

THE FINANCIAL CRISIS: WHY THE CONVENTIONAL WISDOM HAS IT ALL WRONG

Richard Kovacevich

Like many of you, I am appalled at the political environment and gridlock that continues to exist in this town. I simply cannot understand nor do I accept why our elected officials continue to concentrate on party politics and the next election above doing what's right for America, especially as we endure the past five years of economic stagnation and high unemployment. Nothing is more debilitating and unfair than a head of household willing to work but who cannot find a job. Why hasn't job creation been the number-one focus of our government during this economic crisis?

Don't believe for a moment those economic theorists who tell us the reason for our slow growth, economic malaise, and continued high unemployment is due to the uniqueness of a financially led economic recession. Rather, it is due to the failure of the leaders in this town to adopt those monetary, regulatory, and fiscal policies that have successfully worked in the past while, alternatively, focusing on a political agenda that did not put economic growth and jobs at the top of the list. In my opinion, the early 1980s' economic recession—with its exceptionally high 10 percent

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inflation, 20 percent interest rates, and 12 percent unemployment—was far more difficult to correct and resolve. Yet our economy bounced back in 18 months with GDP growth of over 7.5 percent the next year. In the 1980 recovery, GDP growth averaged 4.9 percent, and for all recoveries since the Second World War, the average was 4.1 percent. The current recovery has been a paltry 2.2 percent.

With the appropriate monetary, regulatory, and fiscal policies our economy should be growing at 3 percent or even higher, which is what is needed to bring employment, our budget deficits, and the labor participation rate to acceptable levels.

One of the many reasons our economy is growing at historically low rates is the extraordinary and unprecedented increase in regulations facing job creators—the most by any administration ever. For example, small businesses have always been the major source of new jobs in our country as compared to large companies. Not this time, however. Why? According to small business polls over the past five years, the job malaise is due to excessive regulation, higher taxes, and increased health care and other costs—the exact opposite of job creation policies that have worked well in the past.

My focus today will be on financial regulation, but similar regulatory burdens are impacting all industries. For example, the Kauffman Foundation, a think tank, reveals in a survey that small businesses, the primary job creators forever, feel more overregulated than even overtaxed. The Competitive Enterprise Institute estimates that the total cost of complying with America's federal regulations in 2013 was \$1.86 trillion, about \$15,000 per household. I will also address why I think the conventional wisdom has it all wrong as to what and who caused the 2008 financial crisis and why the response to it was irresponsibly implemented and can be summarized as "senseless panic." I will posit that recent financial regulation would not have prevented the last financial crisis nor prevent the next one. I believe that because of the Dodd-Frank legislation, and the current monetary policies of the Federal Reserve, the bottom 25 percent of Americans on the economic ladder will have restricted access to mortgage and personal loans and will incur much higher fees for banking services, all of which is inhibiting economic growth and significantly widening the income inequality gap.

Origins of the Financial Crisis: TARP, a Massive Government Failure

So how did we get into this mess? The last time I was in Washington was in October 2008, for the infamous TARP (Troubled Asset Relief Program) meeting between the Treasury Department, regulators, and large bank CEOs. I believed at that time, said so at the meeting, and I still believe today that forcing all banks to take TARP funds, even if they didn't want or need the funds, was one of the worst economic decisions in the history of the United States. What should have happened is that only those financial institutions who were still solvent but had liquidity challenges, and who needed the funds temporarily, should have been given that choice. You can't fool the markets as Treasury officials and regulators believed you could. The market knew which financial institutions were in trouble as evidenced by stock prices and credit default swap rates that existed at that time. Forcing TARP funds on all banks did not restore confidence in the industry. It destroyed confidence as the market concluded that all banks must now be in trouble because all banks were receiving funding and presumed to have needed and wanted it.

