The Lost Cause: The Failure of the Financial Crisis Inquiry Commission

By Peter J. Wallison

It should not have been difficult for the Financial Crisis Inquiry Commission to identify the causes of the financial crisis. Everyone on the commission, and everyone interviewed, believed that the crisis was caused largely by the losses to financial institutions arising from the high rates of delinquency and failure among subprime and other low-quality mortgages in the 1997–2007 housing bubble. Where the commission lost its way was in its refusal to inquire why so many subprime and other weak mortgages were created in the first place—why, in other words, there was such a significant deterioration in mortgage underwriting standards in the years before the bubble’s collapse. Without an answer to this question, the commission could only produce a narrative about the financial crisis, not a coherent description of what caused the financial crisis.

In late January 2011, the Financial Crisis Inquiry Commission issued its report on the 2008 financial crisis. I was one of ten members on this commission and wrote a dissenting statement that is available online through AEI or through the commission’s website. It is also available in hard copy, together with the full report and the other dissents, through the Government Printing Office. Three other Republicans on the commission—Bill Thomas (who was also the commission’s vice chair), Keith Hennessey, and Douglas Holtz-Eakin—also dissented, and their dissent (the THH dissent) can be found on the commission’s website. In this Outlook, I summarize my dissent and the logic on which it rested, offer a brief description of the deficiencies of the five-hundred-page majority report, and explain why I could not join in the dissent of the three other Republicans.

Since the commission’s mandate was to explain what caused the financial crisis, my dissent focuses almost entirely on that question. George Santayana is often quoted for the aphorism that “those who cannot remember the past are condemned to repeat it.” Attempting to identify the causes of the...
financial crisis, however, shows that Santayana’s idea was a bit facile. Even if we know what happened in the past, there is still debate about its causes. The continuing appearance of revisionist histories about important events, such as our own Civil War or the Great Depression, testifies to the protean quality of the past. The difficult task for historians, economists, and public policy specialists is to discern which, among a welter of possible causes, were the significant ones—the ones without which history would have been different.

Using this standard, I believe that the sine qua non of the financial crisis was the US government’s housing policies; these fostered the creation of 27 million subprime and other risky loans—half of all mortgages in the United States—which were susceptible to default when the massive 1997–2007 housing bubble began to deflate. If the US government had not chosen this policy path—feeding the growth of a bubble of unprecedented size and an equally unprecedented number of weak and high-risk residential mortgages—I do not believe that the great financial crisis of 2008 would have occurred. What follows is a brief summary of the argument in my dissenting statement.

The US government’s housing policies were intended to increase homeownership by providing low-income borrowers with increased access to mortgage credit. Under legislation adopted by Congress in 1992, the Department of Housing and Urban Development (HUD) in both the Clinton and George W. Bush administrations carried on an intensive effort to reduce mortgage underwriting standards. HUD used (1) the affordable-housing requirements imposed by Congress in 1992 on the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, (2) its control over the policies of the Federal Housing Administration (FHA), and (3) a “Best Practices Initiative” for subprime lenders and mortgage banks such as Countrywide, to encourage greater subprime and other high-risk lending.

Ultimately, all these entities, as well as insured banks covered by the Community Reinvestment Act (CRA), were compelled to compete for mortgage borrowers who were at or below the median income in the areas where they lived. This competition caused underwriting standards to decline, increased the numbers of high-risk loans far beyond what the market would have produced without government influence, and contributed importantly to the growth of the housing bubble.

When the bubble began to deflate in mid-2007, the millions of low-quality loans produced by this competition began to default in unprecedented numbers. The effect of these defaults was exacerbated by the fact that few if any investors—including housing-market analysts—understood at the time that Fannie Mae and Freddie Mac had been acquiring large numbers of subprime and other high-risk loans to meet HUD’s affordable-housing goals. Thus, when so many mortgages began to default in 2007, investors were shocked and fled the multitrillion-dollar market for private mortgage-backed securities (MBS), dropping MBS values—and especially those MBS backed by subprime and other risky loans—to fractions of their former prices. Mark-to-market accounting then required financial institutions to write down the value of their assets, reducing their capital and liquidity positions and causing great investor and creditor alarm.

