



## Episode 790: The Evils of Dodd-Frank

Guest: Peter Wallison

**WOODS:** I've been saying that we have to talk about Dodd-Frank one of these days, considering that gigantic book I just told people about that you've written on it. And now I think it's a more appropriate time to discuss it than ever, given that it's really back in the news now because of the prospect that it could be repealed or modified because there's an incoming Republican administration.

Let's start at the beginning. There's a certain view of what caused the financial crisis that informs the Dodd-Frank Act, so can you start by telling us what is that view of the financial crisis?

**WALLISON:** Yeah, I think what we've been told from the beginning by the media mostly and by the government too was that the financial crisis was caused by insufficient regulation of the private financial economy, and if we placed more regulation on banks and others, we would avoid another crisis. That gave rise to the Dodd-Frank Act, because that piece of legislation is the most restrictive financial regulation since the New Deal and probably goes a little bit further than the New Deal would have gone.

So when we are looking at what happened here, we have to look carefully at the Dodd-Frank Act, because it's illegitimate in the sense that it was based on the wrong diagnosis of the crisis. As we have talked about in the past, the crisis was actually caused by government housing policies that were pursued over a 16-year period between 1992 and 2008 through two administrations, one Democrat and one Republican.

And in the end, more than the majority of mortgages in the United States were subprime and thus risky mortgages. And 76% of those mortgages were on the books of government agencies, which makes clear beyond doubt that it was the government that created the market, the demand for those mortgages. So we know why we had a financial crisis; the trouble is the American people really haven't been told about it.

**WOODS:** You served on the — was it called the Financial Crisis Inquiry Commission?

**WALLISON:** Yes, that's right.

**WOODS:** Okay, and that basically gave a partisan answer. It basically gave the answer you just gave as to what caused the financial crisis. Now, you just wrote — and I only

saw it just in preparing for today. You have an article from the middle of this year arguing that documents in the files of the FCIC contradict its narrative, and yet these documents were not produced, referred to, inserted into the report. And I wonder if you can say something about that.

**WALLISON:** Yeah, actually, this is actually a scandal and something that the newspapers should be looking at, the American people should be aware of. This was a group that was set up by Congress. It was a majority of Democrats, six Democrats, four Republicans. But the purpose of it was to tell the American people, tell Congress, tell the president what caused the financial crisis. And I ultimately dissented from the report. I was the only one who wrote this particular dissent, claiming that it was the government's housing policies that were responsible.

But when I wrote the dissent, I had not seen all of the documents that were in the files of the FCIC, the documents they had collected in the course of their "investigation." Then as I began to write my book on that subject, which is called *Hidden in Plain Sight* – and I think, Tom, you've seen the book and you've read it – I began to go back through what was then available after the commission closed down, what was available from their files. And I found all kinds of material that showed that they did not do a fair analysis of the crisis.

Among other things, there were statements in the commission's initial report to the effect that, well, Fannie and Freddie were not really very important. That is, Fannie Mae and Freddie Mac, two government-backed mortgage companies that were responsible principally for carrying out the policies, the housing policies of the government, oh, they weren't very important. They really didn't have very much to do with what went on, and Fannie and Freddie themselves did not feel that these government housing policies were forcing them to do anything.

And then you could read in the materials that the commission had collected statements by people of Fannie and Freddie saying, This is terrible; we're being required to do things that will eventually cause us insolvency and go out of business; we cannot continue to sustain this. And so there was a complete contradiction in the materials that the commission had collected of the position that the commission ultimately took, which is that housing policies were really not very important in the financial crisis.

So I did write a long essay on that subject pointing out some of the statements that were in these documents that were in the FCIC's files. And I'm glad you got a chance to see it, because it's a very important document. And the whole thing is a scandal, in my view, because this was a commission established by Congress and paid for by the American people. It had an appropriation by Congress to carry on its investigation, and basically it wasn't even a fair investigation. It was a white wash.

**WOODS:** Well, I am definitely going to link to what you wrote. The paper is "New Questions About the Financial Crisis Inquiry Commission," so I'll link to that on the page with this episode, [TomWoods.com/790](http://TomWoods.com/790).

So let's get into Dodd-Frank proper then. What exactly does this do? Now, that may actually be an easier question to ask than to answer to some degree, because a lot of

it seems very open-ended. But what are the provisions we can make out of this that you think might actually be doing damage rather than helping?

**WALLISON:** Well, there are so many; it's hard to list them all. But among the things that the Dodd-Frank Act did was to create something called the Financial Stability Oversight Council, which is made up of all the financial regulators at the federal level. The Financial Stability Oversight Council was then given authority to designate certain large, non-bank financial institutions as what they call systemically important financial institutions or SIFIs. And those SIFIs then are turned over to the Federal Reserve for regulation, special, stringent regulation required by the Act.

