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Bankruptcies, Bailouts and the Banking Bureaucracy: The Bush Agenda and the Capacity for Crisis

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Abstract

True crises, such as the recent failure of the financial markets, test the capacity of the permanent bureaucracy. Leadership, responsiveness, and creativity, as well as stability and practicality, were put to the test in the intense summer and fall months of 2008. Major financial institutions failed or sat on the brink of failure, liquidity froze, the credit market vanished, foreclosure rates soared, and the government struggled to prevent further economic collapse. Just as critically, the capacities of regulatory foresight and independence, along with long-standing regulatory procedures, had in effect been tested in the decade leading up to the crisis. What was the impact of the Bush Administration's management of the financial regulatory bureaucracy over his eight-year presidency? What was its impact in the midst of the crisis at the close of his last term? This paper examines the longer-term capacity of foresight—the expertise and independence to see a crisis on the horizon and to speak truth to power in the midst of economic boom time—and the short-term capacities of responsive competence in the form of policy and administrative answers to the immediate challenges of the crisis itself.

KEYWORDS: financial regulatory bureaucracy, Bush Administration, bureaucratic capacity, crisis

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As with many presidents before him, President George W. Bush entered office with strong, negative views about the capacity, performance, and potential of the permanent bureaucracy—the policies, practices, professionals, and cultures that govern the day-to-day work of the federal government. A variety of techniques were employed to shape the work of government agencies to facilitate the Administration's perspective of a "unitary executive", one elected with a mandate and a governing philosophy that promoted the compliance and support of federal employees across the government in the management of programs. As the author of a 2001 Heritage Foundation study described the governing philosophy, agency employees should be "personally accountable for achievement of the president's election-endorsed and value-defined program."¹

Just how effective the Administration was in bringing about a responsive bureaucracy is, however, a complicated question. By many accounts, the Bush Administration's initiatives had immediate impacts on the day-to-day functioning of government organizations. Deployment of the five-part President's Management Agenda (PMA), including the Program Assessment Rating Tool (PART), drove a performance agenda evident in the shifting of managerial attention and priorities² while it provided a framework for participants in the budget process to hone objectives, assign meaning to the findings, and negotiate priorities for the future.³ The importance of a performance-based agenda and its role in managing the executive branch was clear for the Bush Administration:

Federal programs should receive taxpayer dollars only when they prove they achieve results. The federal government spends over \$2 trillion a year on approximately 1,000 federal programs. In most cases, we do not know what we are getting for our money. This is simply unacceptable.⁴

Key political appointments and new systems for personnel management were also central to the Administration's efforts to manage the bureaucracy. Ideological loyalists and managerial generalists steeped in business practices edged out technical expertise in decision-making related to regulation, rule

¹ Robert E. Moffit. 2001. "Personnel is Policy: Why the New President Must Take Control of the Executive Branch." *Backgrounder #1403*, The Heritage Foundation. Available on the Web at: <http://www.heritage.org/Research/GovernmentReform/BG1403.cfm>.

² Michael Milakovich. 2006. "Comparing Bush-Cheney and Clinton-Gore Performance Management Strategies: Are they More Alike than different?" *Public Administration* 84 (2): 461-478.

³ Matthew Dull. 2006. "Why PART? The Institutional Politics of Presidential Budget Reform." *Journal of Public Administration Research and Theory* 16 (2): 187-215

⁴ Office of Management and Budget. 2004. "Rating the Performance of Federal Programs. Available on the Web at: <http://www.gpoaccess.gov/USBudget/fy04/pdf/budget/performance.pdf>

making, and scientific policy.⁵ Personnel reform, another strategic component of the PMA, was sweeping, with Chief Human Capital Officers introduced across the executive branch agencies in 2002, and the National Security Personnel System (NSPS) introduced in DOD as a performance-based system for civilian personnel. Yet a similar system, MaxHR, introduced in the new Department of Homeland Security in 2003, was rescinded in 2008 following several court battles contesting implementation and then legislation that prevented funding for the system.⁶

Taken together, efforts by the Bush Administration to bring government agencies under more centralized control continued long-established presidential practices of centralizing, politicizing, and more tightly managing the permanent bureaucracy to align public expectations and presidential objectives with bureaucratic performance.⁷ Yet as the recent rescinding of MaxHR indicates, the long-term impact of the changes is mixed. Recent research across a range of policy areas from homeland security, environmental regulation, education, and energy suggests the impact of the Bush Administration on the structure and actual policy outputs of the permanent bureaucracy was minimal, or neutralized by the steadfast procedures and practices of government agencies.

This paper reviews the impact of the Bush Administration's management of one sector of the permanent bureaucracy, the financial regulatory agencies, by examining the capacities of these agencies leading up to and in the midst of the recent financial crisis. Specifically, how did Administration decisions regarding appointments, performance expectations, structure, and policy change hold up in response to the financial turmoil of the past two years? How did these decisions impact the longer-term capacity of foresight as reflected in the expertise and independence to see a crisis on the horizon and to speak truth to power in the midst of an economic boom time, as well as the short-term capacities of responsive competence for providing policy and administrative answers to the immediate challenges of the crisis?