In this environment, the government’s rescue of Bear Stearns in March 2008 temporarily calmed investor fears but created significant moral hazard; investors and other market participants reasonably believed after the rescue of Bear that all large financial institutions would also be rescued if they encountered financial difficulties. However, when Lehman Brothers—an investment bank even larger than Bear—was allowed to fail, market participants were shocked; suddenly, they were forced to consider the financial health of their counterparties, many of which appeared weakened by losses and the capital write-downs required by mark-to-market accounting. This caused a halt to lending and a hoarding of cash—a virtually unprecedented period of market paralysis and panic that characterized the financial crisis.

**Finding the Cause**

Many commentators, as well as the commission majority and the THH dissenters, have expressed disagreement with my view of the causes of the financial crisis; they argue that the crisis was more complex and cannot be explained by any single cause. However, everyone agrees that the financial crisis had a single cause: the mortgage meltdown in late 2007 and the resulting delinquency and default of an unprecedented number of US mortgages. As the commission majority said, “While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008.”
Indeed, most of the commission majority’s report was taken up with anecdotes about how financial-institution managers and regulators failed to recognize the growth of the housing bubble and prevent the buildup of subprime and other weak mortgages in the US financial system.

Since this was the acknowledged cause of the financial crisis, a commission charged with determining what caused the crisis should want to find out why there was such a massive accumulation of subprime and other risky loans—the “toxic mortgages” described above—that defaulted in the mortgage meltdown. Why, for example, did the underwriting standards that had prevailed for many years in the US mortgage market suddenly begin to deteriorate in the early 1990s? If the financial crisis was in fact caused by the default of these mortgages, why these weak and risky mortgages were created was clearly a key question for the commission’s inquiry. Unfortunately, neither the commission majority nor the THH dissenters made any significant effort to address this central issue.

For example, the majority’s report says only that the “toxic mortgages” were “fueled by low interest rates and easy and available credit.” Exactly how low interest rates and easy and available credit caused a decline in underwriting standards is never explained. Similarly, the THH dissent says that “tightening credit spreads, overly optimistic assumptions about US housing prices, and flaws in primary and secondary mortgage markets led to poor origination practices.” How tightening credit spreads and the other factors led to “poor origination practices” is never addressed. In effect, both the majority report and the THH dissenters treat the existence of 27 million weak loans as a “given”—a starting point for which no explanation is required.

This is not a minor flaw in their arguments. It is a serious failure to address the one aspect of the financial crisis that distinguishes it from all previous financial disruptions and crises. Before the 2008 crisis, the United States had frequently experienced extended periods of low interest rates, large flows of funds from abroad, and excessive optimism about the future of housing prices (housing bubbles). We also had the same general regulatory and financial structure and a private financial system in which managers were expected to anticipate and act on risks to their firms. None of these conditions or factors, separately or together, had ever before resulted in a mortgage-based financial crisis. The one element in the 2008 financial crisis that was completely unprecedented was the presence of 27 million subprime and other risky mortgages; never in the past were half of all mortgages in the United States in danger of delinquency and default when a housing bubble deflated. Treating this factor as a given is a classic case of ignoring the elephant in the room, and it prevented the commission majority and the THH dissenters from gaining a clear understanding of the mechanism through which the 2008 crisis came about.

My dissent addresses this error. It attempts to explain why there were so many subprime and other risky loans in the US financial system in 2008, how the massive number of these loans caused the extraordinary size and longevity of the 1997–2007 bubble, and how the collapse of the bubble and the private MBS market caused the weakness of financial institutions in the United States and around the world.

