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WALL STREET AND DODD-FRANK: The Right Questions to Ask the Candidates

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EXECUTIVE SUMMARY

Over the past few months, President Barack Obama and his challenger, former Massachusetts governor Mitt Romney, have sparred on economic issues ranging from taxes to labor.

But they have been quiet on one issue that is central to economic growth: the importance of a financial system that is subject to competitive, free-market forces, as well as to the rule of law. Wall Street, after all, provides capital to all other industries in the economy and to consumers; if Wall Street is not working right, the rest of the economy is not working right.

Both men should explain to voters whether they think that Wall Street is healthier than it was in the years leading up to the 2008 financial crisis, and, if not, what they would do to fix it.

BACKGROUND

The financial crisis dominated the 2008 election. On September 14, 2008, the Lehman Brothers investment bank collapsed, sending the global financial system into a panic on a scale not seen even in the 1930s. The Federal Reserve and the Bush administration blanketed the financial system with $20 trillion in direct cash infusions as well as guarantees.[1] The rescues ranged from the government's takeover of the insurer AIG to the Troubled Asset Relief Program (TARP), which Congress enacted in October.

Voters were shocked to learn of the brittle nature of their financial system. They sent Obama to the White House in no small part because they thought he was better equipped than John McCain to fix the problem.

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That problem had many roots, all of them intertwined.

First, "too big to fail." Since the Reagan administration's 1984 rescue of the Continental Illinois bank, the federal government had made it clear that its policy was to rescue the creditors of large financial institutions, especially creditors who provided funding to banks and other financial institutions through short-term money-market funds, in order to avoid financial panic. This policy caused investors to misallocate resources to the American financial system. Between 1984 and 2008, domestic financial-sector borrowing rose from $2.2 trillion (in 2008 dollars) to $17.1 trillion, a nearly eight-fold increase.[2]

Second, complexity and opacity. In the absence of market discipline by creditors—who knew the government would protect them—the financial sector grew ever more complicated as shareholders—who did take a risk of loss—pursued high returns. Regulators appointed by both political parties accepted that an explosion of opaque derivatives, for example, reduced risk. In reality, though, such derivatives increased the amount of risk in the financial system as a whole while hiding it on the balance sheets of large financial institutions. This made it inevitable that investors would panic when they realized that they had no idea where risks lied or how big those risks were.

Third, government support for housing. Other bipartisan government policies caused the financial system to misallocate resources to residential housing. Government-backed housing-finance agencies Fannie Mae and Freddie Mac inflated the capital markets' demand for housing finance, providing loans to middle-class home buyers on terms that a free market would not have provided. Reagan-era tax reforms favored housing debt over other types of consumer debt, further distorting the capital markets and encouraging people to take equity out of their homes to refinance credit-card and other types of debt. Clinton-era tax reforms similarly favored capital gains (profits from investment) derived from housing sales over capital gains derived from other asset sales, encouraging people to invest in houses over other asset classes. Financial regulations encouraged banks and other investors to hold housing debt over other types of debt.

In 2008, both the financial and the housing sectors were exposed as brittle, monolithic industries in need of reform.

Congress and the president should have:

- Imposed Depression-era limits on derivatives borrowing and trading. Such fixes would have shrunk derivatives markets, as derivatives would have needed real cash behind them, and cash is finite. Shrinking borrowing also helps to end "too big to fail" by making it easier for large financial firms to go out of business without bankrupting the rest of the financial system.

- Pushed derivatives on to public trading markets. Such a move would have made derivatives trading more transparent and made it even easier for a large financial firm to fail without spreading panic.

- Dealt decisively with the short-term funding from global money markets that withdrew hundreds of billions of dollars in cash from large financial institutions almost instantaneously, sparking mass panic. Lawmakers and the White House should have either decided that such funds would in the future receive an explicit guarantee from government, as bank deposits do, or would need to hold much larger reserves (spare cash) to serve as a buffer in mass withdrawals.

- Phased out financial regulation that pushed banks and other investors to favor housing-related debt over other types of debt. That is, they should have imposed consistent limits on borrowing across financial instruments, not allowed different limits on borrowing for different types of debt.

- Phased out Fannie and Freddie, so as to eliminate one source of capital markets distortion in the financial industry.

- Phased out elements of the tax code—from the mortgage-interest deduction to special treatment for capital gains—that favor housing investment over other types of investment.

