American Enterprise Institute for Public Policy Research

Financial Services Outlook

April 2010

Crisis and Ideology: The Administration's Financial Reform Legislation

By Peter J. Wallison

The Obama administration's financial regulation plan, faithfully replicated in Senator Christopher Dodd's bill, raises the question of whether its purpose is actually to address the causes of the financial crisis or—like ObamaCare—to put the government in control of yet another sector of the U.S. economy. Federal Reserve regulation of all large, nonbank financial institutions—as required by the Dodd bill—would signal to the market that these institutions are too big to fail. Meanwhile, the creation of a $50 billion rescue fund to be managed by the Federal Deposit Insurance Corporation (FDIC) will assure creditors that they will be bailed out if one or more of these large institutions are in danger of failing. Both provisions will substantially restructure the financial markets and the U.S. economy by favoring large financial institutions over their small competitors. This makes sense only if the administration is pursuing an ideological objective instead of striving to ensure a healthy and competitive U.S. financial system in the future.

In his 1987 book, *Crisis and Leviathan*, Robert Higgs attempts to explain why the U.S. government continues to grow ever larger.[1] His thesis is that the stimulus for government growth, particularly in the twentieth century, has been societal crises—wars, depressions, and other calamities. Higgs points out that no other explanation—an increasingly complex society, redistributional impulses, or ideology—can fully explain why the U.S. government grew so rapidly over these years.

The Higgs analysis is compelling; we see elements of it daily. As Higgs observes, in a crisis, "few people outside government have enough information to identify the precise contours of the emergency or to formulate comprehensive plans for dealing with it. Citizens tend simultaneously to demand (a) more governmental action and (b) less research, public consultation, debate of alternatives and general 'due process' in governmental decision-making."[2] It is easy to see how citizens' easy approval and desire for speed in a time of crisis can result in an expansion of government. The Sarbanes-Oxley Act of 2002 is an example of this phenomenon—a sweeping and costly expansion of federal regulatory powers in reaction to a number of corporate and accounting scandals. Higgs's work, however, goes a step further and

Key points in this *Outlook*:

- The Obama administration's financial regulatory proposals fail to address what virtually every report about the financial crisis has concluded—that the crisis was caused by the failure of vast numbers of subprime and other nonprime loans.
- Despite claims that these proposals are designed to control large Wall Street financial institutions, they actually provide competitive advantages to the largest firms, threatening the competitive positions of smaller competitors.
- If adopted, the administration's regulations would establish an unprecedented and unhealthy partnership between the government and the country's largest financial institutions; as with Fannie Mae and Freddie Mac, the government will protect the largest firms from failure in return for their willingness to implement the government's policies.
- Taken as a whole, the administration's proposals suggest an ideological agenda focused on controlling another sector of the economy.

Peter J. Wallison (pwallison@aei.org) is the Arthur F. Burns Fellow in Financial Policy Studies at AEI.

asks why, after the crisis is past, the government does not return to its prior size. His answer also describes what we see occurring: "Crises lead to permanent shifts in the tolerable limits of the true size of government. Crises break down ideological resistance to Big Government."[3]

The Obama Administration and the Role of Ideology

In one respect, however, Higgs's analysis seems misplaced. In his view, ideology arises from the political demands a crisis creates and is subsequently used to maintain the size of the government that results. But with the advent of the Obama administration, it is clear that ideology is a driving force in itself, pushing government to grow larger with or without a crisis. Two current legislative examples—the recent health care legislation and the Obama administration's behavior following its passage—illustrate this point. The health care legislation, which massively increased the government's role in the U.S. health care system, was not a response to a crisis; it was rammed through a reluctant Congress—against the wishes of the American people as expressed in numerous polls—because the political Left believed that a heavily Democratic congressional majority and a president committed to reform had created a fleeting historical moment. Thus, a substantial expansion of government occurred without any discernible crisis, brought about by the ideological commitment of a temporary majority.

Ideology is a driving force pushing government to grow larger with or without a crisis.

The Obama administration's behavior following the enactment of its health reform proposals also demonstrates the driving force of ideology. Despite the administration's frequent statements that it was eager to move beyond the health care debate so President Barack Obama could "pivot" toward what was really at the top of the public's agenda—the economy and jobs—that shift in attention clearly has not occurred. Instead, without any comment in the media, the administration has lined up other policies it wants to pursue, including financial regulation, climate change, energy, education, and perhaps even D.C. statehood. The administration surely knows that failing to address the jobs issue will be disastrous at the polls next November, but it and the leaders of Congress seem ready to sacrifice their congressional majorities in order to achieve the greater government control over the economy that their ideology demands.