### The Deterioration of Underwriting Standards

It seems obvious that such a large number of subprime and other risky mortgages could not have accumulated in the US financial system unless there had been a serious decline in mortgage underwriting standards, and why that decline occurred is a major piece of the crisis puzzle. For fifty years following World War II, US residential mortgages were solid assets, bought and held as investments by banks and other financial institutions in the United States and around the world. During this period, there were two major US housing bubbles—in 1979 and 1989—but when they deflated they resulted only in local losses. If housing prices ever fell nationally—and this is a debated question—it was never more than by a small percentage. Mortgage defaults themselves, under the worst conditions, and in the localities hardest hit by the deflation of a bubble, never resulted in losses of more than 4 percent. It again seems obvious that the reason for this stability was the existence of strong underwriting standards, requiring down payments and good credit records for those who wanted to buy homes.

Why were previous underwriting standards abandoned? As I discuss in my dissent, the deterioration of mortgage underwriting standards began in 1992, when Congress
adopted legislation that imposed what were called “affordable housing” requirements on Fannie Mae and Freddie Mac. Under these requirements, a certain percentage of mortgages purchased by Fannie and Freddie had to be loans to low- and moderate-income (LMI) borrowers—homebuyers whose income was at or below the median income in the areas where they lived. This was an initial step in a US government social policy that eventually had the desired effect: it made substantial amounts of mortgage credit available to LMI borrowers for the first time, and it succeeded in increasing the homeownership rate in the United States from 64 percent (where it had been for thirty years) to more than 69 percent in 2004. However, this policy also created a ten-year housing bubble of unprecedented size, and the growth of the bubble—by suppressing delinquencies and defaults as housing prices climbed—fostered a large market for securitized subprime mortgages held by financial institutions in the United States and around the world. When the bubble collapsed, these subprime and other risky loans became the toxic assets that endangered the stability and solvency of many financial institutions and caused others to become insolvent or illiquid.

Initially, Congress set the affordable-housing requirement at 30 percent—30 percent of the loans the GSEs bought from originators had to be loans to LMI homebuyers. In the succeeding fifteen years, HUD tightened and extended these requirements so that by 2007, 55 percent of all loans had to qualify as affordable-housing loans to LMI borrowers. HUD also added various subgoals that required loans to borrowers at or below 80 percent and 60 percent of area median income.

HUD’s increasingly aggressive affordable-housing requirements put Fannie and Freddie into competition with FHA, the banks that were subject to the CRA, and a group of subprime lenders who had pledged to HUD that they would reduce underwriting standards to make mortgage financing more available for low-income borrowers. With all these entities competing for the same borrowers, it was simply not possible to find enough prime borrowers among the targeted LMI group to meet HUD’s demands. To find goals-eligible loans, the GSEs and others had to reduce their mortgage underwriting standards. In my view, this is the only plausible explanation for why mortgage underwriting standards declined so significantly between 1992 and 2007.

To illustrate what happened to mortgage underwriting standards during this fifteen-year period, consider down-payment requirements. By 2000, Fannie Mae was offering to buy loans with zero down payments. As described below, originators found that they could make loans to people with little or no down-payment resources and still sell those loans to Fannie or Freddie. Between 1997 and 2007, Fannie and Freddie bought over $1 trillion in mortgages with down payments of 5 percent or less. In 1990, only one in two hundred purchase money mortgages (that is, not refinances) had a down-payment requirement of less than 3 percent, but by 2007 almost 40 percent of all purchase money mortgages had down payments of that size. The credit quality of borrowers also declined. Between 1997 and 2007, Fannie and Freddie bought $1.5 trillion in subprime loans and over $600 billion in loans with other deficiencies that would have made them unsalable in 1990, and officials of Fannie and Freddie attended meetings of mortgage originators to ask for more subprime loans.

