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HIDDEN IN PLAIN SIGHT: WHAT REALLY CAUSED THE WORLD'S WORST FINANCIAL CRISIS AND WHY IT COULD HAPPEN AGAIN.

By Peter J. Wallison, Encounter Books 2015

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What really caused the world's greatest financial crisis? The prevailing narrative, as articulated by President Obama and his allies, was that the crisis was caused by insufficient government regulation.

Hidden in Plain Sight is, in essence, a very well-done legal, economic, data-driven, and often entertaining brief as to why the official narrative is wrong.

Peter Wallison is well-known by his many writings, including frequent op-eds in the Wall Street Journal, and he speaks truth to power – a very rare commodity in Washington.

The political leadership in Washington from President Obama on down, including many Republican leaders, has produced the self-serving narrative about how the financial crisis was created by insufficient government regulation.

Wallison argues that, in fact, it was two decades of irresponsible government policies and incompetence by top officials at the Federal Reserve and the U.S. Treasury that caused the crisis,

while clearly acknowledging that many of the bankers and other private sector players were far from saints.

The irresponsibility and incompetence was shared both by Democrats and Republicans – fortunately, Wallison has now been around long enough not to mind being scratched from Washington dinner party lists.

His argument can be summarized as follows: The two giant government-sponsored mortgage companies (GSEs), Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) dominated the housing market – particularly after the government had caused the collapse of the Savings and Loan banks in the 1980s.

In 1992, Congress directed the GSEs to increase loans to low and moderate income, starting with a 30 percent quota, rising over the years to over 50 percent. To meet these goals, underwriting standards were lowered.

Required down payments fell from a typical 20 percent to three percent and then to zero. Credit standards for borrowers were also lowered. These were known as subprime mortgages. By 2008, half of all mortgages in the U.S. were subprime, and 76 percent of these were on the books of government agencies. Before 1992, only about 10 percent of the mortgages were subprime, and frequently made by specialized lenders and insured by the FHA.

Low down payments and other lending standards were again lowered, which fueled the great housing bubble of 1997-2007. The GSEs covered up the risk of having so many subprime mortgages in the mortgage-backed securities they bought and sold. Eventually, housing prices got so high that people could not afford them, even with almost no down payment; and when the slide in prices began in 2007, the situation cascaded with more and more people finding their homes worth far less than their mortgages, causing a tidal wave of defaults. Both the private banks and the GSEs were required by accounting rules to mark their assets to market, and as the defaults soared, the value of the mortgage-backed securities plummeted, thus impairing the balance sheets of the financial institutions that held substantial quantities.

This scenario and conclusion is obvious but politically inconvenient. To create a more politically acceptable "official" narrative of what caused the financial crisis, President Obama and Congress authorized the Financial Crisis Inquiry Commission (FCIC). The FCIC (2009-2011) had 10 members – six Democrats and four Republicans. The chair was Phil Angelides, a confidant of House Speaker Nancy Pelosi and a former Democrat candidate for governor of California.

Wallison was appointed to the FCIC by then House Minority Leader John Boehner. With the exception of Wallison, the FCIC was the equivalent of having the foxes guard the chicken house. The report concluded that the crisis could have been prevented with more vigilant government regulation and regulatory power – which is exactly the conclusion the administration and the Democrat majority Congress wanted in order to justify their enactment of the Dodd-Frank Act, which imposed massive new regulatory burdens on the financial industry.

It is clear that the Democrat-controlled Congress knew what the report would say since it adopted the Dodd-Frank Act six months before the FCIC report was issued. Wallison went on to write more than a hundred-page dissent to the official conclusions.

Peter Wallison is not just another pundit bloviating about what went wrong and what should be done about it. He has held important positions at the very top of the U.S. government, beginning in the Ford Administration when he was counsel to Vice President Rockefeller. In the first Reagan Administration, he served as general counsel of the U.S. Treasury, and counsel to the president in Reagan's second administration.

He was a partner in a prominent law firm frequently dealing with banking and financial issues. Currently he holds the Arthur F. Burns chair in Financial Policy Studies at the American Enterprise Institute and is co-director of the Institute's program on Financial Reform Studies.

As early as 1999, Wallison had publically argued that the two federally charted mortgage giants – Fannie Mae and Freddie Mac were headed for disaster. He was attacked at the time for his statements, which merely caused him to publish an extensive indictment of their irresponsible policies and how a fall was almost a certainty.

