

The Importance of Legitimacy in the Government's Response to the Financial Crisis

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It is a great honor to join you today to present the Elliott Richardson lecture. I was a young public interest lawyer when Mr. Richardson resigned in 1973 as Attorney General of the United States on a matter of principle. In those years of Watergate and Vietnam the legitimacy of government actions was widely questioned. "Don't trust anyone over 30" was a rallying cry for many young people at the time. Elliott Richardson, a distinguished public servant and definitely over 30, showed us that integrity and courage are appropriate at any age.

The theme of the lecture series, Ethics and Integrity in the Public Service, is especially relevant today. We are suffering a new crisis of legitimacy as we try to make sense of the causes of our financial debacle and what to do about it. My concern is that, if public anger is not channeled into a constructive response, we could compound our financial problems and deny ourselves useful options. Policymakers must take care that the public sees their actions as being not only effective, but also legitimate, i.e., involving both fair policies and fair decisionmaking processes.

Today I would like to talk about the financial debacle and why it offends the public's basic sense of fairness. Then we should talk about where to go from here. Three elements are needed to provide a sense of legitimacy for the government's response. One element is leadership. Many years ago, my agency, the Federal Trade Commission, sent me to the Program for Senior Managers in Government at the Harvard Business School. The B-School taught that people expect three things from a leader: a sense of mission, stewardship, and fair play. Effective leadership in the financial debacle means telling the public what the government is doing and why, that the Administration will be a good steward of the economy and taxpayer resources, and that the government response will be fair and open.

The second element is to develop effective policies. The Obama Administration has assembled a team of able economists who are working together with Federal Reserve Chairman Ben S. Bernanke. Mr. Bernanke is a student of financial crises and the Great Depression, and is particularly well situated to respond rapidly to the crisis as it unfolds. But this time is different and experts and policymakers differ on the solution.

If we don't know what the solution will be, we lack benchmarks for determining whether current initiatives are working or not. Should we spend hundreds of billions of dollars to keep insolvent banks open or should we close them down? As we watch the Treasury and Fed struggle to contain the expanding crisis we now understand why President Franklin Roosevelt was known as "the great experimenter."

Third, effective policies alone are not enough. Government also needs capacity to carry them out. Capacity is notably absent today for implementing many parts of the financial rescue and stimulus packages. There is a role here for public administration to help make the case for enhancing government's capacity and to show how. Especially if we still are searching for the right policy solutions, effective leadership and greater governmental capacity are needed so that the public sees the Administration's efforts – and results – as legitimate.

I. The Financial Debacle Upsets Public Conceptions of Fairness

Last week's newspaper bears a headline: "Lawmaker Tried to Aid Bank Partly Owned by Husband".¹ The story is likely to stoke anger on several different levels. First, it involves a member of Congress pressing Treasury to hand out taxpayer money in a way that would benefit a spouse. Second, banks are supposed to be prudent; readers might ask whether Treasury should use taxpayer money to bail out a bank that should have stayed out of trouble in the first place. Third, the bank qualified for this taxpayer money only because it lost rather than made money in its operations.

We can't afford many more stories like this. Public anger can lead to seriously dysfunctional results. Members of Congress, who sometimes encouraged regulatory weakness that contributed to the financial debacle, may try to deflect that anger and accuse the usual populist suspects: highly paid Wall Street moguls, undeserving foreigners, and of course, incompetent government. We are seeing this in the current furor over bonuses paid to executives of AIG, the failed insurance company. Congress could then pass laws or refuse to pass laws in ways that might seriously limit the ability of Treasury and the Federal Reserve to contain and overcome the financial crisis.

Social scientists have long understood this dynamic. Professor Tom R. Tyler has written that legitimacy is "a reservoir of loyalty on which leaders can draw, giving them the discretionary authority they require to govern effectively." Conversely, to the extent that action by authorities loses the perception of legitimacy, the political process is likely to restrain policymakers'

¹Binyamin Appelbaum, "Lawmaker tried to Aid Bank partly Owned by Husband," *Washington Post*, March 14, 2009, p. A3.

discretion.² Tyler adds, and this applies directly to today's circumstances, that legitimacy is based not only on substantive fairness but also on a process that people consider to be fair.

The financial debacle offends public concepts of fairness. The theory of our free enterprise system has been that the reward of success is that companies should be allowed to reap profits, and even huge profits. On the other hand, if a company fails, it and its managers and owners should be prepared to lose everything as the market forces it into insolvency.

