PETER J. WALLISON'S

HIDDEN IN PLAIN SIGHT

WHAT REALLY CAUSED THE WORLD'S WORST FINANCIAL CRISIS—AND WHY IT COULD HAPPEN AGAIN

> "HIS EXPLOSIVE BOOK CAN'T COME SOON ENOUGH."
>
> —NEW YORK POST

The conventional narrative on the 2008 financial crisis holds that Wall Street greed and insufficient regulation of the financial system were to blame—a narrative that yielded the Dodd-Frank Act, the largest, most expensive government intrusion into financial markets since the New Deal.

But in the astonishing ***Hidden in Plain Sight* (January 13th, 2015),** Peter J. Wallison, a dissenter from the majority report of the Financial Crisis Inquiry Commission, uncovers startling new data and documentary evidence that reveals how government housing policy—*not* deregulation—fueled the subprime housing bubble that sunk the financial system.

In this clear-eyed counter-narrative, Wallison shows how federal lending quotas and a reduction in mortgage underwriting standards created a flood of toxic loans from 1997 to 2007. As one Fannie Mae official revealed in 2006, "Everybody understood that we were now buying loans that we would previously have rejected. But our mandate was to stay relevant and to serve low-income borrowers. So that's what we did."

When the crisis hit, Fannie, Freddie, and other Federal agencies were on the hook for *76% of all bad loans*—not the Wall Street banks.

Worse, the Financial Crisis Inquiry Commission swept the evidence that proved government complicity in the crisis under the rug, even censoring Wallison's dissenting opinion. The Commission's unchallenged narrative buoyed the vast (2,300 page) Dodd-

Frank Act, a bill that never seriously addressed housing policy, Fannie, or Freddie. Even today, the Obama Administration is again trying to relax underwriting standards in order to sell more homes.

Hidden in Plain Sight explains why the real lessons of the financial crisis have been ignored, and why, without a proper diagnosis of its causes, another financial crisis is surely lurking in the future.

1 The Department of Housing and Urban Development (HUD) forced Fannie Mae and Freddie Mac to reduce their underwriting standards, then blamed them for the mortgage meltdown.

2 In 2008, 76% of the subprime or otherwise weak mortgages were on the books of government agencies. Only 24% were on the books of the private sector.

3 The members of the Financial Crisis Inquiry Commission never had an opportunity to review the report as a group before it was issued. Congress adopted the Dodd-Frank Act six months *before* the FCIC reported its conclusions, showing that Congress knew what the commission would say.

4 The Group of Thirty—an international organization composed of central bankers and bank regulators under the chairmanship of Paul Volcker—proposed the fundamental elements that became Dodd-Frank only four months after the onset of the crisis, without any serious discussion of whether the causes of the crisis had been correctly assessed.

5 The six federal agencies charged under Dodd Frank with defining the terms of a high-quality prime mortgage, under pressure from the Obama administration, recently released a rule that equates a *prime mortgage* with a loan that has no minimum down payment and no required minimum credit score.

6 Because the US government's housing policies were never seen as the cause of the crisis, these policies will be repeated in the future, with the same results.

To schedule an interview with Peter J. Wallison contact:
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ABOUT THE AUTHOR

PETER J. WALLISON

Peter J. Wallison holds the Arthur F. Burns Chair in Financial Policy Studies and is codirector of the American Enterprise Institute's program on Financial Policy Studies.

"I don't remember any period in modern history when the analysis of historic economic events has been more dominated by the clear thinking of one person. That person's name is Peter Wallison."

—**PHIL GRAMM,** former chairman of the Senate Banking Committee

From June 1981 to January 1985, he was general counsel of the United States Treasury Department, where he had a significant role in developing the Reagan administration proposals for deregulating financial services. During 1986 and 1987, Wallison was White House counsel to President Ronald Reagan.

He testifies frequently before congressional committees and is a frequent contributor to the op-ed pages of the *Wall Street Journal* and other publications. He has also been a speaker at many conferences on financial services, housing, the financial crisis, the Dodd-Frank Act, accounting, and corporate governance and was a member of the congressionally authorized Financial Crisis Inquiry Commission (2009–2011). In 2011, Wallison received an honorary doctorate in Humane Letters from the University of Colorado.

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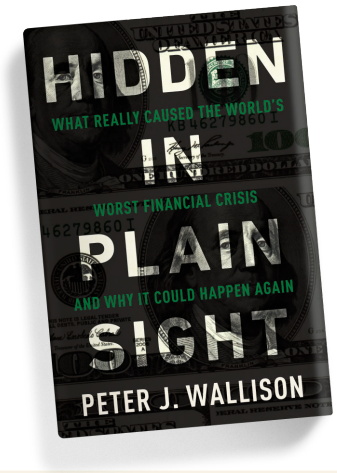

"Those of us who have studied the financial crisis concluded years ago that Peter Wallison 'wrote the book' on the subject. Now he has actually done so."

