Episode 638: Did Deregulation Cause the Financial Crisis?

Guest: Peter J. Wallison

WOODS: This is Episode 638. Better late than never that we're finally getting to this general subject. I've talked about deregulation and how it's a red herring when it comes to the financial crisis, but there are two particular things that get thrown at you when you try to say that. And this is, I'm talking about the more informed people on the Left. The others just have some vague sense that there's some regulations that might have saved us if we hadn't repealed it. So let's start off with this Graham-Leach-Bliley Act and the partial repeal of Glass-Steagall. Tell us what Glass-Steagall was and what it was intended to do, and then let's talk about whether and to what extent it was actually repealed.

WALLISON: Glass-Steagall had two provisions. One said that a bank could not engage in underwriting or dealing in securities. We're talking here about a commercial bank, an insured bank, could not underwrite or deal in securities. The other part of Glass-Steagall said a bank could not be affiliated with a company that engages in underwriting or dealing in securities. In 1999 the Graham-Leach-Bliley Act repealed the second provision; that is, banks could then be affiliated with firms that engage in underwriting and dealing in securities, but the first part of Glass-Steagall is still applicable to banks. They cannot underwrite and deal in securities.

WOODS: All right, now let's dumb this down a bit. I don't mean my audience is dumb, but this is not a layman's discussion really, so I want to make sure that everybody's following along. What does it mean to deal in securities?

WALLISON: What it means is that you buy a portfolio of securities, and you hold them for the purpose of selling them or buying them. It's sort of like thinking of them as a dealer in any product, let's say an iPhone, and if you’re selling iPhones you also buy iPhones for resale. That is dealing in securities.

WOODS: Okay, so in other words, if a bank is sitting on a mortgage-backed security but it's just holding it, that's not "dealing" in it.

WALLISON: Right. If a bank is buying mortgage-backed securities, for the most part they are buying those for investment, to hold them, and that's in fact what they did. But at times, banks can also decide, just like any dealer in any product, let's say Exxon dealing in oil, they can decide that they no longer want to hold the product for investment, and they sell it. That's also permitted. So banks can buy and sell securities, mortgage-backed securities or other kinds of securities — debt securities of various other kinds, not equity securities but debt securities — they can sell those securities at any time if they decide they no longer want to hold them because the investment is not good.

WOODS: So what we have then is that the primary thing that's repealed is the idea that you can't have a single holding company having a commercial bank and an investment bank. Is that right?

WALLISON: No, you are permitted to have a single holding company.

WOODS: Yeah, that's what I mean, yeah, yeah, so they repealed that. They repealed that.

WALLISON: Yes, they repealed that, and so you are now permitted, a single holding company can hold both a bank and a securities firm that underwrites and deals in securities. Yes.

WOODS: Okay, so now let me read you this paragraph. It's says, "We've got Bear Sterns, Lehman Brothers, and Merrill Lynch, three institutions at the heart of the crisis, were pure investment banks that had never crossed the old line into commercial banking. The same goes for Goldman Sachs; the infamous AIG, an insurance firm; New Century Financial, a real estate investment trust. No Glass-Steagall there." This is from *The Washington Post*, which is not known for being anti-regulation, but there's a column from *The Post* from several years ago, saying if you're trying to look for a boogeyman, this one's just not going to work, because it doesn't match up with the financial crisis we just endured. We did not have a problem with institutions where we had a mingling of investment and commercial banking. That's not what happened.

WALLISON: That's entirely right. The whole Glass-Steagall issue is completely irrelevant to what happened in the financial crisis, and people have to really understand what happened in the financial crisis to understand why it is true. And that is, everybody who got into trouble got into trouble because they bought and held mortgage-backed securities or mortgages themselves. The issue of dealing and underwriting in securities was never a question in the financial crisis. AIG got into trouble by, actually, they insured mortgage-backed securities rather than actually holding them. Bear Stearns, Lehman Brothers, Goldman to some extent all got into trouble because they invested in — held, in other words — mortgage-backed securities or mortgages.