**HUD’s Role**

Although there might be some question about whether HUD intended this result, and thus whether the decline in underwriting standards was a deliberate policy of the US government, HUD made no effort to hide its purposes. In statements over several years, the department made clear its intent to reduce mortgage underwriting standards. I have included three of these statements below, the first made in 2000 when HUD was increasing the affordable-housing goals for Fannie and Freddie:

> Lower-income and minority families have made major gains in access to the mortgage market in the 1990s. A variety of reasons have accounted for these gains, including improved housing affordability, enhanced enforcement of the Community Reinvestment Act, more flexible mortgage underwriting, and stepped-up enforcement of the Fair Housing Act. But most industry observers believe that one factor behind these gains has been the improved performance of Fannie Mae and Freddie Mac under HUD’s affordable lending goals. HUD’s recent increases in the goals for 2001–03 will encourage the GSEs to further step up their support for affordable lending. (emphasis mine)

Similarly, in 2004, when HUD was again increasing the affordable-housing goals for Fannie and Freddie, the department stated:

> Millions of Americans with less than perfect credit or who cannot meet some of the tougher underwriting requirements of the prime market for reasons such as
inadequate income documentation, limited down-payment or cash reserves, or the desire to take more cash out in a refinancing than conventional loans allow, rely on subprime lenders for access to mortgage financing. If the GSEs reach deeper into the subprime market, more borrowers will benefit from the advantages that greater stability and standardization create.11 (emphasis mine)

Finally, the following statement appeared in a 2005 report commissioned by HUD:

More liberal mortgage financing has contributed to the increase in demand for housing. During the 1990s, lenders have been encouraged by HUD and banking regulators to increase lending to low-income and minority households. The Community Reinvestment Act (CRA), Home Mortgage Disclosure Act (HMDA), government-sponsored enterprises (GSE) housing goals and fair lending laws have strongly encouraged mortgage brokers and lenders to market to low-income and minority borrowers. Sometimes these borrowers are higher risk, with blemished credit histories and high debt or simply little savings for a down payment. Lenders have responded with low down payment loan products and automated underwriting, which has allowed them to more carefully determine the risk of the loan.12 (emphasis mine)

These statements are strong evidence that the decline in mortgage underwriting standards between 1992 and 2007 did not just happen; nor was it the result of low interest rates, flows of funds from abroad, or any of the other events or conditions suggested by the commission majority and the THH dissenters. HUD intended the direct effect of its policies, which placed Fannie and Freddie into competition with other government agencies and other financial institutions that were effectively under the government’s control—all of which were seeking loans to the same LMI borrowers. Because there were only a limited number of prime borrowers among the low-income groups targeted by government social policies, all these competing entities had to lower their underwriting standards to find the borrowers they needed to meet their government-imposed quotas. That, in summary, is the discussion in my dissent on why there were so many subprime and other high-risk mortgages in the US financial system when the housing bubble deflated in 2007. In contrast, neither the majority report nor the THH dissent had a plausible explanation for the decline in underwriting standards. In both cases, this decline was treated as something that happened as a result of low interest rates or greater capital availability, without any explanation of why these factors would have that effect. With that view, they could only—at best—tell half the story of the financial crisis.

The Majority Report

Because of its refusal to consider the reasons for the decline in underwriting standards, the commission majority was forced to argue that the low quality of so many loans in the US financial system resulted from a failure to regulate loan originators, especially mortgage brokers. As is true throughout the majority report, the discussion in this area is critical of certain practices in the market but educes no data on how widespread these practices were or how significant they might have been in contributing to the financial crisis.

