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The Financial Crisis: Why the Conventional Wisdom Is Wrong

RICHARD KOVACEVICH

One advantage of being retired is that I do not have to come back to Washington, D.C., as I used to do at least half a dozen times each year. Like many of you, I am appalled at the political environment that exists in this town. I simply cannot understand why our elected officials continue to concentrate on party politics and the next election above doing what's right for America, especially as we've endured the past five years of economic stagnation and high unemployment.

My focus today will be on financial regulation, but before I get started I'd like to mention one thing. I am sure most of you have noticed the publicity surrounding Bao Bao, the new panda cub at the Smithsonian National Zoo this year. Well, Bao Bao should fit in well in Washington: she costs a fortune, she has no useful skills, and she is always on TV.

RICHARD KOVACEVICH IS CHAIRMAN EMERITUS AND FORMER CEO OF WELLS FARGO & CO. HE SPOKE IN JULY AT THE CATO INSTITUTE'S FINANCIAL REGULATORY CONFERENCE, "AFTER DODD-FRANK: THE FUTURE OF FINANCIAL MARKETS."

CATO INSTITUTE

So how did we get into this mess? The last time I was in Washington was in October 2008, for the infamous Troubled Asset Relief Program (TARP) meeting between the Treasury Department, regulators, and large bank CEOs. I believed at that time and still believe today that forcing all banks to take TARP funds, even if they didn't want or need the funds, was one of the worst economic decisions in the history of the United States. You may have forgotten that prior to TARP, and even a month after the bankruptcy of Lehman Brothers, markets had declined but were still behaving reasonably well, except for those financial institutions that were having liquidity issues. With the announcement of TARP, isolated liquidity issues turned into a tsunami impacting all banks and all industries.

> "Forcing all banks to take TARP funds, even if they didn't want or need them, was one of the worst economic decisions in U.S. history."

What should have happened is that only those financial institutions that were still solvent—but had liquidity challenges and needed the funds temporarily—should have been given that choice. You can't fool the markets as Treasury officials and regulators believed you could. The market knew which financial institutions were in trouble as evidenced by stock prices and credit default swap rates that existed at that time. Forcing TARP funds on all banks did not restore confidence in the industry. Within two months, the Dow Jones Industrial Average fell by 40 percent and financial stocks fell by 80 percent. It destroyed confidence as the market concluded that all banks must now be in trouble because all banks were receiving funding and presumed to have needed and wanted it.

TARP contributed to an unnecessary panic in the marketplace and required an unprecedented $29 trillion dollars of market intervention by the Federal Reserve and the Treasury, over twice the annual GDP of the United States, to restore the very markets that they themselves helped to collapse. It precipitated a dramatic drop in the stock market, froze trading and the capital markets, magnified and extended the market collapse, damaged the reputations of many financial institutions who did no wrong, increased moral hazard, institutionalized "too big to fail," and outraged the general public. Because of TARP and the anger it fomented, Congress had an excuse to burden the financial industry with the largest increase in bank regulations in history.

As Will Rogers used to say, "If stupidity got us into this mess, why can't stupidity get us out?" Congress remembered what Will said and enacted the Dodd-Frank legislation. It's

some 2,500 pages long and will produce more than 25,000 pages of new regulations from the same regulators who presided over the last three major financial crises. Even four years after its passage, regulators have still completed only 52 percent of its 398 rules. These regulations were created and passed not with sound judgment, but rather as a political response to the understandable outrage of Americans at the ill-conceived bailouts. Dodd-Frank does absolutely nothing to address the major causes of the recent crisis. It offers few approaches to prevent the next one. It is a grab bag of so-called reforms that ignores the fact that regulatory failures were the real cause of what should have been a manageable problem.