Rushing to contain the financial crisis, policymakers have violated this principle. Wall Street managers and corporate CEOs receive bonuses even as their companies collapse and seek taxpayer bailouts.

The public sees this as unfair. Failed companies dominated the political system and blocked legislation that might have forestalled their collapse. For years General Motors blocked fuel economy standards, limits on hazardous emissions, and auto safety laws. GM lost market share to more nimble firms that produced better cars. GM also lost the perception of its legitimacy that might have softened objections to providing a bailout. A basic question hovers in the background: how will infusions of taxpayer money help GM if the auto industry has extreme overcapacity and too few people want to buy GM cars?

Short-sighted application of political power also contributed to collapse of major Wall Street firms. In 2004 five large investment banks convinced the Securities and Exchange Commission (SEC) to liberalize capital requirements and let them greatly inflate their leverage. The investment banks complained that the SEC should relax this regulatory burden because of overseas competition. High leverage meant greater profits. It also meant that the companies lacked enough capital to absorb losses from the hundreds of billions of dollars of questionable mortgages and mortgage securities that they funded. The five companies succumbed to the ancient curse: be careful, you may get what you want. Bear Stearns failed and was rescued with taxpayer support. Merrill Lynch sold itself to Bank of America. Lehman Brothers went bankrupt. Goldman Sachs and Morgan Stanley converted to commercial banks supported by taxpayers under the Treasury's Troubled Asset Relief Program (TARP).

Fannie Mae and Freddie Mac had the situation even more in hand; until Congress finally passed a new law last July, they operated under preferential rules that kept their capital requirements at one-third to one-half of the capital requirements of commercial banks that also held mortgages. High leverage meant that Fannie Mae and Freddie Mac virtually doubled in size every five years until they funded over \$ 5 trillion of mortgages, over 40 percent of the market, when they went into government hands last September.

² Tom R. Tyler, *Why People Obey the Law*, Yale University Press, 1990, p. 26.

The lore of the free enterprise system has been seriously damaged. The public didn't necessarily believe that firms that made large profits deserved to keep them, but people at least acquiesced. Now they see that failed companies want to have it both ways; auto executives flew their corporate jets to Washington to argue for a taxpayer bailout. Saving them was essential, they said, to protect their many workers, suppliers, and dealers, and states like Michigan and Ohio.

As often is the case, Wall Street executives were more adroit. *Vanity Fair* listed the payment of taxpayer funds to seven big financial institutions compared to the size of bonuses that these firms paid in 2008. Big winners included Merrill Lynch, Bank of America, Morgan Stanley, and Citigroup, all of which paid out more money in bonuses than the billions of dollars they received from the Treasury's TARP.³ To many, it seemed as if we were privatizing the profits and socializing the risks of high finance.

Little wonder that the 2009 stimulus bill, enacted shortly after this became public, greatly limits compensation at financial institutions that receive future taxpayer support. Some suspect that the new legislation may prove dysfunctional, as firms try to repay their government funds at inopportune times or because there will be an exodus of capable managers from firms with compensation caps.

Another area of public contention and concern about legitimacy relates to taxpayer support for homeowners who otherwise might default on their mortgages. The continuing drop in home values means that roughly ten percent of homeowners now owe more on their mortgages than the property is worth. These are called "upside down" mortgages. Perhaps eight million households face the prospect of defaulting on their mortgages. It is reasonable to ask: if we are bailing out insolvent financial institutions, why not bail out insolvent homeowners as well?

While question is easy to ask, answers are harder to devise. Supporting homeowners who are likely to default on their mortgages involves what economists call "moral hazard." How can we avoid providing an incentive for other homeowners, who have been paying promptly, to default on their mortgages and take advantage of taxpayer support too? Won't many homeowners consider themselves fools if they still pay on time?

As someone who has struggled with the issue of unforeseen incentives, I assure you that the problem is complex and manageable only by making practical rather than conceptually elegant choices. If the lender gets to decide whether to seek taxpayer assistance for upside-down mortgages, government will get the worst candidates. Also, experience shows that many homeowners with restructured mortgages will default again. The Obama administration grapples with these questions in a market that continues to decline as more homeowners, current on their mortgages, lose their jobs and are forced to default. These are some of the conundrums in trying

³ Christopher Bateman, "Bonus Babies: The Big Tarp Recipients and their Booty," *Vanity Fair*, February 2, 2009, <http://www.vanityfair.com/online/politics/2009/02/bonus-babies-the-big-tarp-recipients-and-their-booty.html>, accessed February 16, 2009.

to achieve substantive fairness while trying to stave off an even greater economic debacle than we already have.