The general topic of crisis and the permanent bureaucracy is briefly examined in the next section. We look then specifically at the broad goals of the

⁵ Gerald Markowitz and David Rosner. 2003. "Politicizing Science: The Case of the Bush Administration's Influence on the Lead Advisory Panel at the Centers for Disease Control." *Journal of Public Health Policy*, Vol. 24, No. 2 (2003): 105-129; Rob Stein. 2009. FDA Ordered to Rethink Age Restriction for Plan B: Judge Says Politics Influenced Policy on the Contraceptive." *Washington Post*, March 23, 2009. Available on the Web at:

<http://www.washingtonpost.com/wp-dyn/content/article/2009/03/23/AR2009032301275.html>

⁶ Thomas D. Cairns. 2008. "Memorandum for all DHS Employees: DHS Human Resources Management System." Available on the Web at: <http://www.govexec.com/pdfs/100208b1.pdf>

⁷ Terry M. Moe. 1985. "The Politicized Presidency," in *New Directions in American Politics*, ed. John E. Chubb and Paul E. Peterson. Washington, D.C.: Brookings.

Bush Administration for financial regulation coming into office, at the agendas and leadership styles of political appointees heading up the various financial regulatory agencies, at staffing, resources, and initiatives, and finally, at the responsiveness of each agency in the midst of the crisis. The point is not to place or remove the blame from the Bush Administration for the financial crisis, but to use this crisis as a means to look simply but powerfully at the impact of the Administration on this important segment of the permanent bureaucracy.

Crisis and the Permanent Bureaucracy

For the family facing foreclosure on their home, the victim of a hurricane, or employees in a factory that has just closed its doors, crises are often unanticipated and unimaginable. But rarely do crises strike without a preamble of warnings, signals, or the incremental ratcheting up of stress points, discussed and interpreted by key experts. From the perspective of a government agency, continuously gathering data about the arena in which it operates, the challenge is finding ways to gather the early data in a coherent actionable manner, finding the political will to take preemptive or flexible action, and focusing resources on planning, prevention, and the ability to respond.

The 9-11 Commission report, for example, documented a long trail of scattered information about members of Al Qaeda, available to components of the FBI, the CIA, and other intelligence agencies in the years and months leading up to the attacks on the World Trade Center, the Pentagon, and the plane crash in Pennsylvania. Yet nowhere was the information of an impending terrorist attack available in a comprehensive, or more systematic, form.⁸ On the other hand, crises do not always result from organizational stovepipes and poor communication, but instead from an inability to act or take collective action to halt a growing and well-known problem. For example, at current levels of taxation and benefits, the Social Security trust fund assets will be exhausted in 2037,⁹ yet political efforts to address the problem falter without the will to make hard choices of higher taxes, lower benefits, or both. And sometimes crises are anticipated, but planning is poor or the potential crisis is simply ranked as a lower priority on a broader scale of immediate risks. Such was the case with Hurricane Katrina.

The federal government's failed response to Katrina had its roots in Bush Administration policy and organizational decisions leading up to the formation of the Department of Homeland Security (DHS), and immediately afterward, that

⁸ *The 9-11 Commission Report*. See chapters 6, 7, 8 and 11. Available on the Web at: <http://www.9-11commission.gov/report/911Report.pdf>

⁹ Social Security Administration. 2009. "Status of the Social Security and Medicare Programs. A Summary of the 2009 Annual Reports." Available on the Web at: <http://www.ssa.gov/OACT/TRSUM/index.html>

reduced resources and commitment to natural disasters in favor of a comprehensive focus on preventing, preparing for, and responding to terrorist attacks.¹⁰ Critics of the Administration's response focused on a variety of failures in communication between the federal, state, and local governments, failures in preparation, and perhaps most critically, failure by the administration and appointed leaders to take preemptive action.¹¹ The passive response of Mike Brown as director of FEMA and Michael Chertoff as secretary of DHS reflected their lack of emergency management experience. As reported by the Select Bipartisan Committee of the House of Representatives (U.S. Congress 2006):

[P]assivity did the most damage. The failure of initiative cost lives, prolonged suffering, and left all Americans justifiably concerned our government is no better prepared to protect its people than it was before 9/11.¹²

Government agencies need to be consistent and steady in their processes, while having the capacity to be flexible and responsive. Consistency, perhaps even passivity, is at times required to insure efficient operations, accountable procedures, and due process. Yet crises require organizations to be proactive, and to work outside of established parameters. In his work, *The Next Government of the United States*, Donald Kettl¹³ describes "vending machine" problems that can be addressed with many existing organizational capacities: the issue or problem is understood, the solution or method of engaging the problem is established, and the consistent, steady implementation by government organizations is sufficient.

Other problems, however, require "rocket science" innovation: the nature of the problem is complex, layered across questions of federalism, public and private sector boundaries, and global implications. It is a rare organization able to build and sustain both capacities, and as Kettl notes, most government

¹⁰ Anne Khademian. 2009. "Hurricane Katrina and the Failure of Homeland Security," in Robert Maranto, et al (eds.) *Judging Bush*. Stanford, CA: Stanford University Press.