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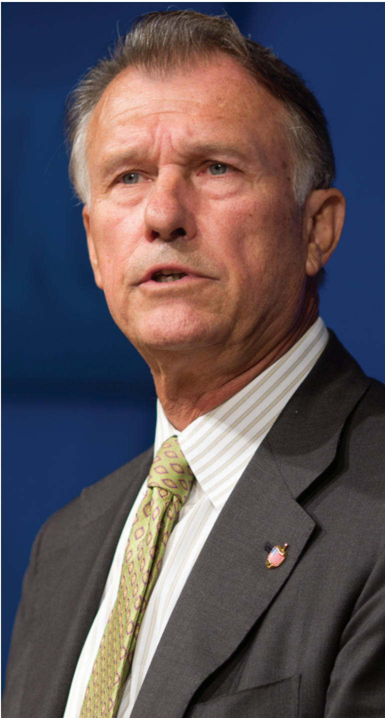
Why didn't Congress rein in Fannie Mae and Freddie Mac and their increasingly large portfolios of risky assets after two decades of warnings by industry experts, regulators, and administration officials that one day they would cost taxpayers hundreds of billions of dollars? The housing crisis got as big as it did to bring down our entire economy *only* because of the existence of quasi-private/public entities such as Fannie and Freddie. Now six years after the crisis, Fannie and Freddie still exist.

What regulatory authority did the Fed and other bank regulators not have to rein in the risks taken by financial institutions that precipitated this crisis? I can't think of any. What regulatory authority did the Securities and Exchange Commission (SEC) not have to rein in the excessive risks and grossly inadequate liquidity plans of investment banks? Why didn't the SEC overrule the financial accounting standards board, which insisted that banks mark-to-market their securities portfolios even when the markets ceased functioning, needlessly reducing precious bank capital during the crisis? Why didn't it properly regulate the rating agencies that incomprehensibly designated certain subprime mortgages as AAA? Even if only the rating agencies had been doing their jobs, the subprime mortgage problem would have been contained. In short, the SEC completely failed in its regulatory oversight time and time again.

Many in the financial markets knew what was going on. Hedge funds were betting against subprime portfolios. Responsible players like Wells Fargo were losing over 25 percent mortgage market share. Home prices were increasing to unprecedented levels. I personally told top bank regulators at least a dozen times

that subprime mortgages were worse than toxic waste dumps. So did many others. Where were our safety valves?

If you don't remember anything else I say today, please remember this: *only about 20 financial institutions perpetrated this crisis*. About half were investment banks and the other half were savings and loans. Only one, Citicorp, was a commercial bank, but was operating more like an investment bank. These 20 failed in



every respect, from business practices to ethics. Greed and malfeasance were their modus operandi. There was no excuse for their behavior and they should be punished thoroughly, perhaps even criminally. Yet 6,000 commercial banks are being punished with Dodd-Frank penalties in the same way as the guilty parties. Why punish the vast majority of banks that behaved appropriately?

The focus should be on reforming those regulators who had the power to stop these perpetrators and completely failed. Effective regulation is all about consistency and appropriate risk oversight. It's clear from the three major U.S. banking crises over the past 40 years that the United States has not yet achieved this balancing act. None of these past crises occurred due to lack of regulatory authority. It was the failure of regulators to use their existing authority effectively to rein in excessive speculation by financial institutions. Politicians and regulators have responded to each crisis by piling on more extensive and burdensome regulations, assuring citizens that they have fixed the problem without addressing the actual causes.

Today the 6,000 commercial banks and their boards and management are spending most all of their time and resources on compliance, regulatory changes, and litigation for something they didn't do. Regulators blame bank board members for improper oversight of management. But there are upwards of 100 regulators at large banks. Those regulators have an average of over 15 years of experience in the financial services industry and work full time at these banks. Bank directors have roughly 12 members, who spend about a day a month on bank business, and who are not experts in the financial services industry because if they were, they would not be considered independent. So who is more responsible for insufficient oversight of bank management: 100 full time regulators or

about 12 one-day-a-month bank directors?

We need to immediately replace the litigation risk associated with the "ability to pay" language that is in the Dodd-Frank bill. Mainstream commercial banks have been making loans to lower-income consumers and those with credit blemishes on their records for decades. They were not among the 20 institutions who perpetrated this crisis. They did not originate loans to subprime borrowers who could never pay them back as the S&Ls did; nor did they buy and insure them as Fannie and Freddie did; nor did they package, sell, and distribute them as investment bankers did; nor did they rate them AAA as rating agencies did.