WOODS: So in other words, they were doing something they had always been allowed to do. There was no phantom regulation that was repealed that suddenly allowed them to do these things.

WALLISON: Exactly. In fact, that's a really good way to put it, Tom, because if Glass-Steagall had never been touched by the Gramm-Leach-Bliley Act in 1999, the financial crisis would have unfolded exactly the way it unfolded in 2008.

WOODS: I get the sense, though, that people who say what we need is a resurrection of Glass-Steagall — let's say we're talking about the more informed ones. Their view might be, okay, you're right, it's not directly related to the financial crisis, but they seem to think there's some connection between the partial repeal and the rise of institutions that were too big to fail that contributed to the creation of these gargantuan institutions. Is there anything to that?

WALLISON: No, because the ones that actually failed, there were three different kinds, three different kinds of institutions that failed. There were the AIGs, which was in fact an insurance holding company, but it also engaged in insuring, in effect with this so-called credit default swap, it was also insuring mortgages. That's one kind. Another kind was an investment bank, like a Goldman Sachs or a Lehman Brothers or a Bear Stearns. They got into trouble because they bought and held as investments mortgage-backed securities. And then there were commercial banks like Wachovia or WaMu — that is Washington Mutual, known as WaMu — or IndyMac, three different kinds of commercial banks. They also got into trouble by holding mortgage-backed securities or mortgages themselves. So what we learned from all of that is that it doesn't matter what kind of institution it was or what kinds of laws applied to the way they carried on their business. But the fact was that they got into trouble by investing in these very low quality mortgages.

WOODS: All right, so it all basically comes down to trying to figure out what the fundamental cause of the crisis was, and the cause of the crisis is quite mundane. It's that you have banks that extended mortgages that should not have been extended, and that's something that banks always had the power to do. They always had the power to make lousy mortgages.

WALLISON: Yes. Now, we're talking about Glass-Steagall, but if you want to know — and I'm saying to you that Glass-Steagall had nothing to do with the financial crisis, and no restoration of Glass-Steagall would have prevented the financial crisis, so let's leave that aside, because, in fact, there was a cause for the financial crisis that no one is talking about, and especially people on the Left are not talking about, because it was government housing policy that caused the financial crisis. And in fact, I would argue that the whole Glass-Steagall idea was raised as kind of a smokescreen —

WOODS: Yeah.

WALLISON: — to prevent people from talking about the real problem, which was what the government did in housing policy.

WOODS: We had — I'm going to link on today's show notes page; we're on Episode 638, so TomWoods.com/638, I'll link to our previous discussion where we really, really — you had some great information; we really went into that and explained and exposed it. You're right. I think — and I read an economist named Bill Woolsey said that the only reason he can think of — and it might have been Alan Meltzer. But one of them said the only reason they can think of that anyone would point to Gramm-Leach-Bliley and the partial repeal of Glass-Steagall is that it's the only regulatory move and change of any kind that's even remotely connected to anything having to do with anything.

WALLISON: Actually, I said that, Tom (laughing).

WOODS: (laughing) Oh.

WALLISON: Maybe Alan Meltzer picked that up too. I haven't read all his stuff, but I've been arguing that from the beginning.

WOODS: (laughing) Well, hold on a minute; I have to point out something. Before we went on — this actually confirms what I told you before we went on. I said that people have been wanting to know about this Glass-Steagall thing, and I want you to talk about it, because everything I know I learned from you, including your funny lines, apparently.

WALLISON: (laughing) Well, it is very, very frustrating, because people who know better have been talking about this as though they understand it. A senator from Massachusetts by the name of Elizabeth Warren has been saying on radio programs that I've been on with her that Glass-Steagall was responsible for the financial crisis.

WOODS: Ugh.