In any event, what the majority report failed to recognize or communicate is that brokers do not finance mortgages. Before they make a mortgage, they must have a buyer to provide the financing. The reason that brokers were so active during the housing boom is that they could always find a buyer for the mortgages they were originating—and most of the time that buyer was Fannie, Freddie, FHA, a subprime lender involved in a HUD program, or a bank that needed certain kinds of mortgages to comply with the CRA. If those government mandates had not existed—if the GSEs and others had not been required by law to buy affordable-housing loans—many fewer subprime and other risky mortgages would have been originated. Subprime lending would have remained what it was before 1992, a niche business. Instead, the commission majority argued that the brokers were the source of the problem—as though regulating their activities was the solution to excessive subprime lending rather than ending the government mandates that made it possible for brokers, whether unscrupulous or honest, to find buyers for the subprime or other risky mortgages they originated.

The commission majority ended this portion of its report by concluding that “there was untrammeled growth in risky mortgages. Unsustainable, toxic loans polluted the financial system and fueled the housing bubble.”13 This statement is correct if one considers the 27 million subprime and other risky loans that existed in the US financial system before the financial crisis. However, the commission majority failed to produce data that connect the abusive practices the report condemns, such as
yield-spread premiums, to any given number of subprime or otherwise risky loans. Without this data, it is impossible for anyone to conclude that abusive lending practices or predatory lending had any significant effect on the financial crisis. This is true throughout the commission majority’s report. Because the majority refused to do a thorough analysis of why and how so many subprime and other risky loans were originated, they were left to claim that “toxic loans polluted the financial system and fueled the housing bubble” without any supporting evidence.

There is some irony here. Although no statistics for the prevalence of predatory lending were ever produced, the commission majority identified it as a cause of the housing bubble and, presumably, the financial crisis; yet, even though the commission had data showing that Fannie and Freddie had made 12 million subprime and other risky loans—enough to drive them into insolvency—it concluded that the role of these two GSEs in the crisis was only “marginal.” The political bias in this conclusion is clear.

Sometimes, the commission majority’s efforts to protect Fannie and Freddie were unintentionally humorous. One example involves piggyback loans. Fannie and Freddie were required by their charters to limit their purchases to mortgages with loan-to-value ratios of no more than 80 percent, unless the borrower paid for mortgage insurance. “Worried about defaults,” the commission majority intones, “the GSEs would not buy mortgages with down-payments below 20% unless the borrower bought mortgage insurance.” By 2000, however, as I report in my dissent, Fannie was offering to buy loans with no down payment and no mortgage insurance. How did it do this? The commission report is a bit cagier: “Unluckily for many homeowners, for the housing industry, and for the financial system, lenders devised a way to get rid of the [insurance requirement] that had added to the cost of homeownership” (emphasis mine). The answer that the lenders purportedly thought up was the piggyback mortgage in which, as the commission reports, “[t]he lender offered a first mortgage for perhaps 80% of the home’s value and a second mortgage for another 10% or even 20%. . . . Lenders liked them because the smaller first mortgage—even without mortgage insurance—could potentially be sold to the GSEs”14 (emphasis mine).

The commission makes clear that piggyback loans were risky: “[T]he piggybacks added risks. A borrower with a higher combined [loan-to-value ratio] had less equity in the home. In a rising market, should payments become unmanageable, the borrower could always sell the home and come out ahead. However, should the payments become unmanageable in a falling market, the borrower might owe more than the home was worth. Piggyback loans—which often required nothing down—guaranteed that many borrowers would end up with negative equity if house prices fell.”15 So the commission majority starts its discussion with a statement that suggests the GSEs were cautious and conservative (they were “worried about defaults” and so “would not buy mortgages with downpayments below 20%”), but ends with a description of a common transaction—the piggyback loan—in which Fannie and Freddie bought loans with no down payment and no mortgage insurance, loans the commission majority itself characterizes as risky. Given that Fannie was offering a zero down payment mortgage in 2000, without any mortgage insurance, it is obvious that the firm knew it was buying loans with piggyback mortgages and no down payment at all. In fact, in 2008, both Fannie and Freddie disclosed in their 10-K forms that they had made sizable purchases of piggyback loans that had materially added to their exposure of loans with down payments of 5 percent or less.