What did the president do on this front?

Two years into his term, Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act. The law, the president said at the time, would "rein in the abuse and excess that nearly brought down our financial system," "bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis," and end "tax-funded bailouts" by "giv[ing] us the ability to wind [large financial firms] down without endangering the broader economy."[3]

The law fell short of these goals. Dodd-Frank did give regulators new authority to regulate derivatives, but the regulations that have emerged contain many loopholes. Neither political party has encouraged regulators to err on the side of firmness rather than leniency.

The law maintains regulations that favor housing debt over other types of debt, thus encouraging the capital markets to make the same mistake all over again, necessitating bailouts.

The law did not end special treatment for large financial firms that have failed. Instead, Dodd-Frank created an "orderly liquidation authority" that maintains discretion over how to treat creditors and other investors. Moreover, failure to fix derivatives and impose consistent limits on borrowing makes future bailouts inevitable. The law also failed to address whether government should insure money markets or force them to hold bigger capital buffers; this continued uncertainly also makes future bailouts inevitable.

Finally, the law did nothing to wind down Fannie and Freddie and nothing to end other capital-market distortions in the housing markets.

Moreover, the law contained many irrelevant provisions, including the Volcker Rule, which bans banks from making bets with their own capital. These ancillary elements of the law distract regulators from the real problem.

THE CANDIDATES' POSITIONS

Obama's position is simple. He believes that Dodd-Frank fixed Wall Street.

The president's "historic Wall Street reform," his campaign literature says, "ended 'too big to fail,'" "hold[s] big banks accountable" for their own actions, and "set ground rules for risky speculation."[4]

The president is largely silent on housing policy. He rarely discusses Fannie Mae and Freddie Mac. He says only that he is opposed to letting the housing market hit bottom, something that has already happened in much of the country.[5]

Romney's position is different. Romney correctly diagnoses the problem, saying the causes of the crisis were "overleveraging of our financial institutions and our homeowners."

Romney says further that he would repeal Dodd-Frank and replace it with a "streamlined regulatory framework" to allow for "greater transparency for inter-bank relationships, enhanced capital requirements, and provisions to address new forms of complex financial transactions."[6]

During primary season, however, Romney was neutral on bailouts. At a debate in October 2011, he answered a question about hypothetical bailouts by saying that "No one likes the idea of a Wall Street bailout," but he wouldn't rule one out. In an interview that fall, he further said that "you don't want to bail out anybody." But his examples of firms that should not have received bailouts were auto firms, not financial firms. Furthermore, he focused his language on shareholders, not on creditors and derivatives counterparties.[7]

On housing, Romney says that he would "reform" Fannie Mae and Freddie Mac and "revitalize the private sector's role in the housing market."[8] But he does not provide details.

Romney would eliminate another capital-markets distortion that misallocates resources to housing. His plan to eliminate capital gains, dividends, and interest taxes on taxpayers earning less than $250,000 in total income annually would end one big element in the tax code that favors investment in housing over investment in other assets. However, Romney would not phase out the mortgage-interest tax deduction, saying only that he might consider phasing out the deduction for higher-income earners' second homes.[9]

TOPICS FOR DEBATE

Wednesday evening, Lehrer, the moderator of the first presidential debate and the only debate devoted to domestic policy, should ask each candidate some specific questions on the topic of Wall Street, financial and housing reform, and bailouts.
Some suggested questions:

For President Obama:

If the Dodd-Frank law fixed Wall Street, how would you explain that just this May, 52 percent of potential voters told pollsters that they had little or no confidence in the financial industry – not much different from the 55 percent who had such little faith in the industry in the weeks after Lehman Brothers collapsed?[10]

The Dodd-Frank draft was 2,000 pages. Even two years after you signed the bill, experts still can't quite figure out what it says and how regulators could use the law to wind down a failing financial firm. Why did financial regulation have to be so complicated on your watch?

This past spring, JPMorgan Chase took a multi-billion-dollar loss on some speculative bets it had made. If the loss had been even bigger, do you think your administration would have let JPMorgan Chase go bankrupt?

Your opponent wants to eliminate capital gains and dividends taxes for middle-class families. This measure would encourage people to invest in something outside of their houses, by letting them keep more of the gains from suck risk-taking. Do you think that proposal is a good idea?