¹¹ Senate Committee on Homeland Security and Governmental Affairs. 2006. *Hurricane Katrina: A Nation Still Unprepared (A Report)*. Washington, DC: US; Christopher Cooper, and Robert Block. 2006. *Disaster: Hurricane Katrina and the Failure of Homeland Security*. New York: Times Books; Donald Menzel. 2006. "The Katrina Aftermath: A Failure of Federalism or Leadership?" *Public Administration Review* 66(6): 808-12; Charles Wise. 2006. "Organizing for Homeland Security After Hurricane Katrina: Is Adaptive Management What's Missing?" *Public Administration Review* 66(3): 302-18.

¹² U.S. Congress. Select Bipartisan Committee to Investigate the Preparation for and Response to Hurricane Katrina. 2006. *A Failure of Initiative: Final Report of the Select Bipartisan Committee to Investigate the Preparation for and Response to Hurricane Katrina*. 109th Congress, 2nd Session, H. Rept. 109-377. Washington, DC: U.S. Government Printing Office.

¹³ Donald Kettl. 2009. *The Next Government of the United States: What our Institutions Fail us and how to Fix them*. W.W. Norton.

organizations today are built upon the model of Progressive reform to address specific problems through hierarchy, clear spans of control, and written rules and procedures. This is in contrast to the approaches required to address many of today's complex problems—terrorism, exploding costs for social security and Medicare, and disasters on the scale of Hurricane Katrina—that may require collaboration, innovation, broad delegation, and a clear focus on the mission as a guide, rather than on adhering to established procedures. The financial meltdown of 2008 stands out as one such complex problem.

The Financial Meltdown as Public Policy Crisis

On April 2, 2007, the largest independent provider of home loans to people with poor credit ratings, New Century Financial, declared bankruptcy. Several weeks earlier, the company's auditing firm, KPMJ, and New Century accountants told the Board of Directors that reserves for high-risk home loans had been calculated incorrectly; \$300 million in profits for the second half of 2006 were now gone.¹⁴ In addition to New Century's accounting problems, the company was highly leveraged. Just over \$2 billion in equity was used to control more than \$25 billion in assets. Other financial firms who were creditors to the sub-prime lender soon felt the blow back of New Century's failure on their own balance sheets. More than \$8 billion in loans had been made to New Century by Bank of America (BOA), Citigroup, UBS, Morgan Stanley, and others. As part of the bankruptcy restructuring, New Century announced the company would cut 3200 jobs from its workforce.¹⁵

The New Century failure manifests many of the problems that would soon define the financial crisis: lax accounting, complex assets built upon sub-prime mortgages, a staggering real estate market and daily foreclosures, excessive leverage (companies controlling assets worth as much as 35 times the equity held), intricate and distressing connections with balance sheets across the global financial world, contracting credit, layoffs and job loss, and more home foreclosures. Other troubled institutions met a similar fate, from American Home Mortgage Investment Company and Countrywide Financial Corporation to the investment banks Bear Stearns and Lehman Brothers, to the financial giants Bank of America and Citigroup, to the insurance behemoth AIG. Among these, Lehman

¹⁴ Vikas Bajaj and Julie Creswell. 2008. "A Lender Failed: Did its Auditor?" *New York Times*, Available on the Web at: <http://www.nytimes.com/2008/04/13/business/13audit.html>

¹⁵ CNNMoney.com. 2007. "New Century files for Chapter 11 bankruptcy: Troubled subprime mortgage to cut 3,200 jobs, sell servicing, seek funding while it reorganizes." (April 2). Available on the Web at: http://money.cnn.com/2007/04/02/news/companies/new_century_bankruptcy/. Federal Reserve Bank of St. Louis. The Financial Crisis: A Timeline of Events and Policy Actions. Available on the Web at: <http://timeline.stlouisfed.org/index.cfm?p=timeline>

Brothers collapsed. Others, such as Countrywide and Bear Stearns, found a white knight to rescue them with support from the Fed. Still others, such as Wells Fargo, BOA, Citigroup, and AIG took billions from the Troubled Asset Relief Program (TARP), a fund established to prop up capital positions through Treasury purchases of bank stock and loans from the Fed.¹⁶

Just over a year later, a massive rescue package passed by Congress (the Emergency Economic Stabilization Act which created the TARP), and a series of extraordinary measures implemented by the Fed, the Treasury, and other financial regulators had averted a financial meltdown, and signs of economic recovery were evident. Through purchases of troubled assets, loans, and purchases of securities, the Fed and Treasury injected nearly \$3 trillion into the financial system to insure liquidity, restore credit, and support lending once again. Today, in late 2009, residential mortgage lending is slowly on the up-tick, several of the largest banks have begun to pay back money drawn from the Troubled Asset Relief Program, the overall economy is showing signs of growth, but unemployment remains at a very high 10 percent.¹⁷

As evidenced by criticism of the Fed during the reconfirmation hearing of Ben Bernanke, Federal Reserve Board Chairman, before the Senate Banking Committee in December, not everyone is thrilled with the extraordinary measures taken by the Fed and other financial regulators to ease the financial crisis.¹⁸ Indeed, the most significant impact of the crisis on the financial regulatory bureaucracy may be the congressional changes mandated to reassign regulatory responsibility across a number of agencies—some new, some existing—to prevent a similar crisis from happening in the future. But let us back up to the early days of the Bush Administration. What were the plans for the financial

¹⁶ John Cassidy. 2008. "Anatomy of a Meltdown: Ben Bernanke and the Financial Crisis." *The New Yorker*, December 1, 2008: Available on the Web at

http://www.newyorker.com/reporting/2008/12/01/081201fa_fact_cassidy; Ethan Harris. 2008. *Ben Bernanke's Fed: The Federal Reserve After Greenspan*. Cambridge, MA: Harvard Business School Press; Roger Lowenstein. 2008. "The Education of Ben Bernanke." *The New York Times*, January 20, 2008.