An ideological commitment of this magnitude is highly unusual—perhaps unprecedented—in American politics. Even during the New Deal, most administration actions seemed motivated by a pragmatic (although ultimately ineffective) desire to address the high level of unemployment in the Great Depression. President Franklin Delano Roosevelt advertised that he would try anything until something worked. The Obama administration's actions do not have that character; instead, they seem focused on achieving certain goals in this Congress, during the brief period that this opportunity exists.

Contrary to Higgs's thesis, then, this appears to show that ideology can be a principal element in the growth of what Higgs calls Big Government. Indeed the existence of a crisis becomes an argument for doing what various officials would want to do anyway, but could not—a point made abundantly clear by the iconic statement of Rahm Emanuel, the president's chief of staff, that new and comprehensive financial regulation should be pursued now because "you never want a serious crisis to go to waste."[4]

If an ideological objective is the principal focus of policymaking, there is much less interest in the long-term effects of policies. Ideology dictates that the goal is to put the plan into effect and worry about the consequences later. This, again, is far different from the usual approach adopted in Congress. While the congressional mill operates painfully slowly for some, it grinds exceedingly fine. When significant changes occur, they are usually the result of serious and long-term deliberation, which often has taken place over the course of several congressional sessions. When these policies are finally adopted, they represent a kind of consensus, even if the ultimate vote is distinctly partisan. The initiative's survival over many Congresses demonstrates its enduring support in the population. That is not what we saw with ObamaCare, nor does it appear to be happening with other policy initiatives that have been pushed by the current administration.

Ideological Use of the Financial Crisis

The Bush administration's approach to the financial crisis was different; it seemed dominated by a pragmatic desire to "do something." Whether or not one agrees with them, the rescue of Bear Stearns in March 2008, the subsequent request for funds under the Troubled Asset Relief Program, and the use of emergency resources by the Federal Reserve and Treasury were practical attempts to address the investor panic that arose as the banks and the financial

system began to falter. These steps undoubtedly increased the role of government in the economy, but the Bush administration seemed to make efforts—even at that early stage—to avoid using the enhanced government power it had accumulated to direct or channel private-sector activity.

The Obama administration assumed office with a different view. During the preceding campaign, Obama had argued that the financial crisis was caused by "Republican deregulation." There is little evidence to support this claim. The history of bank regulation during the twentieth century is a history of gradual tightening after each financial crisis occurred. The most recent restraints and regulatory authorities were conferred in the Federal Deposit Insurance Corporation Improvement Act of 1991, put in place after the savings and loan crisis of the late 1980s (when almost 1,600 commercial banks also failed). As a result, banks are the most heavily regulated sector of our economy, and the fact that they got into the most trouble in the financial crisis shows that regulation is far from the panacea many seem to assume. The bailout funds that the American people most resent went to the institutions that have been most thoroughly under government control: the banks and the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. No bailout funds were used to rescue a hedge fund, and hedge funds as a group—completely unregulated—suffered fewer losses for their investors than heavily regulated banks.

The existence of a crisis becomes an argument for doing what various officials would want to do anyway, but could not.

The use of candidate Obama's campaign slogan as a basis for profound policy change was part of the administration's ideological focus from the outset, and this allowed it to ignore evidence of the government's own responsibility for the financial crisis. Almost every study of the crisis has acknowledged that it began with the deflation of a housing-price bubble in late 2006 and early 2007. We have had housing bubbles before, but they never caused a worldwide financial crisis. The reason this bubble was different is because, this time, almost half of all mortgages in the financial system—27 million loans[5]—were subprime or Alt-A mortgages. These inherently weak and high-risk loans were ready to default as soon as the housing bubble stopped growing. That the U.S. financial system was suffused to this extent with weak and high-risk mortgages is without precedent and certainly unusual enough to trigger a financial crisis.