Now, shortly after it was created, the FSOC designated GE Capital as a SIFI, and that was turned over to – this is a major financial subsidiary of the big company GE, but it was actually even larger than GE itself. It was a huge financial provider in our economy. It was turned over to the Federal Reserve for special, stringent regulation. And pretty soon, the parent company, GE, found that GE Capital was no longer profitable. It was no longer a useful subsidiary. So they actually wound it down. As a result, there was much less available credit, especially for small companies and risky companies, which is what GE Capital specialized in. And as a result of that, that was one source of financing in our economy that simply disappeared because of Dodd-Frank.

Another example is something called the Volcker Rule, which said that banks could no longer trade securities for their own account, which is something they had regularly done and created liquidity in the financial markets. So when someone wanted to buy a debt security, which doesn't have – Debt securities have much narrower trading than, say, equity securities, which trade in stock markets. But debt securities trade between companies, not on a trading market of some kind.

So if you want to buy a debt security, you have to go into the market and look for someone who is selling that security. Well, banks used to be the major market makers in the sense that they had a portfolio of these debt securities, and if you wanted to buy them, you would negotiate a price with the bank. Similarly, they would buy securities just as they would sell them. That's what a market maker does. And so if you wanted to sell your debt security, you would go into the market and look for a bank that was offering to buy this security, and you'd negotiate price.

So the point is that once they took the banks out of this business, the liquidity in the markets went down substantially. And as a result of that, it became much more expensive even to buy or to sell a debt security, which meant that it was riskier for people to buy and hold these securities, because they couldn't be assured of being able to sell them at a fair price. That's another example of the Dodd-Frank Act, and that has had an effect on the ability of companies to finance inexpensively in the markets.

Other examples are something called the Consumer Financial Protection Bureau, which was an idea of Elizabeth Warren, the senator from Massachusetts who is quite a progressive.

**WOODS:** Yeah, I was going to ask you about this, because it sounds like – as so many progressive things, it sounds benign. I was actually going to ask you specifically about this. What could be wrong with that?

**WALLISON:** (laughing) Well, yes, consumers should have protection. That's true. But the way this agency has been operating it has made it very difficult for the companies that serve consumers to function. For example, they made a rule about how companies should engage in making mortgages. The rule with explanatory material was about 1,000 pages. Now, if you are the CEO of a small bank, you don't have the compliance officials, the lawyers, and others on staff to help you interpret 1,000 pages of rules about how to make a mortgage. And if you can't interpret it properly and you make a mistake in making a mortgage, you are likely to be charged by the Consumer Financial Protection Bureau with a violation of their regulations, which can be very expensive. It can also even put you out of business. And so it is yet one more part of the Dodd-Frank Act which is making it very difficult for our financial system to function in the way that it did in the past.

**WOODS:** Is there anything good in the Dodd-Frank Act?

**WALLISON:** (laughing)

**WOODS:** What the heck, I thought I would ask. Why not?

**WALLISON:** Well, I've read through the Act many times; I've written about it as you've suggested. I really can't find anything in it that is worth preserving, so I would – I think the easiest thing would be to just repeal it. Now, there are, as often occurs in these cases, there are things in legislation like this that some institutions will benefit from, and so there will be opposition to a complete repeal. But that's okay. Congressman Jeb Hensarling, who was the Chairman of the House Financial Services Committee, has already drafted and gotten passed through that committee – it's on the House floor now – what he calls the Choice Act, which would repeal many of the things that I've just talked about in the Dodd-Frank Act, but leaves many other things in place.

So that's a good way for Congress to start. They should go through each of the things that Hensarling would like to repeal, the new things that he would like to put into the law, which will make things much easier for consumers and businesses to get financing, and then see what other things can be taken out of it, because I think there are still other things that worry me a lot that are in the Act and have not been proposed for repeal.

**WOODS:** Here's what worries me: the problem is that the old view, the traditional view of the financial crisis just seems to be impossible to dislodge. I mean, as somebody who's also written a book on this subject, I can tell you you can sell a lot of books, and still there's a huge number of people you'll never reach who still believe deregulation caused the crisis. So if you wind up repealing or even replacing Dodd-Frank – a lot of these people are not known for subtlety, so they'll treat that as repeal – then the next time there's a recession or a downturn, they'll be able to say, Well, there you go. We got rid of Dodd-Frank, and look what happened.

**WALLISON:** (laughing) Yeah. And of course, we will have other recessions and downturns, and the same people will say, See? Dodd-Frank was not strong enough. We have to have more regulation than Dodd-Frank. It wasn't sufficient. And that's of course what Hillary Clinton was arguing during the campaign. She was saying, I want to go beyond Dodd-Frank. It doesn't deal with enough of the abuses in the financial area. And Elizabeth Warren now will carry on that fight for her as a senator.

And so we're always going to have people on the left who are going to distrust the private financial and the private economy in general. They don't trust anything that isn't controlled ultimately by the government. They think it's inherently unstable. The likelihood is that we will always have another crisis as long as the government isn't in charge.