<http://www.nytimes.com/2008/01/17/news/17iht-20benbernanket.9285552.html>;

Roger Lowenstein, 2008. "Triple A Failure: The Ratings Game," *The New York Times*, April 27, 2008; Anne Khademian (ed). 2009. "A Public Administration Review Symposium on the Financial Crisis." *Public Administration Review* 69 (4): 595-667

¹⁷ Secretary of Treasury Timothy F. Geithner. 2009. "Written Testimony before the Congressional Oversight Panel December 10, 2009." Available on the Web at:

<http://www.treas.gov/press/releases/tg437.htm>

¹⁸ Chairman Ben S. Bernanke. 2009. Confirmation hearing before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., December 3, 2009. Available on the Web at: <http://www.federalreserve.gov/newsevents/testimony/bernanke20091203a.htm>; Edmund L. Andrews. 2009. "Bernanke says 'Fed should have done more.'" December 3, 2009. Available on the web at: <http://www.nytimes.com/2009/12/04/business/economy/04fed.html>

regulatory bureaucracy? And how were the financial regulators equipped to engage the financial crisis?

The Bush Administration's Financial Regulatory Agenda: Appointments, Appointments, Appointments

There are explicit limits on the influence the President can exercise over the financial regulatory bureaucracy. First, there are multiple regulatory entities, each with jurisdiction over slices of financial market activities:

- The Board of Governors of the Federal Reserve System (Fed), for example, is responsible for national monetary policy through the regulation of bank reserves. The Fed has the authority to supervise state chartered banks that are members of the Federal Reserve System, the US branches of foreign banks, bank holding companies, and, with the passage of the Gramm Leach Bliley Act in 1999, financial holding companies.
- The Federal Deposit Insurance Corporation (FDIC), on the other hand, provides insurance for customers of banks and thrifts (since the crisis began, up to \$250,000 in the event of a failure) and supervises the safety and soundness of state-chartered banks that do not belong to the Federal Reserve System. Risk-based assessments are levied against depository institutions to generate the Bank Insurance Fund, managed by the FDIC to resolve the assets of failed or failing banks.
- The Office of the Comptroller of the Currency (OCC), grants charters to national banks and supervises national bank activities for safety and soundness, while the Office of Thrift Supervision (OTS) supervises the safety and soundness of nationally chartered thrifts (or savings institutions) and thrift-holding companies, plus state-chartered thrifts with federal insurance.
- Nationally chartered credit unions (member-owned, not-for-profit financial cooperatives) are regulated by the National Credit Union Administration (NCUA), as are state chartered credit unions.
- In addition to the depository, or banking-related financial regulators, the Securities and Exchange Commission (SEC) regulates the securities markets by enforcing disclosure of information about publicly traded companies, establishing rules for the buying and selling of securities, and overseeing the work of brokers, dealers, and other financial market intermediaries along with the regulatory efforts of self regulatory organizations (SROs) such as the New York Stock Exchange.
- Financial instruments traded as futures contracts are regulated in a similar fashion by the Commodities Futures Trading Commission (CFTC). This list is

not exhaustive, but provides an overview of the complexity associated with any comprehensive effort to guide or influence financial regulatory policy.

Second, despite the numerous agencies with regulatory authority, a wide range of financial activity is not regulated. Non-bank lenders, or institutions without bank, thrift, or credit-union charters, issued many of the sub-prime loans at the heart of the financial crisis. Hedge funds, privately traded securities, derivatives traded in over-the-counter markets, foreign exchange markets, and the markets for US Treasury securities all remain unregulated, or lightly regulated. Any presidential effort to influence comprehensively the activities of the regulatory agencies would miss a wide range of vital financial activity.

Third, the regulatory agencies that are in place are primarily self-funded. The Fed, FDIC, OCC, OTS, and NCUA, for example, generate income through their regulatory activities that fund the organizations. Presidential efforts to influence staffing or regulatory priorities are limited by the internal generation of the budget. With the exception of the OCC and the OTS (both agencies located in the Department of Treasury), these agencies are also governed by Boards of Directors with bi-partisan membership and individual terms that exceed or overlap with presidential terms.

Yet presidents enter office with policy preferences, constituent backing, leadership obligations, and, importantly, opportunities to appoint the chairs of the regulatory agencies. When President Bush entered office in January of 2001, the financial industry was on a roll. The barrier between banking, securities, and insurance that had been imposed during the Depression was removed with the passage of the Gramm-Leach-Bliley Act, signed into law by President Bill Clinton in 1999, and barriers to interstate banking were removed during Clinton's first term in 1994 by the Riegle-Neal Interstate Banking and Branching Efficiency Act.

