Solving the financial crisis by causing another

by Eric Grover

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There appears to be appetite on Capitol Hill to take another stab at financial-system reform. The House Financial Services Committee's top Democrat, Rep. Maxine Waters, recently scolded bankers in the industry's flagship newspaper, the American Banker. The op-ed, titled "How to prevent another financial crisis," underscores how difficult it will be. She, like many hard-left Democrats, clings to the false narrative that insufficient regulation, greed and risky private-sector behavior caused the crisis and that Washington should continue to prop up the housing market.

First, one must acknowledge the problem. Government policy politicizing and weakening mortgage credit standards and the Federal Reserve's easy credit fueled unprecedented housing and subprime mortgage bubbles and the consequent crash, causing the financial crisis and Great Recession.

The views Mrs. Waters held a decade ago and still holds are what caused the financial crisis and will cause another one.

With Orwellian chutzpah, Mrs. Waters decries "irresponsible lending" and "lax mortgage standards," for which she and her ideological kin were, and continue to be, huge cheerleaders.

In 2003, she applauded "100 percent loans" — i.e., borrowers with no skin in the game. By 2006, a whopping 40 percent of U.S. mortgages had loan-to-value ratios equal to or greater than 97 percent.

She hailed government "affordable-housing goals" and praised Fannie Mae and Freddie Mac for exceeding them. Indeed they did. The Federal Housing Administration (FHA) recklessly ratcheted up Fannie's and Freddie's affordable-housing goals for more than a decade. Every year until 2008, the mortgage goliaths exceeded them. In 2007, 56 percent of

Fannie's and Freddie's mortgages were to borrowers at or below area median income.

To meet Federal Housing Administration and Community Reinvestment Act objectives, competition for less-creditworthy borrowers was intense. By 2008, 71 percent of subprime and other high-risk mortgages were held or guaranteed by the federal government.

Interest rates are the price of future versus present consumption and investment. They are the economy's most important price. The Fed kept its real funds rate at or below zero from 2001 through 2005. Notwithstanding market interest rates and a strong and stable dollar being consistent with maximum sustainable long-term economic growth and wealth creation, the Fed's dual mandate to pursue full employment and stable prices gave it license to try to pump up the economy with easy money. In spite of the resulting catastrophe, Mrs. Waters wants the central bank to keep interest rates artificially low. Dovish Fed Chairman Ben S. Bernanke has obliged, keeping the Fed funds rate near zero since 2008.

The House Financial Services Committee's ranking member writes that the Dodd-Frank law "changed the paradigm" for our financial system and will prevent a future crisis. It changed the paradigm all right — for the worse — converting banking into a public utility, but it did not address the financial crisis's root causes. Her signature contribution — a provision requiring financial regulators to open an office of minority and women inclusion — politicizes oversight. Does anyone seriously think having the Fed hire employees and suppliers based on skin color and gender rather than individual merit makes the financial system safer?

Mrs. Waters contends progress has been made "turning the economy around," noting unemployment is down. Actually, Dodd-Frank put a boot on the throat of the naturally resilient American economy. With 15 million more Americans now than in November 2007, there are 4 million fewer full-time workers. The 58.6 percent employment-to-population ratio, a better gauge of the employment situation than the unemployment rate, is hovering near a 30-year low. Real median household income is lower than five years ago. Most Americans would call that malaise, not recovery.

Mrs. Waters supports Washington supporting the mortgage market. With government buying or guaranteeing nine out of 10 mortgages originated in

2012, and the Consumer Financial Protection Bureau, the Federal Housing Administration, and Fannie and Freddie specifying features and credit-underwriting criteria, the market has been nationalized in all but name. Pressure from Realtors, mortgage brokers, homebuilders, community "activists" and politicians will inexorably erode credit standards, under the banner of promoting higher home prices and ownership.

The American Enterprise Institute's Ed Pinto warns that an FHA 30-year fixed-rate loan with 4 percent down, a 43 percent total debt ratio, and a 580599 credit score with an expected foreclosure rate of 28 percent, would be designated prime by Consumer Financial Protection Bureau logic.

The state setting credit standards and owning the risk is political rather than market discipline, for which we all pay the price.

What's to be done? Real reform would limit government's role in the mortgage market to that of the night watchman and end the Fed's dual mandate, focusing it on price stability. Sen. Bob Corker's and Sen. Mark Warner's bipartisan Housing Finance Reform and Taxpayer Protection Act, phasing out Fannie and Freddie is faux reform because it simply substitutes the Federal Mortgage Insurance Corporation as a government backstop for mortgage-backed securities. Rep. Scott Garrett's Protecting American Taxpayers and Homeowners Act would be a step in the right direction. If some Democrats break from their dogma that a greater Washington role is the solution to the disaster Washington spawned, it may have a chance.

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