WALLISON: But then later on in candid discussions with other people, she has said, well, no, of course it really had nothing to do with the financial crisis, but it's important to understand that it was deregulation of some kind. The important thing to understand about "deregulation of some kind" is that we've had a lot of deregulation, and it's been great for the United States. We've had deregulation in some parts of finance, like the elimination of regulated costs for trading securities. That's now all free market. We've had deregulation in communications. That has given us the Internet and iPhones and so forth. We've had deregulation in transportation. The one area where we have not had any deregulation is in the regulation of banks. That has only gotten tighter and tighter over time, with the exception of Glass-Steagall, and that was not a deregulation of banks at all; it was a deregulation, if you want to call it that, of the companies that own banks. They could then own also firms that were engaged in underwriting and dealing in securities.

So the Left — and I'm sorry to say this and impugn their motives — but the Left has been looking around for some kind of deregulation that could have caused the financial crisis, and they hit on the Glass-Steagall Act. And since no one else knew anything about it, it's a complicated idea, they've been pumping that idea now for years, and people have fallen for it, but in fact, it had nothing to do with the financial crisis, and the Left unfortunately has to face the facts. And the facts are that government has a policy, as I made clear in my book — and you were kind enough to talk about my book at one time — as I made clear in the book, the financial crisis was caused by government housing policy. Nothing more.

WOODS: Remind us of the full title of that book?

WALLISON: Oh, it's called *Hidden in Plain Sight: What Caused the World's Worst Financial Crisis and Why It Can Happen Again*. *Hidden in Plain Sight*.

WOODS: Okay, so that's also going to be linked at TomWoods.com/638. You know what's funny about the whole boogeyman story of Glass-Steagall is that the same people who push that also tell us that in Canada they weathered the financial crisis better than we did here, yet Canada had no Glass-Steagall in the first place, so they're contradicting themselves.

WALLISON: (laughing) Yeah, yeah, of course they are. And you can't really compare Canada's banking system to our own banking system. Canadian banks have different powers, and in fact, Canada did not have the government policies that created the very poor quality mortgages that suffused our financial system in the United States.

WOODS: Let's switch now to the other thing. Now, this is something I don't know the first thing about. I know nothing about this. I am the last person in the world to be talking about this at all. There's the — when you get them on Glass-Steagall, then they come out with something that sounds even more complicated: the Commodity Futures Modernization Act of 2000.

WALLISON: Mm hmm, mm hmm, right.

WOODS: And I know you've written about this too. Tell me what that was and what's the deal. How is that connected to anything?

WALLISON: (laughing) In the year 2000, this was during the Clinton administration, the person who was the chairman of the Commodity Futures Trading Commission said that she wanted to regulate credit default swaps. I'll get to what those are in a minute. The chairman of the Federal Reserve, the chairman of the banking committees in the House and the Senate, the Secretary of the Treasury at the time, Rubin, all said that would be a terrible idea. In addition, not only is it a terrible idea, but the idea that you are going to be regulating the credit default swap market is going to make that market very difficult to operate, because people are going to be afraid to get involved in the market if they think that the Commodity Futures Trading Commission is going to come in and impose various kinds of regulations, making their investments weak or troubling or bad.

So they adopted in something called the Commodity Futures Modernization Act a rule that said the CFTC, the Commodity Futures Trading Commission, cannot regulate credit default swaps. That's what the Commodity Futures Modernization Act was about. There are other provisions in that act that did good things, but in this case they did a bad thing, according to the Left, and that is they restricted regulation of the credit default swap market.

Now, what are credit default swaps? Sounds very complex. They're not actually very complex. They are simply a kind of insurance product on a financial instrument, and you can buy protection for your financial instrument — its decline in value or its failure or whatever — by paying a premium to someone who will protect you. That transaction is called a credit default swap.

Again, same thing as we have been talking about Glass-Steagall. The same thing happened with credit default swaps, and that is as soon as there was a problem in the market, various people, principally on the Left but also the government and I will have to blame this in part on the late part of the Bush administration, began to say, well — this is particularly Henry Paulson, who was the Secretary of the Treasury at the time — well, it was also the fact, the reason we had to bail out Bear Stearns is because these credit default swaps were going to make all of these companies fail. If one of them failed, it would drag down all of them, because they're all interconnected through these credit default swaps.