The Dow Jones Industrial Average was over 10,000, and the Standard and Poor Index hovered around 1300.¹⁹ The banking industry was undergoing extensive consolidation, but experiencing high profits spurred in large part by financial product innovation involving securitization and derivative markets.²⁰ While periodic warnings about the need to disclose the risks associated with the newer financial instruments were expressed by regulators,²¹ there was no urgency

¹⁹ Dow Jones Indexes. Available on the Web at : <https://users.djindexes.com/>

²⁰ Remarks by Governor Olson. 2002. "The Banking Industry in 2002 after a Decade of Change" Before the First Annual Convention of the Ohio Bankers League, Columbus, Ohio, November 12, 2002. Available on the Web at: <http://www.federalreserve.gov/boarddocs/speeches/2002/200211124/default.htm>

²¹ Barbara A. Rehm. 2003. "Here's an Idea: Disclose Risks, Not Just Data." May 23 . *American Banker* 168 (99).

in the Administration or in Congress to more tightly regulate, much less rein in, a flourishing Wall Street. Wall Street firms gave generously to the Bush campaigns of 2000 and 2004 to try to help ensure a light regulatory touch, as well. In 2000, presidential candidate Bush had received \$4 million in campaign funds from Wall Street firms, and \$8.8 million in 2004.²²

The collapse of markets for sub-prime mortgages beginning in 2007, however, spread throughout the financial world, dragging financial companies large and small to bankruptcy or the brink thereof. Candidates for blame in this overall failure were multiple: from the titans of Wall Street with their greedy behavior, to members of Congress for the lax regulation of the mortgage giants Freddie and Fannie, to the Clinton Administration for having supported financial deregulation, to the Bush Administration for continuing to support those same deregulatory policies. Much of the finger-pointing, however, singled out the regulatory bureaucracy. At a Senate Banking Committee hearing in 2007, Committee Chairman Chris Dodd (D-Connecticut) put it bluntly:

Our nation's financial regulators were supposed to be the cops on the beat, protecting hardworking Americans from unscrupulous financial actors. Yet they were spectators for far too long.²³

Dodd's assessment was credible. As late as the summer of 2007, Fed Chairman Ben Bernanke told the audience of an international monetary conference that "solid growth in incomes" and "low mortgage rates" would "ultimately support the demand for housing." The "troubles in the subprime sector" he continued, "seem unlikely to seriously spill over to the broader economy or the financial system."²⁴ The spillover, of course, did occur. Within the Fed, Edward Gramlich, a member of the Board of Governors who was appointed in 1997, had signaled the dangers of subprime lending and the need for the Fed to take action, nearly a decade before the crisis.

The challenge, as Gramlich saw it, was that institutions outside of the boundaries of federal supervision extended most of the sub-prime lending: state-chartered mortgage companies, bank subsidiaries, or affiliates of financial holding

²² Janet Hook and Bob Morain. 2003. "Democrats are darlings of Wall St. Some fear donations will soften attitudes on financial regulation". *LA Times*, March 21, 2008. Available on the Web at: <http://articles.latimes.com/2008/mar/21/nation/na-wallstdems21>

²³ Senator Chris Dodd (D-Conn). March 22, 2007. "Mortgage Market Turmoil: Causes and Consequences," Senate Banking Committee. Dodd's opening statement available on the web at: <http://dodd.senate.gov/index.php?q=node/3795>

²⁴ Chairman Ben S. Bernanke. 2007. The Housing Market and Subprime Lending. To the 2007 International Monetary Conference, Cape Town, South Africa, (via satellite). June 5, 2007. . Available on the Web at: <http://www.federalreserve.gov/newsevents/speech/bernanke20070605a.htm>

companies.²⁵ Gramlich worked to prompt action under the Fed's mandate to regulate high-cost loans in the Home Ownership and Equity Protection Act passed in 1994 and to consider other policy actions as well. As the quote by Bernanke in 2007 indicates, however, the warnings did not have much impact on official Fed policy.

Members of Congress took other regulators to task, as well. The OTS directly supervised several large thrifts whose failures in 2008 were quite costly—Washington Mutual, the largest bank failure in US History, and IndyMac Bancorp.²⁶ The activities of the credit-rating agencies, central to the sloppy securitization and sale of sub-prime loans, fell partially under the jurisdiction of the SEC.²⁷ The SEC also failed to anticipate the financial difficulties of major investment firms and, most dramatically, missed entirely the \$50 billion scandal involving money manager Bernard Madoff.²⁸

On the one hand, beyond disclosure of company information, enforcement actions, and the oversight of self-regulatory organizations, the SEC's authority over segments of the financial world is limited. On the other, given the agency's regulatory record since its creation in 1934, the agency had perhaps the most potential in the long run to pre-empt portions of the crisis. Sustaining its independence and effectiveness as a regulator, however, had been strained over the previous two decades by staffing and resource constraints.²⁹ Of all the financial regulators, the SEC was also the most exposed to presidential and congressional influence going into and following the crisis. With few exceptions, appointments to the SEC reflected a preference for reducing the regulatory burden, a loyalty to the White House, and a lack of interest in advocating the autonomy of the agency, all reduced the organization as a potential player in regulatory preemption of the financial crisis.