As Professor Tyler has pointed out, the perception of legitimacy also depends heavily on the perceived fairness of the *process* of decision-making. Here, the Treasury and Federal Reserve appear to have worked themselves into a dilemma. As AIG was failing last year, government discussed the situation with Wall Street CEOs to help gauge the nature of the problem and implications of proposed solutions. But the rescue of a firm helps to protect the firm's counterparties. The perception of legitimacy when the government infused billions of dollars of public funds into AIG was not helped by revelations that the CEO of Goldman Sachs, a major AIG counterparty, both advised policymakers who made that decision and benefited from it.⁴

Treasury Secretary Timothy Geithner later tried the opposite tack: he decided not to consult with Wall Street or other interested private parties before rolling out proposals how to help banks and other financial institutions. That way he could try to avoid perceptions that his plan was engineered by Wall Street and other interested parties. But there was a cost: not consulting with the affected companies meant that Treasury could not vet the plan with the companies involved or set realistic expectations for its success.⁵

Policymakers also face issues of legitimacy in deciding whom to hire or which contractors to select. In reaching for experienced Wall Street hands, former Treasury Secretary Henry Paulson hired or contracted for capable financial managers. But given widespread belief that Wall Street excesses caused the current debacle, excessive reliance on Wall Street also can arouse popular suspicion and concern.

Once people and organizations suspect a lack of fairness, problems of perceived legitimacy become even more difficult. Many believed that Treasury's original TARP rescue plan involved inconsistency and favoritism in decisions, for example, about which banks would receive taxpayer funds and which wouldn't. The *Washington Post* reported that a processing backlog led banks to seek out influential members of Congress to push for prompt and favorable decisions. Reports surfaced that political pressure paid off; then the perception of legitimacy eroded further.⁶

Thus, legitimacy is a critical issue to address. Seeking technically superior solutions, while important, is not enough. Commentary by Michael Lewis and David Einhorn that, "At every turn

⁴ Gretchen Morgenson, "The Reckoning: Behind Insurer's Crisis, Blind Eye to a Web of Risk," *New York Times*, September 28, 2008; Mary Williams Walsh, "A.I.G. Lists Banks It Paid With U.S. Bailout Funds," *New York Times*, March 16, 2009.

⁵ Neil Irwin and Binyamin Appelbaum, "Late Change in Course Hobbled Rollout of Geithner's Bank Plan," *Washington Post*, February 17, 2009, p. D01.

⁶ David Cho and Lori Montgomery, "Delays in Bank Aid Spur Frustration; As Requests Pile Up, Executives Leery Of Treasury's Silence on Bailout Decisions," *Washington Post*, January 23, 2009, p. D01.

we keep coming back to an enormous barrier to reform: Wall Street’s political influence,”⁷ is likely to be a harbinger of popular criticism that could seriously constrain the ability of government to respond to the crisis.

II. Where Do We Go From Here?

Consider three elements needed for a perception of legitimacy: effective leadership, effective policy, and effective implementation.

Effective Leadership

The Obama administration begins with leadership strengths. The president is smart and articulate. He came into office only recently and cannot be blamed the debacle. He understands the need to explain publicly why government makes particular policy choices.

For example, some ask why taxpayers should bail out banks. There is an answer to this question, relating to the essential nature of our financial system, but the technical justifications are not easy to explain.⁸ In his first address to the Congress, President Obama positioned the question brilliantly:

“So I know how unpopular it is to be seen as helping banks right now, especially when everyone is suffering in part from their bad decisions. I promise you – I get it.

“But I also know that in a time of crisis, we cannot afford to govern out of anger, or yield to the politics of the moment. My job – our job – is to solve the problem.

“Our job is to govern with a sense of responsibility. I will not spend a single penny for the purpose of rewarding a single Wall Street executive, but I will do whatever it takes to help the small business that can’t pay its workers or the family that has saved and still can’t get a mortgage.

“That’s what this is about. It’s not about helping banks – it’s about helping people.”⁹

The president seems ready to provide the key elements of leadership: to convey a sense of mission (why we are making particular policy choices), stewardship (that he will protect our economic resources), and fair play (within the realistic limits of political leadership, that he will

⁷ Michael Lewis and David Einhorn, “How to Repair a Broken Financial World,” op-ed commentary, *New York Times*, January 4, 2009.