Remember, Wallison was not just some muckraker, but a senior member of the Washington legal and financial establishment – who is known both for his keen intellect and his good judgment. When the crash came, many of his earlier critics had to admit he was prescient.

Wallison begins "Hidden" by using the Reagan technique of telling you what he is going to tell you, and then telling you in detail what he said he was going to tell you, presenting the evidence and data in an airtight manner, and concluding by briefly telling you what he told you – and why it is going to happen again. The Washington political class is slow to learn and prefers the myth that somehow regulators are smarter than the people they regulate, more pure in motive, and can see the future more clearly – what hubris.

It is not easy to stand up and say "I am right – and the facts bear me out," when the establishment is saying you are wrong. I expect that Copernicus, Galileo, Billy Mitchell, Einstein, Hayek, and other truth tellers had the same frustration that Wallison at times evidences in 'Hidden.' To make his case, Wallison carefully documents his narrative by presenting both the history and numbers as to what was said, predicted and then happened.

He goes on to deal with each of the other possible causes and narratives, and demolishes each of these excuses as a good prosecuting attorney would. Specifically, he deals with the low interest rates and flow of funds from abroad; deregulation and risk taking, including 'repeal' of Glass-Steagall; investment banks, insured deposits, SEC 'deregulation'; Riegle-Neal and the Basel risk-based capital rules; the FDIC improvement Act; credit default swaps, failure of risk management in banks and other financial institutions; securitization; collateralized debt obligations; credit rating agencies; predatory lending; and perfect storm theories, as explanations of what caused the crisis.

In each case, he lays out the argument of the proponents of the issue and then shows why their arguments are either irrelevant or insufficient to explain what happened.

His description of the actions of the people-in-charge at the Federal Reserve, Treasury, and elsewhere in the government, once the crisis had started, is sufficiently disturbing to even give the most ardent admirer of government pause.

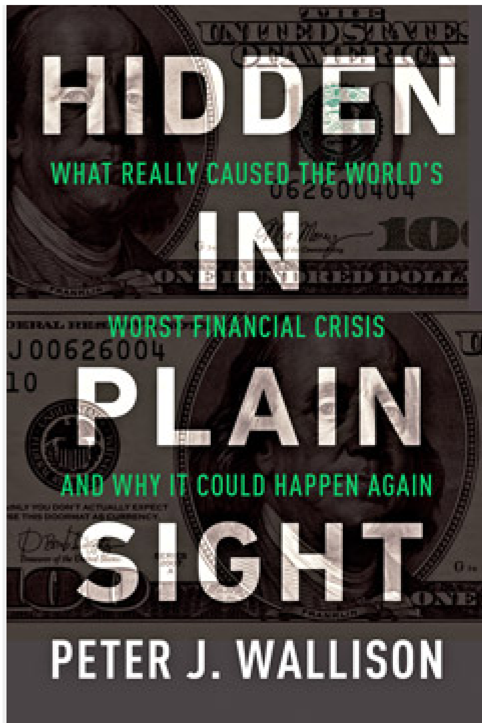
In sum, Fed Chairman Bernanke and Treasury Secretary Paulson and their colleagues had little understanding of what was happening, and the appropriate course of action, particularly since in many cases they did not even know the real financial situation of the various entities they were dealing with. Rather than calm helmsmen, as portrayed in the press, they were in panic, which caused them to be inconsistent and overreact and make the situation much worse. Wallison includes part of an exchange he had with Bernanke during testimony before the FCIC, which is both frightening and amusing.

Up to the time of the Great Depression, the U.S. had gone through a number of "panics," but the government basically let the market cure itself – which it always did, usually resulting in a return to "normalcy" with a few months.

As with ObamaCare and numerous other government programs, government officials dealing with the financial crisis misdiagnosed the problem and then came up with solutions that made matters worse – but increased the power of the political class in Washington.

Because of new government regulations, banks and other financial institutions are "not lending enough" to homeowners and small businesses but only to the cronies of those in power. So again, the call goes out to reduce home mortgage lending standards – and the call is being heard by the regulators and acted upon by some financial institutions, seeding the next bubble and set of problems.

Perhaps we will get lucky that enough financial writers and commentators, responsible regulators, and politicians will read and understand the lessons from "Hidden." But I fear the tragedy of our time is that all too many in the Washington power circles will ignore the evidence and warnings that Wallison has presented – and then be forced, after the repeat of the crisis, to acknowledge again that Wallison was prescient.



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