You may have forgotten that prior to TARP, and even a month after the Lehman bankruptcy, markets had declined but were still behaving reasonably well, except for those financial institutions that were having liquidity issues. With the announcement of TARP, isolated liquidity issues turned into a tsunami impacting all banks and all industries. It precipitated a dramatic drop in the stock market, froze trading and the capital markets, magnified and extended the market collapse, damaged the reputations of many financial institutions who did no wrong, increased moral hazard, institutionalized "too big to fail," angered and outraged the general public, and provided Congress an excuse to burden the banking industry with a massive 25,000 pages of new regulations—the largest increase in bank regulations in history. Even four years after its passage, regulators have still completed only 52 percent of its 398 rules according to law firm David Polk and Wardwell. These Dodd-Frank regulations were authored not by considered judgment, but rather as anger and punishment for the TARP bailouts. Without TARP, the Dodd-Frank bill would unlikely have been passed or at least not in the form that now exists. It was TARP that started this whole mess.

Conventional wisdom, on the other hand, especially inside the Beltway, suggests TARP was a great success in restoring confidence in the financial industry. The facts suggest it was an *unmitigated disaster* and TARP should *never* be repeated. The spin never stops in Washington. No surprise, as all the authors of TARP were Washington insiders focused on protecting their reputations and deflecting blame for their failure to do their jobs of properly monitoring and reducing excessive risks being taken by some financial institutions.

TARP contributed to an unnecessary panic in the marketplace and required an unprecedented \$29 trillion dollars of market intervention by the Fed and the Treasury, over twice the annual GDP of the United States, to restore the very markets that they, themselves, helped to collapse. I warned at that meeting that politicians, especially those from the rust belt, wouldn't stand for giving banks money but not to struggling automobile and other companies. I also argued that by giving capital to all banks, even the sound ones who didn't need it, the market would likely decide that even the healthy banks were in trouble and confidence levels in the industry would actually decline, not improve.

So what actually did happen? Why was TARP clearly a mistake? Within two months of giving all banks money, the Dow Jones Industrial Average fell by 40 percent and financial stocks fell by 80 percent. How can anyone claim that an 80 percent drop in the stocks of financial companies, reaching their all-time lows, is a show of confidence? In fact, it was an unmitigated disaster. Now giving some banks money, who were having liquidity issues, may make sense if those banks were not insolvent but are just facing liquidity pressure. Giving *all* banks funds should *never* occur—never ever again. Because of TARP, Congress and the administration demonized and vilified *all* financial companies, even those who did no wrong and who didn't want, need, or even use the money, destroying their reputations with customers and the general public.

Forever more, we will hear Wall Street was bailed out but Main Street wasn't. The 1 percent versus 99 percent "Occupy Wall Street" demonstrations against banks have been going on for years and still haven't stopped. Populist initiatives that increase taxes, fines, and other fees on banks are being justified because taxpayers bailed out Wall Street and now it's Wall Street's turn to bail out Main Street.

Who bailed out whom? Wells Fargo, for example, within one year of receiving TARP funds, paid the U.S. government back including \$2.5 billion in interest costs and warrants for money we never wanted and for money we never even used. Is that a bailout? Wells Fargo had record earnings, the best in our 160-year history—the very next quarter after being forced to take TARP funds—and record yearly earnings for each of the last five years. Wells Fargo is now the highest-valued financial institution in the world, even though we are only the 21st largest in assets. Obviously, we didn't need the money.

TARP also cemented, perhaps forever, that too big to fail and moral hazard are acceptable U.S. policies—a profound mistake that should have been anticipated. And what about the small investor who lost hundreds of billions of dollars when they sold their bank stocks as they declined by 80 percent in price. Who should compensate the small investor for these unnecessary losses? The professional investor, on the other hand, profited on the way down by shorting bank stocks and then bought near the bottom and rode them back up. Was that fair? Because of TARP and the anger it fomented with the general public, Congress responded with Dodd-Frank legislation, a grab bag of so-called reforms most of which had nothing to do with the actual causes of the financial crises.

Prudential Risk Taking and the Case against Too Big to Fail

So, instead of TARP, what should we have done? As we all know, banks provide loans and access to capital markets to allow businesses to grow and create jobs. We serve consumers and allow them to save, borrow, and make payments. Banks are absolutely essential to economic growth. We enjoy cursing banks from time to time, but in truth we cannot prosper, create jobs, and grow the economy without them.

