Dodd-Frank Bill Doesn't Right What Fed Got So Wrong

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By Eric Grover

The 2,323-page Dodd-Frank Wall Street Reform and Consumer Protection Act would impose an enormous regulatory burden on the financial services industry and do little to prevent another financial crisis.

It is not yet, however, a done deal.

The bill was falsely sold as essential to preventing the next financial debacle. It doesn't, however, address the principal causes of the housing bubble, mortgage meltdown and consequent financial crisis.

Easy Fed credit, the politicization of credit and the government's systematic weakening of mortgage underwriting standards, not insufficient regulation, were the culprits.

Yes, there's greed on Wall Street. In the private sector self-interest drives wealth creation. In the public sector, however, self-interest is dangerous.

Private-sector mistakes self-correct. Finance companies making too many bad loans go belly up. Resources are reallocated to better uses. In contrast, government errors beget further interventions and mistakes.

The Fed's easy credit stoked the housing bubble, overextension of credit and ensuing crash. From 2001 to 2005 the real Fed funds rate was negative. Dodd and Frank's putative reform does nothing to address the Fed's mispricing of credit.

Worryingly, Obama is packing the Fed's board with monetary doves. He reappointed "Helicopter" Ben Bernanke as chairman and nominated superdove Janet Yellen, regulator Sarah Bloom and economist Peter Diamond to fill board vacancies, all but guaranteeing the Fed will keep real interest rates near zero, priming the next bubble.

To increase homeownership and loans to politically favored groups, the government gutted credit standards.

In 2003 Barney Frank enthused, "I want to roll the dice a little bit more in this situation toward subsidized housing." Fannie Mae and Freddie Mac cheerleader Maxine Waters said, "We do not have a crisis at Freddie Mac, and in particular at Fannie Mae. … In fact, the GSEs have exceeded their housing goals." Therein lies the problem.

HUD demanded Fannie and Freddie increase the percent of mortgages they bought or guaranteed for less-affluent Americans. HUD gave them 2006 targets 53% of mortgages should be low and moderate income and 38% to underserved area borrowers.

Fannie and Freddie exceeded their bogeys, purchasing 3.7 million mortgages for "low-and-moderate-income families," 1.8 million for "very-low-income" or "low-income-families in low-income neighborhoods" and 2.1 million from "underserved areas."

Lo, from the fourth quarter of 2006 to the fourth quarter of 2009 mortgage chargeoffs ballooned by 1,820%.

With taxpayers pouring money into failed, now-80%-government-owned mortgage Goliaths Fannie and Freddie, it will get worse. Real reform would privatize and break them up into businesses small enough that each would be allowed to sink or swim.

The market and the possibility of failure for shareholders, creditors and management are a better regulator and steward of the public interest than Washington mandarins.

CRA was used to force banks to make loans to politically favored borrowers they would not otherwise have made. Genuine reform would permit credit to be allocated on economic merits.

At least America's top 10 financial institutions are "too big to fail," with attendant moral hazard. Dodd and Frank enshrine "too big to fail." It's not at all clear, however, that the time-tested bankruptcy process wouldn't be entirely adequate to deal with a colossus such as Bank of America if it failed. Dodd and Frank should define "too big to fail" and make the case for breaking up institutions above the threshold.

Much of their bill doesn't even offer a fig leaf for addressing the financial crisis.

A Consumer Financial Protection Bureau would be established, defining products, how they can be delivered and who they can be sold to. It would smother innovation and restrict consumer choice. Consumers responsible enough to vote for Chris Dodd may be held not competent to choose a credit card. Self-anointed consumer activists lobbied hard for the bureau. In a world where consumer credit products' material features are disclosed and sovereign consumers manage their financial affairs by their compasses, there isn't a big role for consumer activists.

Diversity czars would be planted in each regulatory agency, further politicizing credit.

At the merchant lobby's behest, punitive price controls would be imposed on debit cards' primary revenue source — interchange fees. Banks would raise cardholder fees and slash benefits.

Merchants obtaining price concessions in Washington they can't in the market is a kind of Mafioso capitalism with government being used to transfer wealth from cardholders to retailers. Walgreen and Wal-Mart should get the best deal they can negotiate in the market, nothing more, nothing less.

However, government benefit cards, reloadable consumer cards and card issuers with less than $10 billion in assets would be exempt. Not because their interchange is fairer, but rather because they are politically sympathetic, whereas Goliath banks are pariahs.

Passing Sen. Feingold's test — would it prevent the next crisis? — is a necessary but not sufficient condition for supporting the bill. It wouldn't prevent another crisis.

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