> "If you don't remember anything else I say today, please remember this: *only about 20 financial institutions perpetrated this crisis.*"

Mainstream banks have the experience and expertise to make loans to appropriate borrowers, and take the credit risk, but not litigation risk. Because of this litigation risk, it is more difficult today to qualify for a mortgage than any other time in my 40 years in this business. Mortgages are one of the most valuable assets the general public owns. Housing is critical to economic recoveries and is usually one of the first industries to increase employment after a recession.

It doesn't have to be this way. Because of the litigation risk, most small community banks have closed their mortgage departments and aren't even making mortgages any more—a tragedy for small communities. Until the litigation language of Dodd-Frank is changed, the bottom 25 percent of Americans will not get loans, stifling economic growth and denying this group, who need banks the most, access to financial services.

There have always been bank failures and there always will be. The trick is to allow sufficient risk-taking to promote economic growth, but not so much that it leads to widespread bank failures and financial panic. We need to insist that no financial institution is too big to fail, get rid of the "ability to pay" litigation risk, and indict any institution or individuals who behave in a criminal or predatory fashion. We also should replace our current fiscal and monetary policies with those policies that worked well in the past for fast and strong economic recoveries.

As a result of all of the mistakes I have mentioned, our economy is growing at the slowest recovery pace in history. Unemployment continues to be high, our labor participation rate is at an all-time low, and our budget deficits are the highest they have ever been. Americans have lost confidence in our leaders, in themselves, and in our free-enterprise system—a system that has created the greatest wealth of any nation in history. ■

CATO SCHOLAR PROFILE

Tim Lynch

TIM LYNCH IS DIRECTOR OF THE CATO INSTITUTE'S PROJECT ON CRIMINAL JUSTICE, THROUGH WHICH HE HAS BECOME A LEADING VOICE IN SUPPORT OF CIVIL LIBERTIES. HIS RESEARCH INTERESTS INCLUDE THE MILITARIZATION OF POLICE TACTICS, THE WAR ON TERRORISM, OVERCRIMINALIZATION, THE DRUG WAR, AND GUN CONTROL. HE IS THE EDITOR OF *IN THE NAME OF JUSTICE: LEADING EXPERTS REEXAMINE THE CLASSIC ARTICLE "THE AIMS OF THE CRIMINAL LAW."* IN 2000 LYNCH SERVED ON THE NATIONAL COMMITTEE TO PREVENT WRONGFUL EXECUTIONS. HE EARNED BOTH A B.S. AND A J.D. FROM MARQUETTE UNIVERSITY.

WHAT DO PEOPLE MEAN WHEN THEY REFER TO THE "MILITARIZATION OF POLICING"?

There are several trends at work. First, the military itself is being called upon to do police work, such as catching drug smugglers. Second, an alarming number of civilian police departments have created paramilitary units, or SWAT teams. They can be found in small town departments these days—even places where there is little violent crime. Third, the police departments are receiving military vehicles and weapons, such as armored vehicles and M-16s, from the Pentagon. Fourth, the local paramilitary units are no longer reserved for rare, extraordinary situations. They are increasingly involved in routine policing matters.

WHAT IS MOST TROUBLING ABOUT THESE TRENDS?

We used to keep the line between the military and the police clear. The distinction is important because the police and the military have different missions. Soldiers are trained to fight and win wars. The military mission is to destroy the enemy forces. We want the police to avoid the use of force. They should use force as a last resort and only use the minimum that may be necessary to bring suspects into court where disputes can be resolved peacefully. When the police start emulating the tactics of soldiers, there is too often unnecessary violence.

WHAT IS THE PURPOSE OF POLICEMISCONDUCT.NET?

About two years ago, Cato launched our National Police Misconduct Reporting Project (NPMRP), of which PoliceMisconduct.net is the cornerstone. The project has several aims, including aggregating misconduct stories from around the country, trying to discern trend lines, and identifying policies that can minimize misconduct. Since the police wield enormous powers, such as the ability to search homes, seize children, incarcerate adults, and so forth, we think it is crucial that these actions be scrutinized closely.

Our researchers scan media reports each day to locate news stories on misconduct, record those reports in a database, and transmit the details through a social media newsfeed on Twitter—providing transparent data that allows for independent verification through public review.