²⁵ Governor Edward M. Gramlich. 2004. "Subprime Mortgage Lending: Benefits, Costs, and Challenges" (see especially Table 2)., At the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois. May 21, 2004, Available on the Web at:

<http://www.federalreserve.gov/Boarddocs/Speeches/2004/20040521/default.htm>

²⁶ Despite the major bankruptcies, thrift-based subprime lending has traditionally been a small percentage of the overall subprime lending. See the comments by Governor Gramlich, *ibid*.

²⁷ For an overview of the credit rating agencies and the regulatory relationship to the SEC, see Mark Rom. 2009. "The Credit Rating Agencies and the Subprime Mess: Greedy, Ignorant, and Stressed?" *Public Administration Review* 69 (4):640-650.

²⁸ US Securities and Exchange Commission, Office of Inspector General, Case No. OIG-509. *Report of Investigation, Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme*. Available on the Web at: <http://www.sec.gov/spotlight/secpostmadoffreforms/oig-509-exec-summary.pdf>

²⁹ Anne Khademian. 2002. "The SEC: A Small Regulatory Agency with a Gargantuan Challenge," *Public Administration Review* 62 (5): 515

The SEC

The inclination toward less regulation was reflected in early appointments to financial regulatory agencies in the Bush Administration, particularly the appointment of Harvey Pitt to chair the Securities and Exchange Commission (SEC). On the one hand, Pitt fit the profile of a securities-law expert that many SEC chairmen before him had represented. Having joined the SEC in 1968 as a staff attorney, he became chief of staff for Ray Garrett, Jr., the SEC chairman from 1973 to 75, and was named the SEC general counsel from 1975 to 1978. Pitt, however, entered office pledging to be “kinder and gentler” than his predecessor, Chairman Arthur Levitt, Jr. who pursued tight regulation of accounting firms, of over-the-counter trading, and of the markets for municipal securities—an approach many critics, including former SEC commissioners, saw as heavy-handed.³⁰ In contrast to Levitt’s regulatory efforts, it was Pitt’s work for the accounting industry throughout the 1990s that raised eyebrows. In the wake of the accounting scandals at Enron, Xerox, and World Com, members of Congress called for his resignation.³¹

Pitt’s leadership grew more controversial when he supported the nomination of William Webster, former FBI and CIA director, to chair the newly created Public Company Accounting Oversight Board (PCAOB)—a private, not-for-profit organization created by Congress to oversee accounting firms that audit publicly traded companies. Part of the Oxley-Sarbanes Act of 2002, the PCAOB board members are appointed by the SEC commissioners. Despite Webster’s ties to a company being sued by investors for fraud and no experience in financial regulation, Pitt pushed the nomination through to a partisan 3 to 2 vote by SEC commissioners; Pitt did not disclose the fraud investigation until after the vote.³²

Pitt resigned from the SEC shortly thereafter, even though the White House continued publicly to support his leadership. His brief tenure reflects the presidential choice of an industry insider with a light regulatory touch, and a presidential commitment to remain loyal to appointees, even in the midst of scandal. Bush’s follow-up appointment of William Donaldson, a former president of the NYSE and industry leader, was intended to restore confidence and morale in the agency, and tighten up regulations on Wall Street, but following a

³⁰ Paula Dwyer. 1997. “Arthur Levitt’s Hardball at the SEC: The SEC Chairman is stepping on toes. Is that really such a bad thing?” *Business Week*, September 29. Available on the Web at: <http://www.businessweek.com/1997/39/b3546087.htm>.

³¹ John McCain. 2002. “The Free Market Needs New Rules,” *New York Times*, July 8. Available on the Web at: <http://mccain.senate.gov/corpgovnyt.htm>

³² Greg Farrell. 2002. “Harvey Pitt Resigns as SEC Chief,” *USA Today*, November 6, 2002. Available on the web at: http://www.usatoday.com/money/companies/regulation/2002-11-05-pitt-resigns_x.htm

tumultuous two years in which Donaldson sided with the two Democratic members of the Commission against the two Republicans on most regulatory measures, Donaldson too stepped down.³³

In the historic patterns of SEC chairmen leaning toward industry and lighter enforcement, or leaning toward a securities-law emphasis on rigorous disclosure and enforcement,³⁴ Donaldson's chairmanship furthered the latter in the wake of scandal and crisis. Industry pressures for a more industry-friendly leader were again embraced by the Administration with the appointment of Christopher Cox, former Republican Congressman from California. Cox presided over an SEC with low morale, a new but highly contested salary system aimed at bringing SEC salaries into a competitive range with other financial regulators,³⁵ and increasingly outdated financial expertise, most painfully exposed in the inability of the agency to follow up on the Bernard Madoff scandal.³⁶ Allegations that SEC staff failed to investigate warnings about the illegal activities of Madoff's \$50 billion investment fund, combined with concerns that the agency failed to use its regulatory authority to tighten the work of the credit-rating agencies and to anticipate the declining condition of major Wall Street firms, sealed the perception of the SEC as a failed regulatory agency.