But the fact is that it's the government's involvement in the economy that causes the crises that are constantly coming along, because the government creates situations in which people believe they can take much more risk on certain kinds of activities, because the government is backing them. That's what happened in the housing system. Fannie Mae and Freddie Mac, these two companies I mentioned before, were backed by the government, and as a result, they could take all kinds of risks without people realizing what they were doing. And ultimately, they failed, and when they failed they brought down the rest of the financial system.

**WOODS:** On our sister podcast – I do this one every weekday, and then once a week I do *Contra Krugman*, where we refute Paul Krugman every week.

**WALLISON:** (laughing)

**WOODS:** By the way, you'll be surprised to learn, Peter, that Krugman is all of a sudden concerned about the national debt again. Interesting timing for that.

**WALLISON:** (laughing)

**WOODS:** But on an episode of that show, I went through – I haven't done it on this one, so I want to do it on this one. I went through and explained how you've made the connection between Dodd-Frank and lower than desirable economic growth in the U.S. Can you make that case here?

**WALLISON:** Sure. I mean, I think it's pretty clear what happens. The way the United States economy works – and this is very good, one of the real strengths of the U.S. economy – is that the growth bubbles up from below. It starts with startup companies that people with initiative and innovative ideas start little companies, and those companies are tested in the market to see whether they are in fact advancing and improving things. And if they succeed, they hire more people, and the economy grows. The largest proportion of our new employment, when it comes, comes from these small startups.

So if you so construct regulation that it makes it very difficult for startups to get financing, then you are going to stymie the growth of the economy, and I think that's basically what happened. All of the new regulations, like the one about banking that I

talked about, about mortgages that I talked about before, that were imposed on small and community banks, which are the principal source of financing for startup companies and small business, made it very difficult for those companies to make loans to startups and other companies that hadn't proven already that they were profit-making. And if you stymie the development of those companies, you are gradually going to deprive the U.S. economy of the kind of growth engine that has always been supplied by these smaller companies.

So that to me is the way the Dodd-Frank Act has actually slowed the growth of our economy. It's through the major regulations, the costly new regulations that were placed on smaller banks, which in turn caused them to hire compliance officers instead of hiring calling officers who would go out and try to make loans to people in their communities. And when that stopped happening, growth stopped happening, and I think it will continue until we eliminate many of those restrictions.

**WOODS:** So I'm also going to link to – you have I'm sure more than one, but an article I read where you lay out this logic as well, so I'll link to that too. But one final thing: how do you answer somebody who would say, Well, Wallison, if we do things your way, what do you mean, we just have to trust the private sector to regulate itself? Isn't that hopelessly naive? How do you answer that?

**WALLISON:** Well, regulation is not bad. It is very useful in many cases, and there are cases where the private sector doesn't operate perfectly well, where what is called market discipline – that is the concern by investors about the risk-taking of certain companies – is not working well enough. And that happens from time to time. But we have to find that balance. We have to find the balance between the kind of regulation that actually protects us and the kind of regulation that suppresses this growth in the economy, and Dodd-Frank went way over to the other side and has in fact suppressed the growth of our economy. We have to eliminate Dodd-Frank and then go back to look at those areas where regulation is still necessary.

And in fact, before Dodd-Frank we had a sufficient amount of regulation. We probably could have pared back that regulation a bit, but instead, after Dodd-Frank, the people on the left how are very suspicious of the private sector wanted to take complete control of the financial system, and they did that through the vehicle of this Dodd-Frank Act. If we got rid of that, if we got rid of many of its restrictions, went back to the regulation that we had before – which didn't fail. What failed of course was the housing finance system that the government was controlling through Fannie Mae and Freddie Mac. So we didn't fail in the past. We should go back to the regulation we had before, tweak that to the extent that it is not sufficient or too suppressive of growth, and then we'll probably have an economy that will grow.

When I look at what is happening in the stock market now – it went over 19,000 yesterday – what I see is investors recognizing that under Donald Trump, whatever other policies he might have, he has talked about eliminating excessive regulation, especially Dodd-Frank. And to the extent that he is able to do that, it will help the economy grow.

**WOODS:** Well, the book is *Bad History, Worse Policy: How a False Narrative About the Financial Crisis Led to the Dodd-Frank Act*. I'm linking to that and to some of Peter's

articles at [TomWoods.com/790](http://TomWoods.com/790). Well, happy Thanksgiving, Peter. I appreciate your appearance, especially here on my Thanksgiving episode. It just goes to show what a bad planner I am that I have the Dodd-Frank episode – But maybe next year we can give thanks that we got rid of it.

**WALLISON:** Well, let's hope; let's hope. I think there's every chance, if Trump follows through, that this Choice Act that Jeb Hensarling has drafted and is now on the floor of the House and can be introduced next year will be functional and will solve a lot of our problems, I think.

**WOODS:** I do fear, by the way, that with Hillary more or less finished at this point, that a name you mentioned earlier is going to replace her as a really up and coming and very dangerous figure in politics, and that is Elizabeth Warren. So we may have less to celebrate, but let's focus on the near term right now. Let's get this thing repealed, and we'll think about our problems later. Thanks again, Peter. I appreciate your time.

**WALLISON:** Thank you, Tom.