That idea was shown to be false when Lehman failed, because when Lehman failed, no other firm got into trouble because of Lehman's failure, and Lehman was a big player in the credit default swap market. But the idea has lived on that it is necessary to regulate credit default swaps, and in the Dodd-Frank Act there was a very strong set of regulations or power to make regulations that were given to the CFTC, the Commodity Futures Trading Commission, in order to regulate credit default swaps, and they had now been thoroughly regulated. That to me is not a good idea. It has not produced anything good, and it did not save us from and will not in the future save us from anything bad.

WOODS: Your mention of Dodd-Frank reminded me of something that I have to tell you, but before we do that, let's thank our sponsor.

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You mentioned Dodd-Frank; maybe your ears were burning today, because we were recording — I have another podcast; I do this show every weekday, but I have a weekly show called *Contra Krugman*. We refute Paul Krugman every single week, my friend and I.

WALLISON: (laughing) Well, that's easy.

WOODS: Oh, it's great. Yeah, we've got to get you on that show.

WALLISON: (laughing)

WOODS: Why should everybody else have all the fun? We had Dan Mitchell from Cato on today —

WALLISON: Great. Great guy, Dan.

WOODS: Oh, yeah. And I talked to him about — or we were talking about, Krugman had a column about how Obama's actually been a terrific president and here are some of his accomplishments. And he gave financial reform as one of his accomplishments.

WALLISON: Yeah, right.

WOODS: And I cited an article you wrote maybe six months ago, connecting Dodd-Frank and the disproportionate burden it places on community banks, small institutions, and that's where small businesses, where a lot of the job growth was coming from, get their credit. And now suddenly we're not seeing job growth coming from small business anymore, and you connected the dots very effectively in that column.

WALLISON: Yes, well, it is true. It is absolutely true that the reason that our economy has not recovered as smartly as it always recovers from steep recessions is because of the Dodd-Frank Act and the burden that it has placed not only on small banks, but also on the financial industry in general. It raised their costs tremendously, made them much more risk averse than they had been before that. But the major problem with small business is coming from the burdens that have been placed principally on community banks by the Dodd-Frank Act and the behavior of the regulators after Dodd-Frank was adopted.

WOODS: I'm looking at Amazon. You have a book called *Bad History, Worse Policy: How a False Narrative About the Financial Crisis Led to the Dodd-Frank Act*. And according to Amazon, this book is 552 pages. Is that right?

WALLISON: (laughing) Yes, yes, it is. But, but, but, let me say this, and that is that this book is a series of essays that I wrote —

WOODS: All right.

WALLISON: — about Dodd-Frank before Dodd-Frank — well, before the book was published, but while it was under discussion, after it had been adopted I wrote maybe 20 essays, long ones, and they're all collected in this book. So that's my contribution to the Dodd-Frank issue.

WOODS: All right, well, let me ask you this. Would you be open some day to coming back and talking exclusively about Dodd-Frank to us?

WALLISON: Oh, of course. Oh yes.

WOODS: Well, look, you write a book that length, I'm afraid you're tethered to that issue for a while (laughing).

WALLISON: Right. I'm happy to talk about Dodd-Frank. Of course I'll talk about Dodd-Frank. I really do think it has been a catastrophe for this country and one of the reasons that we have so many disaffected people in this country, because we have not had the economic growth that people are accustomed to since Obama came into office. And the principal reason for that — look, let's put it this way. There are only three major things that have happened in the financial world since Obama became president. One is the Fed cut interest rates down to virtually zero. There's Obamacare. And there is Dodd-Frank.

Now, those first two, Obamacare and the Fed cutting interest rates to zero should stimulate the economy, Obamacare because it added so much more government money into a major sector of the economy, which of course is healthcare. But we haven't had any growth. We've had the slowest recovery every since the 1960s. And why is that? It can only be one reason, and that is the Dodd-Frank Act.