There have always been bank failures and there will always be. The trick is to allow sufficient risk taking to promote economic growth but not so much that leads to widespread bank failures and financial panic. We also need to insist that no financial institution is too big to fail, period. Why don't we let banks just fail like all other companies? In my 40 years in this business I have seen hundreds if not thousands of banks that were rescued by using Federal Deposit Insurance Corporation (FDIC) and/or taxpayer funds to make uninsured creditors and depositors whole. In my opinion, there was not

any *systemic* economic reason to not let banks fail over this time. Why then has it occurred so consistently? Simple, rescuing failed banks is a method used by regulators to attempt to “cover up” their failures to properly identify the risk in the banks they regulate. It must stop!

In my opinion, for example, if Bear Stearns, which was about half the size of Lehman, would have been allowed to go bankrupt, instead of Lehman Brothers, Lehman would have been sold and the subsequent financial crises would have been greatly reduced. Both J.P. Morgan and the Federal Reserve made a profit as the rescuers of Bear Stearns so it would have worked. But assume it didn't work, then obviously Lehman Brothers would have been rescued and the financial crises would have been much shorter and dramatically less stressful than the way it was handled. We must always start first with letting financial institutions fail.

Regulatory Failures and the Need for Balance

Effective regulation is all about consistency and appropriate risk oversight. It's clear from the three major banking crises in the United States in the past 40 years (1974–76, 1980–82, and 2008–09) that the United States has not yet achieved this balancing act. None of these past crises occurred because of lack of regulatory authority but rather the failure of regulators to use their existing authority, effectively, to rein in excessive speculation by financial institutions. Politicians and regulators have responded to each crisis by piling on more extensive and burdensome regulation and assuring our citizens that we have now fixed the problems without addressing the actual causes of the crisis or the ineffective regulatory system that allowed it to happen.

So let me put these regulator failures in perspective. When Wells Fargo rescued Wachovia in the fall of 2008, it took us less than a week to determine that Wachovia would have credit and litigation losses exceeding their existing reserves by over \$60 billion. The actual losses have been within 10 percent of that estimate. Yet the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC had been examining Wachovia's balance sheet for decades. Why did they not find these losses?

These same regulators, who failed to detect the high risks being taken by certain banks leading up to this crisis, continue to dictate to

banks how to improve their risk process. These same regulators, especially the Federal Reserve, say they have a risk model that they believe is so accurate that they will reject the stress test capital plans of those banks whose submissions show results different from the Fed model. The Federal Reserve claims to be transparent yet they will not share their model with banks.

How accurate is the Fed model? Here's my experience. In the first stress test submission in early 2009, banks were asked to submit their profit and capital forecast for a six-month period from May to November of 2009, a fairly easy thing to do given it is only six months in the future. The Fed's model showed that Wells Fargo's revenues would be over 30 percent lower than our forecast, resulting in lower profits and lower capital than our submission. Our actual results were 2 percent better than even our forecast. How can the Federal Reserve have confidence in a model that inaccurately forecast revenues only six months in the future by over 30 percent? I wouldn't share a model that inaccurate either!

Ineffective regulators are worse than no regulators at all because they give citizens a false sense of confidence that someone is watching out for and protecting them so that they don't have to do it themselves. As Will Rogers used to say, "If stupidity got us into this mess, why can't stupidity get us out?" Congress remembered what Will said and enacted, stupidly, the Dodd-Frank legislation. It's some 2,500 pages long and will produce more than 25,000 pages of new regulations from the same regulators who presided over the last three major financial crises. Dodd-Frank does not address the major causes of the recent crisis and offers few approaches to prevent the next one. It also specifically requires identifying systemically important financial institutions (i.e., SIFIs), thus reinforcing that those institutions are too big to fail. Dodd-Frank regulations are also prohibiting banks to offer certain products that the markets want and need. Products that did not in any way contribute to or cause the financial crises. Who is now offering these products? The so-called shadow banks. But hold it; it was the shadow banks that caused this crisis in the first place and who needed to be bailed out, not insured-deposit commercial banks. It was investment banks like Bear Stearns and Lehman and about a dozen others. We are just repeating our past mistakes. Why can't the administration, regulators, Congress, and the press see and understand this?

What Congress Should Have Done

So instead of Dodd-Frank, what should Congress have done? How do we end too big to fail once and for all?