⁸ See, e.g., Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash D. Persaud, and Hyun Shin, “The Fundamental Principles of Financial Regulation,” preliminary conference draft, International Center for Monetary and Banking Studies, January 2009, p. 3, at <http://www.voxeu.org/reports/Geneva11.pdf>, accessed January 28, 2009.

⁹ President Barack Obama, Address to a Joint Session of Congress, February 24, 2009.

not allow hidden political influence to distort choices that need to be made on behalf of the national interest). It remains to be seen whether President Obama's analysis will persuade an angry public to take politically unpopular steps in the future that may be needed to resolve the financial crisis.

Effective Policies

Despite Herculean efforts of the Treasury and the Federal Reserve since mid-2007, the economy continues its downward spiral. We are in uncharted territory. Policymakers continue to search for policies to restore our economy and, indeed, the global economy.

One popular complaint about TARP is that banks are not using TARP funds to expand their lending enough. I am not sure whether that is the right issue. Do we really want to pressure banks to lend in today's declining market?

There is precedent for this question. The Roosevelt Administration engaged in federal lending, as well as a much larger version of today's TARP investments in commercial banks, through the Reconstruction Finance Corporation (RFC). In the 1930s, as today, banks hesitated to lend into a difficult market.¹⁰ Perhaps, rather than criticizing banks, the government today should implement New Deal-type programs of credit support to key sectors of the economy. Programs from the RFC were dispersed among federal agencies such as the Small Business Administration, Export-Import Bank of the United States, and Ginnie Mae. Given the need to act quickly today, coordinated lending by separate federal agencies would make more sense than trying to recreate a central lending facility.

It will take time before we find the right policy solutions. Government must maintain a perception of legitimacy during the search, so that the public maintains the patience needed to work through our problems. As Professor Tyler has shown, and indeed common experience shows, people are willing to accept even unsatisfactory outcomes, so long as the process is perceived as fair.

Effective Implementation

Whatever policies ultimately seem appropriate, they must be well implemented. Public administration has much to contribute in informing policymakers how to increase government's *capacity* to respond effectively. The institutional infrastructure of government must be strong, not only to respond to the evolving financial and economic crisis, but also to respond in a way that the public finds legitimate.¹¹

¹⁰ James S. Olson, *Saving Capitalism: The Reconstruction Finance Corporation and the New Deal, 1933-1940*, Princeton University Press, 1988, chapter VIII.

¹¹ This is explored more fully in, Thomas H. Stanton, "Increasing Government's Ability to Deal with the Financial Crisis," IBM Center for the Business of Government, March 2009,

We need to increase the capacity of Treasury and other federal departments and agencies, notably the Federal Housing Administration (FHA), and back these up with increased capacity on the management side of OMB. Consider each of these in turn.

Treasury

Because of limited staffing, Treasury has delegated much of its work to others. Treasury largely leaves to the federal bank regulators decisions about which institutions qualify for TARP funds. Treasury also hires contractors to manage critical aspects of TARP. Treasury requests its contractors to report on their own conflicts of interest and ways of addressing them. This hands-off approach may well raise questions of legitimacy down the road if self-reporting turns out not to be accurate.

The government landscape is littered with federal projects that involve such excessive delegation without the host agency retaining adequate capacity to ensure that contractors faithfully and cost-effectively carry out their responsibilities. Treasury needs to build its own capacity. One approach would be to turn Treasury's Office of Financial Stability that implements TARP into a wholly owned government corporation or, perhaps more appropriately, into a performance-based organization. Both of these organizational forms permit government agencies to conduct their operations on a more businesslike basis and with potentially greater organizational capacity and flexibility than they otherwise could. Whichever form is selected, it would be advisable to borrow from the experience of the Resolution Trust Corporation, a temporary wholly owned government corporation, which effectively disposed of assets from the savings and loan crisis, and to make the new organization temporary rather than permanent, with a sunset date in its charter. A temporary organization can attract superior talent without undergoing the increasing rigidity that sometimes besets permanent agencies of government. This approach will be especially important if Treasury decides to use TARP to purchase troubled assets from financial institutions.

The Federal Housing Administration (FHA)

HUD Secretary Steve Preston pointed out in November 2008 that FHA's volume trebled over the prior year. He said that FHA is not strong enough, either in statutory authority or administratively, to carry the load. Secretary Preston objected to Congress' refusal to allow FHA to implement modest risk-based pricing. He pointed to FHA's patchwork of IT systems, noting that FHA's core loan processing system is still written in COBOL.¹²

The HUD Inspector General and other housing experts worry that fraud will increase as subprime lenders move their loan production to FHA. Kenneth M. Donahue, HUD's Inspector

http://www.businessofgovernment.org/publications/grant_reports/details/index.asp?gid=332, accessed March 20, 2009.