Of course, the important policy question is why so many mortgages in the U.S. financial system were high-risk loans before the financial crisis occurred. The answer is not hard to find. According to the work of mortgage expert Edward Pinto,[6] two-thirds of these loans were held or guaranteed either by the U.S. government or by government-backed and controlled institutions like Fannie Mae and Freddie Mac. This fact suggests strongly that the vast number of weak mortgages that have been universally implicated in the financial crisis were made as a result of a government policy to increase homeownership in the United States. When these loans began to default at the end of 2006 and the beginning of 2007, they caused an unprecedented decline in U.S. housing prices and raised doubts about the solvency and stability of the financial institutions that had invested in them, either directly or through mortgage-backed securities. It was the failure of large numbers of private institutions—Bear Stearns, Lehman Brothers, American International Group, Wachovia, Washington Mutual, IndyMac, Countrywide, and many others—that caused the worldwide investor panic that we know as the financial crisis. There is strong evidence, however, that the crisis would not have happened if the U.S. government had not stimulated, through government-backed funding, the origination of the subprime and Alt-A loans that ultimately weakened the financial system. To prevent a future crisis, then, all that would have been necessary was to change U.S. government policy; there was and is no need to bring the entire financial system under government control.

That, however, is not the approach the administration has taken. The financial regulation legislation now before Congress says nothing about government housing policy or the role that Fannie Mae and Freddie Mac may have played in creating the massive number of subprime and Alt-A mortgages that ultimately brought down the financial system. It does not even say anything about significant improvements in the system that failed to regulate banks adequately. Instead, following the ideological agenda of the Left, the administration's regulatory proposal and the Dodd bill[7] use a crisis that may have occurred solely because of government policy as a pretext to extend to the financial system as a whole the same failed regulatory regime that had previously been applied only to the banks.

The Crisis and the Power to Control the Financial System

Two provisions of the administration's plan are key to understanding its purposes. The Dodd bill, following the administration's initial proposal, would authorize the Federal Reserve to regulate large, nonbank financial institutions that are designated as systemically significant and would authorize the FDIC to take over and resolve failing financial institutions outside the normal bankruptcy process. Both of these provisions will bring the financial industry under the control of the government and substantially change competitive conditions in financial markets and the economy generally. Among other adverse effects, large companies would be favored over smaller ones, the U.S. financial-services industry would morph from a competitive and innovative system—with many large and small competitors—into a system dominated by large institutions that are virtual wards of the government, and successful financial firms would prosper through effective representation in the power corridors of Washington rather than competition in the marketplace.

The designation of certain firms for special regulation and supervision by the Fed will pose a serious challenge to the competitive financial system we have today.

How this would happen is reasonably clear. Identifying large financial institutions as systemically important and placing them under regulation by the Fed will signal to the financial markets that these firms are too big to fail. There is little question about this. The whole rationale for regulating large institutions is that their failure could bring down other firms and cause some kind of systemic breakdown. Indeed, simply being regulated by the Fed can persuade the financial markets that a firm will not be allowed to fail. This was demonstrated when Goldman Sachs and Morgan Stanley decided to become bank holding companies subject to Fed regulation during the financial panic in the fall of 2008. As bank holding companies, they had no legal right to access the Fed's discount window, but the market clearly believed that the Fed would provide them with whatever funds they needed to meet their obligations; once these two investment banks moved under the Fed's wing, the panic about their financial condition subsided.

Accordingly, the competitive implications of Fed regulation for any large financial institution are stark. The first advantage is financial; firms that are seen as too big to fail will have easier access to credit at lower costs than smaller firms. There are also advantages in selling products. Consider the insurance industry. Several large insurance companies are likely to be among the firms designated as systemically significant and thus subject to Fed regulation. Potential customers will undoubtedly be told that they will be better protected if they buy insurance from these specially regulated and too-big-to-fail firms rather than smaller firms that might be allowed to fail. This will be a significant competitive advantage that will not be overcome by the additional costs of whatever regulation the Fed imposes.

Similar competitive advantages in their respective industries will accrue to other large institutions regulated by the Fed under the administration's plan. That is why Senator Richard Shelby (R-Ala.) was correct to suggest that the Dodd bill—which largely recapitulates the administration's original plan—will create new Fannies and Freddies in every area of the financial system in which large institutions are designated as systemically significant.[8] Because Fannie and Freddie were considered to be government backed and too big to fail, their funding costs were lower than any potential competitor, and they were able to drive all other firms from the market for prime middle-class mortgages. For this reason, the designation of certain firms for special regulation and supervision by the Fed will pose a serious challenge to the competitive financial system we have today.