Regulatory autonomy is rare. Throughout much of its history, the SEC has demonstrated autonomy in its ability credibly to engage a diverse industry in order to address problems, to rely effectively upon self-regulatory entities to enforce best practices, and to use disclosure and enforcement actions rigorously as a means to keep the markets safe for individual investors.³⁷ That autonomy had been achieved by a leadership focused on hiring and retaining the best and the brightest, by bipartisan support in Congress, by cultivating the perception of fairness across the industry, and, most critically, by presidential appointments that

³³ Greg Farrell. 2005. "Donaldson steps down as head of the SEC," *USA Today*, June 1, 2005. . Available on the Web at: http://www.usatoday.com/money/companies/regulation/2005-06-01-sec-chief_x.htm

³⁴ Anne Khademian. 1992. *The Securities and Exchange Commission: The Politics of Expertise*. Pittsburgh, PA: University of Pittsburgh Press.

³⁵ Diego Ruiz. 2008. Executive Director, Securities and Exchange Commission, Testimony concerning the SEC's Pay-for-Performance System, Before the Subcommittee on Federal Workforce, Postal Service, and the District of Columbia, Committee on Oversight and Government Reform, U.S. House of Representatives. Available on the Web: <http://www.sec.gov/news/testimony/2008/ts021208dr.htm>

³⁶ US Securities and Exchange Commission, Office of Inspector General, Case No. OIG-509, *Report of Investigation, Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme*. Available on the web at: <http://www.sec.gov/spotlight/secpostmadoffreforms/oig-509-exec-summary.pdf>

³⁷ Joel Seligman. 2003. *The Transformation of Wall Street*. Wolters Kluwer Law & Business

reflected a range of acceptable variation from Wall Street to the legal world.³⁸ With the exception of Donaldson, the Bush Administration selected leaders friendly to industry, particularly the ascending accounting industry, and leaders who did not advocate on behalf of the SEC for resources, staff, or bipartisan support. This lack of rigorous leadership directly impacted the capacity of the SEC to play a preemptive role in the build up to the financial crisis.

The Bank Regulatory Agencies

The FDIC, the OCC, and the OTS are each self-funding agencies with the authority to pay salaries in excess of Title 5 pay ceilings—an essential exemption to recruit and retain the skilled individuals needed to regulate the financial markets.³⁹ The singular focus on nationally chartered banks in the case of the OCC, and on nationally chartered thrifts in the case of the OTS, make both agencies vulnerable to possible regulatory capture. The FDIC's mission, on the other hand, to provide insurance, to manage and maintain the bank insurance fund, and to supervise state-chartered banks that do not belong to the Federal Reserve System, provides the agency with a breadth of influence and independence from any one type of depository institution.

Bush Administration choices to fill the leadership positions of these three agencies and to influence priorities reflected a complex mix of recent history as well as Administration priorities. Ultimately, despite their varied constituencies and vulnerabilities, long-standing patterns of leadership influenced by institutional priorities and histories in each agency mattered more in developing and sustaining the capacities of these agencies than presidential priorities or efforts at policy influence.

In 2001, President Bush nominated Donald Powell, president and chief executive officer of First National Bank of Amarillo, Texas, to be Chair of the FDIC. At the time, Powell also served as the chairman of the board of regents of Texas A&M University since his appointment by then-Governor Bush in 1995. Between 2001 and 2005, when Powell stepped down as Chairman to lead the Gulf Coast recovery effort for the Administration,⁴⁰ the number of FDIC annual safety

³⁸ Anne Khademian. 1992. *The SEC and Capital Market Regulation: The Politics of Expertise*. Pittsburgh, PA: University of Pittsburgh Press. Anne Khademian. 2002. "The Securities and Exchange Commission: A Small Regulatory Agency with a Gargantuan Challenge." *Public Administration Review* 62 (5): 515

³⁹ The SEC received this authority in 2002 with passage of the Investors and Capital Markets Fee Relief Act (Pay Parity Act). For more details see, US Securities and Exchange Commission. 2002. *Pay Parity Implementation: Plan and Report*. Available on the Web at: <http://www.sec.gov/news/studies/payparity.htm>

⁴⁰ Spencer S. Hsu and Terence O'Hara. 2005. "FDIC Chairman to Oversee Storm Recovery." *Washington Post*, November 2, 2005. Available on the Web at:

and soundness examinations, receiverships, and liquidations remained remarkably constant.⁴¹ Powell oversaw a significant reduction in personnel over the course of his tenure, related to the winding down of staff hired to resolve the banks and assets associated with the banking crisis of the late 1980s and early 1990s. He also oversaw the stand-up of leadership training programs to prepare FDIC staff for impending retirements among senior FDIC managers.

Powell was connected to Bush through Texas politics, and as the president of his own community bank of \$352 million in assets, he had a close connection with the banking industry.⁴² More so than the connections with the White House and industry, however, one could argue that the institutional dynamics of the FDIC most heavily influenced Powell's leadership. Central to the work of the FDIC is maintenance of the bank insurance fund. Banks insured by the FDIC pay insurance premiums to the agency to cover individual depositors in the event of a bank failure. When the fund is flush, industry failures are at a minimum, and the agency retains significant degrees of autonomy from Congress. When the fund is low, or in the red, political scrutiny increases and the FDIC loses autonomy.