—**JEB HENSARLING,** chairman of the House Financial Services Committee

"Academic economists generally agree that the mortgage meltdown during the recent financial crisis was in large part a consequence of government "affordable housing" policies. Peter Wallison's *Hidden in Plain Sight* details the evidence in a totally convincing way."

—**EUGENE F. FAMA,** 2013 Nobel laureate in Economic Sciences

"Government housing policies were a major cause of the financial crisis, and we are now repeating the same mistakes. Peter Wallison told the story better than anyone else and is sounding the warnings again."

—**MARTIN FELDSTEIN,** professor of economics at Harvard University

"Peter Wallison exposes how the government's push to weaken traditional mortgage underwriting standards proved to be a root cause of the financial crisis. Lawmakers reshaping federal housing policy today should take heed."

—**EDWARD DeMARCO,** acting director of the Federal Housing Finance Agency from 2009 to 2014

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PETER J. WALLISON

AUTHOR Q&A

Why is this book important today, 6 years after the financial crisis?

WALLISON: If we don't understand what caused the financial crisis, we will stumble into another one. The US government's housing policies caused the 2008 financial crisis, but the American public has not heard that from the government or the mainstream media.

Aren't the major Wall Street banks the cause of the crisis?

WALLISON: No. The private sector was certainly not blameless, but 76 % of the subprime and other risky mortgages, many of which failed in 2008, were on the books of government agencies. This shows where the demand for these mortgages came from. If it hadn't been for the government's demand—carrying out federal policy—there would not have been enough bad mortgages in the financial system to cause a crisis. The government's policies created an environment of rapidly increasing home prices—the biggest bubble ever in the US—which made it look as though it was not risky to buy and hold subprime mortgages or mortgage-backed securities. That's what happened to the private sector, primarily the banks.

How did that happen?

WALLISON: In 1992, Congress enacted affordable housing goals, which required Fannie Mae and Freddie Mac to meet a quota of loans to borrowers at below the median income where they lived. HUD raised this quota substantially reaching 56% by 2008, requiring Fannie and Freddie to reduce their underwriting standards in order to find borrowers below the median income. By 2008, most of the mortgages in the US were subprime or otherwise risky.

Why were Fannie and Freddie so important?

WALLISON: They were both government-sponsored enterprises that dominated the mortgage markets. The underwriting standards they used became the standards for all banks and other mortgage originators. In that way, the loosened mortgage standards spread from the low-income mortgages to the wider market.

Did the government save the financial system from collapse?

WALLISON: We'll never know. What we do know is that the government would not have been required to act if it had not caused the problem in the first place. When it did act, it caused more problems than it solved. First, it saved Bear Stearns in March 2008, signaling to the market that it would save large firms; then it let Lehman fail in September, shocking the market and causing a panic. Most of the funds

the government required the banks to take were unneeded and were repaid within months.

Why did you dissent from the Financial Crisis Inquiry Commission majority?

WALLISON: It was obvious to me that the FCIC was not going to consider any ideas about the causes of the financial crisis other than one that blamed the private sector and provided the basis for more regulation.

Was Dodd-Frank a mistake?

WALLISON: Yes, the government has told the American people that a strong new regulatory law was necessary to prevent another crisis. That law, Dodd-Frank, gave more power to the government, and is responsible for the very slow recovery from the 2009 recession, but did not address the government's role in causing the crisis.

How should the new Congress approach housing?

WALLISON: The lesson of the financial crisis is that if we give the government the authority to determine underwriting standards for mortgages it will reduce them as far as it can. It will say it is trying to help low-income homebuyers—and it may actually believe it is. But sadly, as happened in 2007 and 2008, the low-income homebuyers often can't afford to keep the homes when the economy declines and these families are evicted. As even Barney Frank admitted in 2010 "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it." The best way to protect low-income homebuyers is to create a stable housing market and that can only be done with sound underwriting standards.

Should we shut down Fannie Mae and Freddie Mac?

WALLISON: Shutting down Fannie and Freddie can't be done all at once. It will take years to wean the market off this government support. But if we gradually reduced the size of mortgages Fannie and Freddie could buy, the private sector will pick up the slack.

What mistakes would put us on a path to another housing calamity—are we heading there already?

WALLISON: Policy mistakes like reducing underwriting standards in order to spur home buying. That is where the problem started in 1992 and ended with a crisis in 2008. Recently, the Federal Housing Finance Agency, which regulates Fannie Mae and Freddie Mac, directed them to accept 3% down payments on mortgages, much lower than they had been requiring since the financial crisis. Here we go again.