As authorized in the Dodd bill, the Fed's control of large, nonbank financial institutions—securities firms, insurance companies, hedge funds, finance companies, and any other financial institution designated as systemically important—will be almost total. The agency will have control over their capital, leverage, liquidity, competitive activities, and ability to expand or merge. It will even have the power to break them up. This means that these firms will feel compelled to follow the directions of their regulator on every major policy or competitive issue. They will no longer be independent and innovative competitors, but government-controlled institutions. Each will have to pay more attention to what Washington wants them to do than to what competition would demand.

Some commentators have argued that the administration's proposals are socialistic, but this is surely wrong. Socialism implies that the government owns the means of production. The administration's plans are far closer to the corporative model, in which there is a kind of partnership

between the government and large, privately owned enterprises. These do the bidding of the government in exchange for the competitive advantages and financial protections that come with government control. The bald pursuit of this objective is astonishing. BusinessWeek.com recently reported that top administration officials warned the largest banks to stop opposing the administration's plan.[9] As my AEI colleague Michael Barone wrote, "In other words, abandon your First Amendment right to petition the government for a redress of grievances. Or to put it in Chicago language, Nice little bank ya got here. Wouldn't want anything to happen to it."[10]

The plan is also unworkable in practice. If adopted, the Fed would have to achieve a competitive balance among many different and competing business models, assigning capital and liquidity requirements to, say, insurance companies, without giving them competitive advantages over hedge funds or bank holding companies. Only the market can do this effectively; there is no indication that any regulatory body, including the Fed, could make such choices other than arbitrarily.

Finally, authorizing the FDIC to resolve large, nonbank financial institutions outside the bankruptcy system will have the same anticompetitive effect as declaring these institutions to be too big to fail. The Dodd bill would create a $50 billion fund available for resolving these institutions. This would alert creditors that loans to firms that might be resolved through the use of this fund are more likely to receive better treatment if the firm fails than loans to smaller companies that will be sent to bankruptcy. This advantage will result in lower capital and credit costs for large institutions than for smaller ones and will again upset the competitive balance in every industry in which these large institutions function. But the elimination of the fund would not make the problem go away. What will be substituted is the power to assess the financial industry for whatever costs the government incurs in taking over large failing institutions. In that case, without any ultimate costs to the government, regulators will have virtually the same incentive to rescue the creditors of failed or failing financial institutions, and this again will perpetuate the notion that some institutions are too big to fail.

At first, it does not seem possible that any administration would offer a legislative proposal with such potentially revolutionary consequences for the economy, but if the objective is to attain an ideological goal—extending government control over the financial system—it all becomes disturbingly clear.

Notes

1. Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (New York: Oxford University Press, 1987).

2. Ibid., 64.

3. Ibid., 73.

4. Rahm Emanuel, quoted in Gerald F. Seib, "In Crisis, Opportunity for Obama," *Wall Street Journal*, November 21, 2008.

5. Edward Pinto, "Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08" (memorandum, n.p., June 30, 2008), available at www.aei.org/docLib/Pinto-Sizing-Total-Federal-Contributions.pdf; Edward Pinto, "Sizing Total Exposure to Subprime and Alt-A Loans in U.S. First Mortgage Market as of 6.30.08" (memorandum, n.p., June 30, 2008), available at www.aei.org/docLib/Pinto-Sizing-Total-Exposure.pdf; and Edward Pinto, "High LTV, Subprime and Alt-A Originations over the Period 1992–2007 and Fannie, Freddie, FHA and VA's Role" (memorandum, n.p., n.d.), available at www.aei.org/docLib/Pinto-High-LTV-Subprime-Alt-A.pdf.

6. Ibid.

7. *Restoring American Financial Stability Act of 2010*, S. 3217, 111th Cong., 2d sess., Open Congress (April 15, 2010), available at www.opencongress.org/bill/111-s3217/show (accessed April 19, 2010).

8. Richard Shelby to Timothy F. Geithner, Washington, DC, March 25, 2010, available at www.politico.com/static/PPM152_100325_shelby_geithner.html (accessed April 19, 2010).

9. Juliana Goldman and Alison Vekshin, "White House Urges Blankfein, Dimon to Stop Bill Fight," BusinessWeek.com, April 14, 2010, available at www.businessweek.com/news/2010-04-14/blankfein-dimon-urged-by-white-house-to-stop-fighting-rules.html (accessed April 19, 2010).

10. Michael Barone, "Gangster Government Returns: Nice Little Bank Ya Got There . . . ," *Washington Examiner* Beltway Confidential, April 14, 2010, available at www.washingtonexaminer.com/opinion/blogs/beltway-confidential/Gangster-government-continued-90856314.html (accessed April 19, 2010).