This example confirms several important points in my dissent: the GSEs bought risky loans that were bad for borrowers because they had no down payment and that led to defaults when the bubble deflated; they both hid and enhanced their risk taking by evading the mortgage-insurance requirement through piggyback loans; and the commission majority was not candid about the GSEs’ role in the financial crisis—in this case, suggesting that “lenders” made up the whole piggyback idea so they could sell the loans to Fannie and Freddie, as if Fannie and Freddie did not realize what they were buying. Despite this inculpatory discussion, the commission majority was still able to claim that the role of Fannie and Freddie in the financial crisis was “marginal.” There is little doubt that the affordable-housing requirements impelled Fannie and Freddie to enter into these risky transactions; apparently, the commission majority was unable to accept this fact.

The THH Dissent

The errors in the THH dissent are of a different order. I will not make any overall judgment about that dissent, but
simply explain why I could not join it. This discussion will consider an op-ed the THH dissenters published in the Wall Street Journal\(^6\) on the same day that the majority report was released, as well as their dissent itself. In the Journal article, they argue that both the majority report and my dissent are too simple as explanations of the financial crisis. Instead, they “subscribe to a third narrative—a messier story that emphasizes both global economic forces and failures in US policy and supervision. Though our explanation of the crisis doesn’t fit conveniently into the political order in Washington, we believe that it is far superior to the other two.”\(^17\)

Both the Journal article and the THH dissent say that “the crisis was the product of ten different factors. Only when taken together can they offer a sufficient explanation of what happened.” This is a “perfect storm” analysis, in which the event in question—the financial crisis—only occurred because the stars were aligned in a particular way. If all ten factors were really necessary for the financial crisis to occur, however, we need not worry about another crisis. The statistical likelihood that all these elements will again come together at the same time is vanishingly small. This explanation is not only inherently implausible but also provides no guidance to policymakers about what actions they should take to prevent a recurrence.

There are several respects in which this dissent is similar to the majority report. First, it has no explanation to support its assertion that “tightening credit spreads, overly optimistic assumptions about US housing prices, and flaws in primary and secondary mortgage markets led to poor origination practices.” Since poor origination practices—that is, low mortgage underwriting standards—were the principal reason that the US financial system was weighed down with subprime and other risky loans, it was incumbent on the THH dissenters to explain how these factors led to low underwriting standards. They never do. Second, in attempting to explain the proliferation of low-quality mortgages in the US financial system, they identify “easy financing,” “ineffective regulatory regimes,” “irresponsible lenders,” and “lenient regulatory oversight” of mortgage originators—all ideas that dominated the commission majority’s report—but do not explain why mortgage underwriting standards declined in the first place. As noted above, none of these elements would have resulted in a proliferation of low-quality loans unless there were buyers with reduced mortgage underwriting standards. There were such buyers: government agencies, GSEs, and banks subject to the CRA, all of which were operating under government-mandated requirements that forced them to reduce their underwriting standards.

Finally, and most troubling, is the THH dissent’s focus on risk management, which also parallels the commission majority’s report. As they put it, “An essential cause of the financial and economic crisis was appallingly bad risk management by the leaders of some of the largest financial institutions in the United States and Europe.” This idea was supplemented in the Journal article with this statement: “ Managers of many large and midsize financial institutions amassed enormous concentrations of highly correlated risk . . . and they amplified this risk by holding too little capital relative to the risks and funded these exposures with short-term debt . . . . They assumed such funds would always be available. Both turned out to be bad bets.” No data are presented for these statements.