Could a crisis really happen again?

WALLISON: As long as the American people and their representatives in Congress believe that the crisis was caused by insufficient regulation of the private sector, they will continue to support the same kind of government policies that produced the financial crisis. The only way to prevent this is for the truth about the government's role to come out.

EXCERPT FROM

HIDDEN IN PLAIN SIGHT

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In their second 2008 presidential debate, almost three weeks after Lehman Brothers had filed for bankruptcy, John McCain and Barack Obama laid out sharply divergent views of the causes of the financial convulsion that was then dominating the public's concerns. The debate was in a town-hall format, and a member of the audience named Oliver Clark asked a question that was undoubtedly on the mind of every viewer that night:

> CLARK: Well, Senators, through this economic crisis, most of the people that I know have had a difficult time. ... I was wondering what it is that's going to actually help these people out?
>
> SENATOR McCAIN: Well, thank you, Oliver, that's an excellent question. ... But you know, one of the real catalysts, really the match that lit this fire, was Fannie Mae and Freddie Mac ... they're the ones that, with the encouragement of Sen. Obama and his cronies and his friends in Washington, that went out and made all these risky loans, gave them to people who could never afford to pay back ...

Then it was Obama's turn.

> SENATOR OBAMA: Let's, first of all, understand that the biggest problem in this whole process was the deregulation of the financial system. ... Senator McCain, as recently as March, bragged about the fact that he is a deregulator. ... A year ago, I went to Wall Street and said we've got to reregulate, and nothing happened. And Senator McCain during that period said that we should keep on deregulating because that's how the free enterprise system works.

Although neither candidate answered the question that Oliver Clark had asked, their exchange, with remarkable economy, effectively framed the issues both in 2008 and today: was the financial crisis the result of government action, as John McCain contended, or of insufficient regulation, as Barack Obama claimed?

Since this debate, the stage has belonged to Obama and the Democrats and their narrative about the causes of the financial crisis was

adopted by the media and embedded in the popular mind. Dozens of books, television documentaries, and films have told the easy story of greed on Wall Street or excessive and uncontrolled risk-taking by the private sector—the expected result of what the media has caricatured as "laissez-faire capitalism." To the extent that government has been blamed for the crisis, it has been for failing to halt the abuses of the private sector.

The inevitable outcome of this perspective was the Dodd-Frank Wall Street Reform and Consumer Protection Act, by far the most costly and restrictive regulatory legislation since the New Deal. Its regulatory controls and the uncertainties they engendered helped produce the slowest post-recession U.S. recovery in modern history.

As long as the financial crisis is seen in this light—as the result of insufficient regulation of the private sector—there will be no end to the pressure from the left for further and more stringent regulation. Proposals to break up the largest banks, reinstate Glass-Steagall in its original form, and resume government support for subprime mortgage loans are circulating in Congress. These ideas are likely to find public support as long as the prevailing view of the financial crisis is that it was caused by the risk-taking and greed of the private sector.

For that reason, the question of what caused the financial crisis is still very relevant today. If the crisis were the result of government policies, as described in this book, the Dodd-Frank Act was an illegitimate response to the crisis and many of its unnecessary and damaging restrictions should be repealed. Similarly, proposals and regulations based on a false narrative about the causes of the financial crisis should also be seen as misplaced and unfounded.

First impressions are never a sound basis for policy action, and haste in passing significant legislation can have painful consequences. During the Depression era, it was widely believed that the extreme level of unemployment was caused by excessive competition. This, it was thought, drove down prices and wages and forced companies out of business, causing the loss of jobs. Accordingly, some of the most far-reaching and hastily adopted legislation—such as the National Industrial Recovery Act and the Agricultural Adjustment Act (both ultimately declared unconstitutional)—was designed to protect competitors from price competition. Raising prices in the midst of a depression seems wildly misguided now, but it was a result of a mistaken view about what caused the high levels of unemployment that characterized the era.

Hidden in Plain Sight is intended to be an entry in the political debate—a debate that was framed in the 2008 presidential contest but never actually joined. In these pages I argue that, but for the housing policies of the U.S. government during the Clinton and George W. Bush administrations, there would not have been a financial crisis in 2008. I do not absolve the private sector, but put the errors of the private sector in the context of the government policies that dominated the housing finance market for the fifteen years before the crisis and the government regulations that induced banks to load up on assets that ultimately proved to be toxic. The future of the housing finance system and the health of the wider economy depend on a public that is fully informed about the causes of the 2008 financial crisis. ★