First, given the long and consistent history of financial failures, we must recognize and acknowledge that regulators are seemingly not capable of using the authority they do have to prevent all failures. Consequently, we must build a regulatory system that assumes failures will definitely occur but limits the damage of such failures, makes them possible, bearable, and tolerable so it does not cause a systemic financial crisis that collapses the entire economy leading to recessions and taxpayer bailouts.

Second, and to mitigate systemic risk, from here forward, we must make clear that for any financial institution failure, large or small, and just like industrial company failures, all creditors, other than insured depositors, should take a “haircut” on their investment so that neither the FDIC fund nor the taxpayer is at risk as the institution is sold or liquidated.

Despite conventional wisdom, requiring large firms to increase their common equity capital to breathtaking levels—say above 9 percent of assets—is not the answer. That lowers returns on equity to the point that banks will not be able to raise sufficient capital and, instead, will shrink their balance sheets to meet their equity-to-asset ratios, impeding economic growth. Also, because the cost of capital becomes so expensive, the more marginable borrower will not get a loan. These are the very companies and individuals who do not have access to capital markets and need access to bank lending the most. This is exactly what is happening in Europe and the United States today. Of even greater concern, requiring excessive levels of capital might cause financial institutions to take even greater risks in order to earn a satisfactory return on the enlarged capital base. Moreover, because equity capital is permanent and cannot declare an “event of default” when it perceives the risks to be excessive, it is only marginally effective in imposing discipline on management. Finally, equity holders have upside potential from taking risks and are therefore more tolerant of risk than creditors.

A much more effective form of market discipline would be to ensure that the total long-term debt that a bank and a bank holding company hold on their balance sheets, when coupled with a bank’s equity and reserves, is more than sufficient to cover any reasonably

conceivable losses the institution might incur. Let me emphasize, I said bank *and* bank holding company debt. Contrary to what regulators are saying at the moment, bank creditors must also be at risk as well as bank holding company creditors.

When an institution fails, the FDIC could choose to put the institution into traditional bankruptcy or use an orderly liquidation authority and create a bridge bank, or another similar functioning entity, that will operate under FDIC control with new management and directors. The bridge bank will continue to serve the needs of depositors and borrowers, leaving the equity and long-term debt behind in a receivership with no guarantee of recovery. The bridge bank will be sold or privatized as soon as possible.

Because total equity and long-term debt at both the bank and bank holding company levels is usually around 30 percent of assets, it is difficult to imagine that the FDIC, much less taxpayers, would ever incur losses on their failure. If more cushion were desired, a 5 or 10 percent hold-back on uninsured depositors or other creditors could also be imposed. Because debt holders have no upside and provide larger amounts of capital to banks than equity holders, they are in a far better position to moderate the size and the risks of banks than equity participants.

This plan would not only protect the FDIC and taxpayers against losses in the event of failure, it would impose discipline by the marketplace that would make failure much less likely. A bank would be required to issue senior and subordinated long-term debt on a regular basis. A risky bank would have to pay higher interest—sending a negative signal to management, the board, investors, and regulators—and ultimately might not even be able to issue debt, which would curtail its growth and force it to adopt a new, lower-risk business strategy. Should this approach be implemented, the role of the Federal Reserve and the FDIC should primarily be to provide the liquidity necessary to liquidate or sell the company but not to bail out uninsured depositors, creditors, and investors.

It's naïve and contrary to all historical experience to believe that Dodd-Frank and the new Basel III capital accords, which significantly increase the cost of capital and regulation on banks and their customers, will solve the problem of regulators failing to do their jobs or will eliminate too big to fail. To substantiate this point, let me ask you these questions: What regulatory authority did the Federal Reserve and other bank regulators not have to rein in the risks taken

by financial institutions that precipitated this crisis? I can't think of any. Can you? If that's true, then why did we need Dodd-Frank? What regulatory authority did the Securities and Exchange Commission (SEC) not have to rein in the excessive risks and grossly inadequate liquidity plans of investment banks? Or to properly regulate the rating agencies whose AAA ratings on certain subprime mortgages were incomprehensible?