And so people have not seen an increase in their salaries, their compensation. In fact, many of them have seen a decrease. The economy's growing very slowly. We do not have the kind of economic growth that has always made people confident about the future, and as a result we have a lot of people who are looking at this election as a way of stopping the terrible things that have happened over the last eight years. And yet it seems very unlikely that either of the candidates that are the frontrunners now will be able to do anything. One of them is of course just backing Obama's policies and promising to make them even worse for the economy, and the other doesn't actually seem to have a very good idea of how to handle the economy anyway.

WOODS: Can I ask you just one more thing before I let you go?

WALLISON: Sure.

WOODS: I'm sure we covered this in the last conversation, but every time I see, whether it's, even Krugman's column that we were talking about on the show today, any time I see somebody like Krugman refer to the financial crisis, they always talk about predatory lending —

WALLISON: (laughing) Right.

WOODS: They think that predatory lending could be bring down — there could be so many loans that were made for the express purpose of deceiving people that that brought the system down. What do you say to the claim that it was predatory lending on the part of institutions, that they knew these people couldn't make the payments but somehow they could make short-term profits that way?

WALLISON: You know, there are two things that I'd like to say about that. First of all, I was a member of the Financial Crisis Inquiry Commission, the one that studied the crisis. I dissented from their view, because I thought they came out with the wrong answer, part of which was that predatory lending occurred and was responsible. It does occur, of course. There are always bad actors in any business, and some predatory lending did occur, but all the time I was on the commission, I said, look, if you think predatory lending is an important factor, give me some data. Show me where it is, how much of it was there, who has calculated all of this. Otherwise, it's just a slogan. And for all the studying that the FCIC did of what led up to the financial crisis, they were never able to provide any data on predatory lending. I will not deny that it occurs; however, I don't think that it was a major factor.

What was a major factor was the vast reduction in mortgage underwriting standards that occurred between the middle of the 1990s and 2008, and that was because of the affordable housing goals that had been adopted by Congress and put and imposed on Fannie Mae and Freddie Mac, and that's what is detailed in my book. That's why we had the crisis. And you could call some of the loans that were made in that case predatory loans, but they were made because the government wanted those mortgages to be made.

Let me give your listeners one fact that is very, very important when you talk about this issue, and that is in 2008 just before the financial crisis, there were 31 million subprime and other low quality mortgages in the U.S. financial system. 76% of those mortgages were on the books of government agencies, principally Fannie Mae and Freddie Mac and the Federal Housing Administration, and that demonstrates one thing beyond question, and that is that the government created the demand for those mortgages.

WOODS: Well, that book is *Hidden in Plain Sight*, as we said, *What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again*, so again, I'm going to link to that at TomWoods.com/638. And I'm looking at it right now on Amazon, and there's a hardcover edition that's dated 2015, and then I see a 2016 — so is there a recent paperback?

WALLISON: Yeah, there's a new paperback out.

WOODS: Oh, we should have done a whole episode, you know, to push the new paperback.

WALLISON: Great, yeah (laughing).

WOODS: Well, I'll at least link to the paperback. Yeah, we've got to give the book new life here.

WALLISON: Yeah, I believe you should —

WOODS: (laughing)

WALLISON: And look, it should have new life because it is still relevant to public policy in the United States. If we continue to believe that our financial crisis was caused by insufficient regulation, we're going to have more regulation, and that's what Hillary Clinton is talking about. If, on the other hand, we understand that government policies caused the financial crisis, then we look at it entirely differently and we understand that regulation is a problem rather than a solution.

WOODS: All right, we're going to leave it there. I'm really glad that we were able to cover this topic. Now I can hold my head up high that I have smashed the last myth that I need to related to the financial crisis. Unfortunately there'll be more myths on all kinds of other topics coming at me in the headlines from now until I drop dead, but at least I've covered this one topic, and I appreciate your time, Peter Wallison. Thanks so much.

WALLISON: Thank you, Tom.