You've had nearly four years to help people work with mortgage lenders to reduce the amount of money they owe. Why haven't you pursued this strategy? Have you been worried that such debt reductions would cause more losses for banks and investors?

For Governor Romney:

You favored the idea of a government-funded "managed bankruptcy" for General Motors and Chrysler even before Obama took office and pursued such a course.[11] Do you think that large financial firms, too, should have to go through such a "managed bankruptcy" process, with creditors as well as employees taking substantial losses? In other words, is it fair to treat one industry different than the other?

You say you want to rein in some types of risk-taking on Wall Street. Could you be more specific? Do you favor pushing derivatives instruments onto exchanges and limiting borrowing against derivatives, even though the instruments would then be less profitable there for large financial firms?

Using your experience in the financial industry, tell us what is the best way to end "too big to fail," and what exactly that means in the first place.

In your convention speech, you implied that it's President Obama's fault that "you'd have to take a big loss on your house" if you sold it.[12] Don't you think the housing market had to fall significantly from 2006 levels, no matter who was president over the past four years? What would you have done to prevent that from happening?

The president once called bankers “fat cats.” Do you think bankers whose institutions depend on taxpayer guarantees should be paid as much as they do? Do you understand why so many Americans are still angry at the financial-industry bailouts?

For both candidates:

A lot of people like the Facebook social-media website. But they are upset that Facebook’s stock-market listing earlier this year seemed to fall prey to insider manipulation, causing big losses for small investors. Do you think the stock market gives all investors a fair shake? If not, how would you fix it?

You’ve both employed top officials tied to the financial industry. Mr. President, your former chief of staff, Bill Daley, was previously a top executive at JPMorgan Chase. Governor Romney, your campaign co-chair, Tim Pawlenty, just left for the biggest lobbying job on Wall Street, a post that will pay millions of dollars. Does Wall Street have too much clout in Washington? Why do you think Wall Street donors have favored one of you over the other in this election?

Do you think Americans should have to save up, say, 20 percent, for a down-payment before they can buy a house? Would either of you favor reforming Fannie and Freddie, even if it meant that many people, including middle-class people, couldn’t get 30-year mortgages?

CONCLUSION

The financial meltdown that helped voters to the last election continues to impact people’s lives. Americans struggle under bubble-era debt. They struggle, too, in a weak economy with poor job growth. This week’s president debate is a good forum for the candidates to showcase their views on the topic.

ENDNOTES

[1] Nicole Gelinas, “Protecting The Economy From Wall Street: Can the financial industry pay for its next bailout?” Manhattan Institute, Issue Brief No. 3, April 2010.

[2] Author’s calculations based on Federal Reserve Flow of Funds Report, Sept. 20, 2012.

[3] “Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act,” White House, July 21, 2010.

[4] “Wall Street Reform,” Obama Biden website, http://www.barackobama.com/for-all/wall-street-reform, accessed Sept. 26, 2012.

[5] “Economy,” Obama Biden website, http://www.barackobama.com/economy?source=primary-nav-om, accessed Sept. 26, 2012.

[6] “Believe in America,” Romney Ryan website, http://www.mittromney.com/sites/default/files/shared/BelieveInAmerica-Plan-ForJobsAndEconomicGrowth-Full.pdf, accessed Sept. 26, 2012.

[7] “Governor Romney and ‘Too Big to Fail,” The Corner, National Review, Oct. 12, 2011.

[8] “Securing the American Dream and the Future of Housing Policy,” Romney Ryan website, http://www.mittromney.com/sites/default/files/shared/housing_white_paper.pdf, accessed Sept. 26.

[9] David J. Lynch, “Romney Tax Cuts Work Only When Mortgage Break Mostly Reduced,” Bloomberg News, Sept. 14, 2012.

[10] NBC News/*Wall Street Journal poll*, May 16-20, 2012, http://online.wsj.com/article/SB10001424052702303610504577420774035054202.html, accessed Sept. 26.

[11] Mitt Romney, “Let Detroit Go Bankrupt,” *New York Times*, Nov. 18, 2008.

[12] “Transcript of Mitt Romney’s Speech at the RNC,” FoxNews.com, http://www.foxnews.com/politics/2012/08/30/transcript-mitt-romney-speech-at-rnc/, accessed Sept. 26, 2012.