Even if only the rating agencies had been doing their jobs, the subprime mortgage problem would have been contained and no national or global economic crises would have occurred. Why didn't the SEC overrule the financial accounting standards board, which insisted that banks "mark to market" their securities portfolios even when the markets ceased functioning, needlessly reducing precious bank capital during the crises by around \$500 billion that was fully recovered when the markets normalized? The SEC also allowed the Financial Accounting Standards Board (FASB) to limit the size of the allowance for loan losses that is required for economic downturns. In short, the SEC completely failed in its regulatory oversight time and time again.

Why didn't Congress rein in Fannie Mae and Freddie Mac and their increasingly large portfolios of risky assets after two decades of warnings by industry experts, regulators, and administration officials that one day Fannie and Freddie would blow up and cost taxpayers hundreds of billions of dollars? The housing crisis got as big as it did to bring down our entire economy *only* because of the existence of quasi-private/public entities such as Fannie and Freddie. Now six years after the crisis, Fannie and Freddie still exist. Yet Congress passed Dodd-Frank in two years. Why the difference? Could it be due to politics as usual? Could it be to protect Congress and especially, Senator Dodd and Congressman Barney Frank, who were the biggest supporters of Fannie and Freddie for over two decades and who didn't heed those warnings?

Once again, we are repeating the mistakes of the past as the current bill recently passed by the Senate Banking Committee to replace Fannie and Freddie is only an improved version of a combined public/private entity. A huge mistake!

Why didn't the Office of Thrift Supervision—which was the primary regulator for the AIG London derivative entity, Washington Mutual, Countrywide, IndyMac, New Century Financial, First Franklin, Option One, Fremont Financial, and other major originators of risky subprime mortgages—do its job?

Finally, why didn't state regulators properly regulate the mortgage brokers who committed outright fraud by knowingly falsifying mortgage applications? Seventy percent of all subprime mortgages were originated by these brokers.

The Dodd-Frank Act does absolutely nothing to correct these devastating regulatory deficiencies. Until we do, we will continue to have bank failures. In fact, the Dodd-Frank Act ignores the fact that these *regulatory failures* actually were the real cause of what should have been a manageable problem but turned into a full-blown, worldwide, financial and economic crisis and the longest and worst recession since the Great Depression. Many in the financial markets knew what was going on. Hedge funds were betting against subprime portfolios. Responsible players, like Wells Fargo, were losing over 25 percent mortgage market share. Home prices were increasing to unprecedented levels. I personally told top bank regulators at least a dozen times that subprime mortgages were worse than toxic waste dumps. Where were our safety valves? Where were the regulators?

If you don't remember anything else I say today, please remember this: *only about 20 financial institutions perpetrated this crisis*. Only 20! About half were investment banks and the other half were savings and loans. Only one, Citicorp, was a commercial bank but was operating more like an investment bank. These 20 failed in every respect, from business practices to ethics. Greed and malfeasance were their *modus operandi*.

There was no excuse for their behavior and they should be punished thoroughly, completely, perhaps even criminally, yet 6,000 commercial banks are being punished with Dodd-Frank penalties in the same way as the 20 guilty parties. Why punish the vast majority of banks that behaved appropriately? Let me repeat that: Why are we punishing 6,000 commercial banks for the ineptness and malfeasance of 20 other financial institutions that were not even commercial banks? Even Barney Frank, no friend of the banking industry, has stated many times that mainstream commercial banks did not cause the 2008 financial crisis. He is right, but then why did he author Dodd-Frank?

Shockingly, certain members of Congress are actually trying to restore the Glass-Steagall Act that would resurrect these very same investment banks who just caused the crisis. What are they thinking? We finally got rid of all the large investment banks as the only two who are left, Morgan Stanley and Goldman Sachs, are now bank

holding companies under the supervision of banking regulators. Why would anyone want to recreate them so they can do it all again?

These uninformed Congress members believe that investment banking is more risky than commercial banking. Nothing could be further from the truth. Basic investment banking—such as best efforts to underwrite bonds and equities, providing M&A and financial advice, buying and selling securities for customers, and helping customers hedge their interest rate, foreign exchange, and commodity risks—is far less risky than making commercial and consumer loans. Lehman’s major problem was actually commercial real estate lending not plain vanilla investment banking. If Glass-Steagall had not been in effect since the 1930s, investment banks would not have grown to be large, risky, trillion-dollar, wholesale funded financial institutions comprised of a very-low-risk traditional investment banking business combined with a giant hedge fund that was created from the profits from their exclusive authority to provide low-risk investment banking. In short, the existence of Glass-Steagall created the investment banks that caused this crisis, and we should never resurrect it or them again.