¹² HUD Secretary Steve Preston, Prepared Remarks at the National Press Club, November 19, 2008, available at <http://www.hud.gov/news/speeches/2008-11-19.cfm>, accessed January 2, 2009.

General, warns that “It looks like an incoming tsunami.” FHA lacks capacity to monitor and respond quickly to fraud. The agency lacks the ability promptly to remove fraudulent or abusive lenders.¹³

We need to address these shortcomings before FHA starts taking heavy losses and adds to a public perception that government doesn’t know what it’s doing. Ideally, now that Fannie Mae and Freddie Mac are in government hands, the two mortgage companies should provide systems and facilities to help FHA implement its expanding responsibilities.

The Office of Management and Budget (OMB)

Input from OMB about management and implementation of the government’s response to the financial crisis is badly needed. OMB should create a new Financial Stability and Credit office to support the government’s response to the financial crisis. The office should be in OMB to ensure that its analyses are done by career officials, appropriately shaped to conform to the Administration’s policy positions, and presented to political appointees for decision, at the National Economic Council, for example. OMB is especially suitable because of its focus on government performance and effective management and implementation of critical government programs.

This staff could include desk officers with responsibility for gathering information from each federal financial and credit agency and for placing that information into a set of policy briefings and policy options. It also would consider the extent that particular policy initiatives raise questions of legitimacy in the eyes of stakeholders and the public. The staff would be particularly attuned to trying to ensure the capacity and accountability of agencies playing important roles in the government’s response.

The staff could help to anticipate unintended consequences of interactions among the diverse aspects of the government response. The staff also can help policymakers to avoid the horns of major dilemmas. For example, should government consult with lenders and other market participants before rolling out major initiatives? If the government does consult, as in the rescue of AIG, it appears to be favoring interested parties with its decision. On the other hand, if government does not consult with market participants it loses the necessary sense of how the market may respond to policy initiatives. The staff can help to remove this dilemma; while career staff would be authorized to sound out market participants in developing policy options, major decision makers could shield themselves from the perception that they somehow were influenced by those market participants. This can help to enhance the perceived legitimacy of such discussions.

OMB and Treasury also should create and strengthen interagency working groups to help bring resources of multiple agencies to bear. The quality of the government’s response will increase if agencies besides Treasury also do their part.

¹³ Barry Meier, “As FHA’s Role Grows, So Does the Risk of Fraud,” *New York Times*, December 10, 2008.

In summary, increasing the capacity of government can improve the perception of legitimacy by reducing the scope of misunderstandings, increasing the role of career federal officials in policy development and stakeholder relations, and reducing the gap between intended policies and their effective implementation. Increased institutional capacity, combined with presidential leadership in articulating the mission, ensuring stewardship of public resources, and emphasizing fair play, can go far when it builds on a platform of increased governmental capability.

III. Conclusion

It is useful to return to the beginning of this discussion, the way that the financial debacle has upset fundamental expectations of the free enterprise system that winners should be rewarded and losers should leave the table. Alan Greenspan's recent testimony is instructive. Mr. Greenspan said: "I made a mistake in presuming that the self interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders and the equity in the firms."¹⁴

Mr. Greenspan's statement raises profound issues about corporate governance and the relationship of managers to shareholders. Given our political culture, which prefers pragmatic solutions to theoretical niceties, it is likely that we ultimately will muddle through to some useful resolution. In addition of course, policymakers across the political spectrum now call for enhanced financial regulation, both of individual institutions and of risks to the larger financial system.

Especially when we are still trying to decide which actions will be most effective, government must strive to maintain the perception of legitimacy. Increasing capacity of relevant government agencies, and especially the management side of OMB, should be an essential part of this. Otherwise the backlash can and will lead to counterproductive policies. The discussion today shows that the issue of legitimacy is pervasive and fundamental and must be addressed to help us to work our way out of today's difficult circumstances.

Thank you.

¹⁴ Kevin G. Hall, "Greenspan takes some blame for financial meltdown," McClatchy Newspapers, October 23, 2008, http://www.mcclatchydc.com/staff/kevin_hall/v-print/story/54712.html, accessed 12-06-2008.