes as opposed to what it is meant for. In Congress what we're trying to do is work one piece at a time, and I think these are the biggest pieces. Let's bring them out into the light of day. Let's let people see exactly what it is they are doing.

John Hinderaker: We have just enough time for a couple of questions.

Question: If not Dodd-Frank, what then?

Wallison: The crisis was caused by the mortgage problem, the fact that our financial system was full of very poor-quality mortgages. They were there because underwriting standards had been reduced by the government.

The answer, then, is to get the government out of the business of defining for the private sector how they should do the mortgage financing business. The government, we should understand, has an incentive to reduce underwriting standards, because when that happens more homes are sold for a while. When more homes are sold, the economy grows, and the government gets credit for that.

If we can get the government out of the business of promoting mortgages, we'll have a stable housing financing system. One other thing. I believe, and I think most economists believe, that the economy is stable when there is sufficient information around about what is happening in the markets. The private economy is not inherently unstable as the Left believes. It is stable. The government destabilizes it with its policies.

Question: How much did the fact that the crash happened in 2008, a presidential election year, have to do with the bailout prescription? Were election-year politics part of the reason why Bear Stearns got bailed out?

Emmer: Within the last month, I actually sat in the room with one of the lawyers for one of the three larger institutions while these discussions were going on. He made the statement that they had a private solution. They were prepared to put a private solution together that did not require a government bailout. It was our government that told them "No. This is the way we're going to do it."

Wallison: If the crisis had not occurred in the fall of 2008 we would have had a different President. We wouldn't have had Dodd-Frank. We wouldn't have had a Democratic Congress. We would have had an entirely different country. That's the fact.

So this financial crisis is far more influential than simply what it has done to the financial system.

Question: Why were Fannie Mae and Freddie Mac not addressed by Dodd-Frank?

Wallison: The short answer is that Congress—specifically the new Democratic supermajority that was elected in 2008—did not want to blame the financial crisis on the government's housing policies, but instead on the lack of regulation of the financial system. Once they did that, there was little reason to do anything about Fannie Mae and Freddie Mac. They were not seen as causes of concern. ■

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