What Should Regulators Look For?

So what does cause a financial crisis? What should regulators be looking for in order to anticipate trouble ahead?

There are three warning signs when a financial institution, large or small, is approaching the danger zone. We don’t need a Dodd-Frank Act; we do need regulators who have the political will and financial skill to take strong actions when they see these three warning signs develop.

The first and most common and important warning sign is concentration of risk. Most financial institutions fail because their risks are too concentrated by geography, industry, and/or product line. Actually, a large bank should be able to diversify its risks more broadly than a small bank. Yet conventional wisdom suggests that risk increases with size and that, therefore, large banks are more risky than small banks. Conventional wisdom is wrong, as far more small banks fail than big banks, because small banks are more concentrated.

Consider this. Assume a single bank operates across the entire United States, does its business in a similar fashion in all states, and is very diversified with 15 percent market share of banking and

related financial products in each state. If it did this, it would then be around two trillion dollars in size. Yet, I believe such a bank is actually at less risk of failing than say a two-billion-dollar bank that has a high concentration, say a 40 percent market share in only one or a few states or communities with limited products, even though the larger bank may be 100 times larger.

The six large Canadian banks essentially operate this way, have 80 percent market share, and have never failed or ever been bailed out. Admittedly, if a large bank does not diversify its risks, it can cause considerably more damage than a small bank.

Let me give some examples to make my point. During the 1980s, Texas banks were small by today's standards but among the most profitable and highly capitalized in the country just before nearly all of them failed. They failed because there was no interstate banking at that time, and they were geographically concentrated in Texas with a very high percentage of commercial real estate and energy loans.

The S&L crisis of the 1980s cost taxpayers \$150 billion, equivalent to almost a trillion dollars today. None of the S&Ls were particularly large, but they failed because of concentrations in commercial and residential real estate.

There were a dozen major originators of risky subprime mortgages in the most recent financial crisis. Two were over \$100 billion in assets. The rest were smaller than \$40 billion in assets. All failed because their risks were concentrated.

The second warning sign is inadequate liquidity. Bear Stearns and Lehman Brothers reported relatively high levels of capital, but they failed because of insufficient liquidity—the proverbial run on the bank. Merrill Lynch, Goldman Sachs, Morgan Stanley, and other investment banks suffered similarly as the crisis unfolded. It is stunning that these institutions were allowed to operate with balance sheets approaching a trillion dollars funded primarily by short-term wholesale liabilities. When rumors—valid or not—surfaced that these firms had problems, they were unable to roll over their short-term funding and failed. Inadequate liquidity has been the primary cause of financial failures, forever. Why can't management and regulators get this right? It's really very obvious and simple to detect.

The third warning signal is significant exposure and concentration to capital markets on either the asset/funding side, or even worse, on both sides. Capital markets have seized up in the past and will seize up in the future—and it usually can't be anticipated. The Russian

crisis of the 1990s brought down long-term capital and intensified a recession in Asia and other markets. Russia was less than 1 percent of the world's economy, yet resulted in a worldwide financial crisis and meltdown. Cyprus with only 800,000 people rattled worldwide capital markets a short time ago.

Any company that syndicates and sells a large percentage of its loans and other assets is far more at risk of failure than a company that originates and holds assets. They have little or no “skin in the game” as they sell all the assets they originate and thus pay much less attention to prudent underwriting standards. Furthermore, capital markets can seize up at any time and severely disrupt the business of a company that relies on an originate-and-sell business model. Moreover, with little or no recurring income because originated and securitized assets are sold not held, they have to keep “feeding the beast”—originating and selling more and more regardless of the risk and markets. When this model also relies primarily on short-term wholesale funding sources, it is especially toxic—a clear sign to regulators to be vigilant.

Conclusion

So let me summarize why I think that enacting the largest increase in banking regulation in history was a huge mistake, that it would not have prevented past crises or future ones, and will likely deny credit availability and other banking services to the bottom 25 percent of consumers on the economic ladder who are in most need of it.