As it happens, there are data on the question of asset concentrations, and they seem to contradict the statement that financial institutions held “enormous concentrations” of high-risk mortgages. Inside Mortgage Finance, a major source for data on mortgages and MBS, publishes an annual report on mortgage-related holdings of financial institutions. These data show that in December 2008 all US financial institutions (excluding Fannie and Freddie and the Federal Home Loan Banks) held a total of $951 billion in MBS not guaranteed by Fannie or Freddie.\(^18\) The Fed’s flow of funds data indicate that the assets of all these institutions at that time totaled $40 trillion.\(^19\) Accordingly, the nonagency MBS held by all US financial institutions was about 2.4 percent of their total assets. That does not sound like an “enormous concentration.” If we just look at commercial banks, they had $13 trillion in assets and held $210 billion in MBS,\(^20\) again representing 1.6 percent of assets and roughly 20 percent of capital. Inside Mortgage Finance also has data for the top twenty-five bank holding companies. If we look just at the top four bank holding companies, we get the same result ($5 trillion in assets and $110 billion in nonagency MBS again equals approximately 2 percent of assets and 20 percent of capital).\(^21\) In contrast, during the early 1980s, the major US banks held debt of Brazil, Argentina, and Mexico—all of which were unable to meet their dollar obligations, which were 147 percent of the capital of the eight largest US banks.\(^22\) Moreover, the total bank holdings include all MBS, not just those backed by subprime or other risky mortgages; accordingly, the holdings of the so-called “toxic assets” would have been smaller. But going beyond data, it is troubling that the THH dissenters believe that a generalized failure of risk management was a cause of the crisis.
First, the idea is inherently implausible. Given the widespread nature of the financial crisis, a very large number of financial institutions in all developed countries would be subject to this criticism. Since virtually all of them were in trouble in the crisis, there would have been what might be called a universal failure of proper risk management throughout the financial markets. Needless to say, it is highly unlikely that the managements of all the world’s major financial institutions would become incompetent at the same time. In the real world, some banks and financial institutions fail, but others are better managed and survive. This suggests that something happened to create the financial crisis that was beyond the experience and expectations of the managements of all these institutions. My dissent suggests what that was: the collapse of the US housing bubble and the sudden appearance in late 2007 of an unprecedented number of delinquencies and defaults among the 27 million subprime and other high-risk loans outstanding in the United States. This caused the collapse of the MBS market. Criticizing the managements of all the world’s major financial institutions without understanding the facts of which they were aware at the time is the purest hindsight.

Second, by suggesting—along with the commission majority—that a major cause of the financial crisis was the wholesale failure of bank and financial-institution management, the THH dissent endorsed a policy foundation for more regulation as well as the underlying rationale for the Dodd-Frank Act. After all, if the managements of virtually all the world’s financial institutions cannot be trusted to manage their firms, then—to protect the public—governments must oversee them. Yes, it is all hindsight, and highly implausible, but that is exactly the rationale that the Democratic Congress used in designing and enacting the Dodd-Frank Act—and, unfortunately, the implicit policy message of the THH dissent.

Conclusion

There is powerful evidence that the financial crisis was caused by government housing policies and not by a lack of regulation or the simultaneous failures of risk management among the world’s largest financial institutions. Under these circumstances, as I state in my dissent, there is reason to doubt that the Dodd-Frank Act was necessary to prevent another financial crisis. It is more likely that a change in government housing policy would provide greater protection against another financial crisis than the Dodd-Frank Act, with none of the adverse effects that the act is likely to have on economic growth in the United States.

Notes

7. Although not the focus of this Outlook, the effect of the bubble’s growth on the development of a huge market in MBS backed by subprime loans is important to note. As a housing bubble grows, it tends to suppress delinquencies and defaults. Homeowners who cannot meet their mortgage obligations can refinance or sell the home for more than the mortgage obligation. As the US bubble grew, investors around the world saw that MBS backed by subprime mortgages were producing high yields but not showing losses commensurate with the risk. Thus, government policies, in stimulating the growth of the bubble, also were responsible for the development of the private market in MBS backed by subprime loans.
9. Ibid., 60.
11. US Department of Housing and Urban Development, HUD’s Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD’s Regulation of


13. Ibid., 101.


15. Ibid.


17. Ibid.


21. Ibid., 283.