The purpose is to determine the extent to which law enforcement officials exceed the limits of their authority. In short, we are trying to create a ruler with which we can measure police misconduct, so that people can determine for themselves if it's really a problem.

From time to time, someone will say, "Isn't everyone, by definition, already against misconduct?" To that question, several responses are appropriate. First, people do disagree about what constitutes misconduct. Second, people disagree about the extent of it. Third, people disagree about what ought to be done about it. We study those questions and more. ■

Ideas Matter

The Cato Institute works in the world of ideas—ideas about limited government, constitutional limits on power, and the notion that governments, like people, need to live within their means. Backed by solid and independent research, ideas originated at Cato reverberate through our national debate.

Still, it's a special moment when one of our "ideas" takes concrete, tangible shape. And that just happened when the Circuit Court of Appeals for the District of Columbia ruled in *Halbig v. Burwell* that, under the clear language of the Obamacare statute, the IRS's authority to issue subsidies is limited to healthcare exchanges established by the states and the District of Columbia (treated as a state for these purposes). Since 36 states declined to establish exchanges this ruling—if upheld—will mean that Obamacare subsidies are prohibited in those 36 states and that the administration acted illegally in paying subsidies to insurers and individuals.

Wow! And the thing is, this ruling simply would not have happened without the groundbreaking work of Michael Cannon, Cato's director of health policy studies. Back in 2011 when, despite clear statutory limitations, the IRS indicated that it planned to go ahead and issue subsidies in D.C. and all 50 states, Cannon began ringing the alarm bell—in print, on TV, in radio interviews, and at conferences. Back then, many Obamacare supporters found Cannon's objections laughable. Not surprisingly, the administration simply barreled on: in 2012 the IRS issued a final regulation flatly stating that subsidies would indeed be offered in D.C. and all 50 states. The IRS cited no authority for this departure from the clear language of Obamacare.

Cannon and others—notably Jonathan Adler, a professor of law at Case Western Reserve—didn't stop with commentary: once the IRS began paying subsidies, they crafted a series of legal challenges to this blatant illegality. And those lawsuits bore a tangible result in the form of the *Halbig* decision—a huge win, but the fight isn't over. The *Halbig* decision was rendered by a three-judge panel, with one of the three judges dissenting. The decision will be reviewed by the D.C. Circuit sitting en banc. And, on the same day that *Halbig* was handed down, the Court of Appeals for the 4th Circuit reached a contrary decision in a similar case. That court found the statutory language to be sufficiently "ambiguous"—a stretch, in our view—that the IRS should be given discretion in interpreting it. Given differing opinions by two Circuit Courts, it is quite possible that the ultimate decision will be made by the U.S. Supreme Court.

The point is: ideas matter. *Halbig* is a good example of the fact that the ideas nurtured at Cato have powerful, practical consequences. So I would ask you to think of making a contribution to support Cato, whether an annual gift or a planned gift. We welcome whatever gift works for you and your personal circumstances. And please bear in mind that, in addition to annual gifts, many people make generous bequests to Cato or designate us as the beneficiary of a retirement asset. ■

IF YOU HAVE QUESTIONS ABOUT MAKING A GIFT OR BEQUEST TO CATO, PLEASE CONTACT GAYLLIS WARD, ASSOCIATE VICE PRESIDENT OF DEVELOPMENT, AT GWARD@CATO.ORG OR (202) 218-4631.

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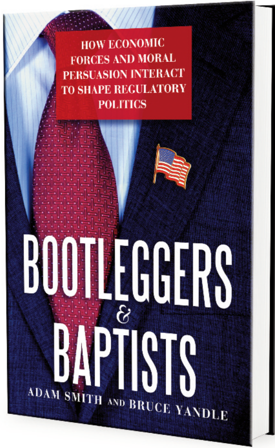

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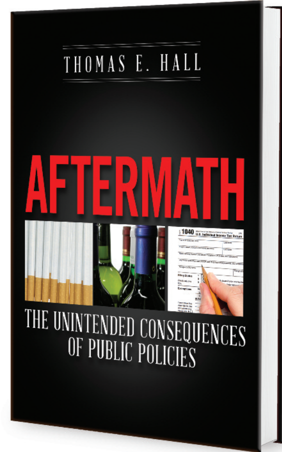

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