It was created and passed, not with sound judgment of what really caused the financial crisis, but as a political response to the understandable outrage of Americans by the ill-conceived creation of TARP, one of the worst decisions in U.S. economic history, which intensified and compounded the financial crisis rather than solving it and created the impression that Wall Street was bailed out and Main Street wasn't.

Without TARP, there would not have been a Dodd-Frank Act as we now know it nor the demonizing and vilifying of the entire banking industry. Only 20 institutions perpetrated this crisis and all of them should be punished, perhaps even criminally. Half of these institutions were investment banks. Half were savings and loans. None were mainstream commercial banks. So why are 6,000 banks being punished for something they didn't do?

Why isn't the focus on reforming those regulators who had the power to stop these 20 perpetrators and who completely failed to do their job? What about Congress admitting its role in allowing Fannie and Freddie to provide the financial support that caused subprime mortgages to grow from a 5 percent market share of the mortgage market to about 50 percent at the peak of the crises? This share gain and the crisis would never have occurred without Fannie and Freddie and other government agencies purchasing or insuring about 70 percent of all subprime mortgages.

I personally warned regulators and leaders in Congress in face-to-face meetings, in annual reports, and in speeches of the eventual collapse of Fannie and Freddie for over 20 years. Similarly, I warned bank regulators that subprime mortgages were worse than toxic waste two years before the crisis started. So did many others. Neither Congress nor regulators heeded such advice. Was Dodd-Frank and demonizing the entire banking industry a coordinated effort to deflect where the blame should be placed?

Today the 6,000 commercial banks and their boards and management are spending most all of their time and resources on compliance, regulatory changes, and litigation for something they didn't do. Regulators blame bank board members for improper oversight of management. Really?

There are upwards of 100 regulators at large banks. Those regulators have an average of over 15 years of experience in the financial services industry and work full time at these banks. Bank directors have roughly 12 members who spend about a day a month on bank business, and who are not experts in the financial services industry because if they were, they would not be considered independent. So who is more responsible for insufficient oversight of bank management: 100 full-time regulators or about 12 one-day-a-month bank directors? Who gets criticized the most for bank failures? Does this town get it?

We also need to immediately replace the litigation risk associated with the "ability to pay" language that is in the Dodd-Frank Act. Mainstream commercial banks have been making loans to lower-income consumers and those with credit blemishes on their records for decades. They were not among the 20 institutions who perpetrated this crisis. They did not originate loans to subprime borrowers who could never pay them back as the S&Ls did, nor did they buy and insure them as Fannie and Freddie did, nor did they package,

sell, and distribute them as investment bankers did, nor did they rate them “AAA” as rating agencies did.

Mainstream banks have the experience and expertise to make loans to appropriate borrowers, and take the credit risk, but not litigation risk. Because of this litigation risk, it is more difficult today to qualify for a mortgage than any other time in my 40 years in this business. Mortgages are one of the most valuable assets the general public owns. Housing is critical to economic recoveries and is usually one of the first industries to increase employment after a recession.

It doesn't have to be this way. Because of the litigation risk, most small community banks have closed their mortgage departments and aren't even making mortgages any more—a tragedy for small communities. Until the litigation language of Dodd-Frank is changed, the bottom 25 percent of Americans will not get loans, stifling economic growth and denying this group, who need banks the most, access to financial services.

By the way, if the current qualified mortgage (QM) exemption of 43 percent of income would have been in effect before the financial crises, 25 percent of all the homes that were foreclosed would have passed this test. Extending credit is much more complicated than congressional mandates and simplified guidelines can solve. Get rid of the “ability to pay” litigation risk and indict any institution or individuals who behave in a criminal or predatory fashion.

We also need to replace our current fiscal and monetary policies with those policies that worked well in the past for fast and strong economic recoveries.

As a result of all of the mistakes I have mentioned, our economy is growing at the slowest recovery pace in history, unemployment continues to be high, our labor participation rate is at an all-time low, our budget deficits are the highest in history, and Americans have lost confidence in our leaders, in themselves, and in our free enterprise system—a system that has created the greatest wealth of any nation in history. We have also lost the respect, admiration, and confidence of the rest of the world.