Elsewhere I have argued that the conservative approach the FDIC takes to the supervision of state non-member banks is to insure low-risk banking behavior, but that the approach has also resulted in consternation among other regulators who see safety and soundness through the lens of competitiveness, as well as of limited risk-taking.⁴³ It is the FDIC's role as manager of the insurance fund, and the institutional expectation that the FDIC will remain autonomous in its regulatory activities, that most heavily influenced the steady leadership of Powell and others. Indeed, the Bush Administration's appointment of Sheila Bair in 2006 as Chair of the agency strengthened the FDIC's role as a steady regulator with independent foresight regarding possible industry problems related to systemic risks.

More than two years before the crisis hit, Bair was warning regulators at the Fed and Treasury of the problems to come with sub-prime lending, while pushing the Fed to exercise its authority to set lending standards across the board for mortgage lenders, non-banks, and banks.⁴⁴ More recently, Bair has exercised strong independent leadership from her position as FDIC chair to challenge broad

<http://www.washingtonpost.com/wp-dyn/content/article/2005/11/01/AR2005110100850.html>

⁴¹ *FDIC Annual Reports*, 2001 – 2005. Tables “FDIC Examinations” and “Liquidation Highlights.”

⁴² Rob Blackwell. 2001. “It's Official: Bush Nominates Powell As FDIC Chairman,” *American Banker*, April 19. Available on the Web at: <http://www.highbeam.com/doc/1G1-73392527.html>

⁴³ Anne Khademian. 1996. *Checking on Banks: Autonomy and Accountability in Three Federal Agencies*. Washington, DC: Brookings Institution Press.

⁴⁴ Ryan Lizza. 2009. “The Contrarian: Sheila Bair and the White House financial debate.” *The New Yorker*, July 6. Available on the Web at: http://www.newyorker.com/reporting/2009/07/06/090706fa_fact_lizza

plans established by Treasury and the Fed for resolving the economic crisis, particularly related to efforts to modify delinquent loans and to manage failing firms that need taxpayer support.⁴⁵ While this leadership represents in part Bair's strong perspectives and outspoken approach, she takes on these challenges from a position of institutional autonomy, and hence strength.

Institutional conditions have also long influenced patterns of leadership and practice at the OCC, particularly the role of the Comptroller. Individual Comptrollers of the Currency can go a long way in setting the policy and tone of the OCC supervisory practices and priorities. The current comptroller of the Currency, appointed by President Bush in 2005, is John Dugan, who has, for example, highlighted consumer protection issues during his leadership at the OCC and throughout the current debates over the creation of a new consumer protection agency for borrowers, while he has supported the role of the Community Reinvestment Act for community revitalization and advocated on behalf of the OCC to retain consumer protection responsibilities.⁴⁶ As with the FDIC, the number of on-site examinations of individual national banks has remained quite constant over Dugan's tenure with the OCC.⁴⁷

Because OCC credibility rises and falls with the health and stability of the nationally chartered banks, the OCC lacks the broader, more diverse constituency that other financial agencies such as the Fed and the FDIC may use to leverage some autonomy. The OCC does, however, have history on its side, unlike the OTS. While the OCC was established in 1863 as the nation's first bank supervisory authority, the OTS was created in 1989 to replace the failed Federal Savings and Loan Insurance Corporation (FSLIC) as the primary supervisor of thrifts. The often-volatile thrift industry offered up several of the largest failures in the recent crisis, including New Century, placing the capacity of OTS to supervise effectively the risk-taking in the industry into question.

Qualified, bold leadership of the OTS must find a way to overcome the inherent weaknesses in the industry and the supervisory authority of the OTS to build a more autonomous character in the regulatory process. Presidents can start by making strong appointments, but the support needed to build some autonomous distance for the agency with strong staff, and the expertise and conviction to speak truth to power, would be an ideal form of presidential influence over the financial regulatory body.

⁴⁵ Ryan Lizza. 2009. "The Contrarian: Sheila Bair and the White House Financial Debate." *The New Yorker*. Available on the Web at:

http://www.newyorker.com/reporting/2009/07/06/090706fa_fact_lizza

⁴⁶ John Dugan. 2008. Remarks before the Enterprise Annual Network Conference (November 18): Available on the Web at: <http://www.occ.treas.gov/ftp/release/2008-136a.pdf>; John Dugan

⁴⁷ See *OCC Annual Reports*, 2005 – 2008. Available on the Web at: <http://www.occ.treas.gov/annrpt/annual.htm>

Forging a Shadow Bureaucracy: The Fed and the Treasury

Viewed by some observers as regulatory heroes making strategic decisions to prevent economic collapse, by others as insiders working to bail out their friends in the financial industry and expand the authority of the Fed and Treasury, the role of Fed Chairman Ben Bernanke and Treasury Secretary Hank Paulson in responding to the financial crisis became the stuff of legend. Bernanke and Paulson orchestrated the government response to the financial crisis beginning in 2007, from decisions to bail out the investment house Bear Stearns but to let Lehman Brothers fail; to extend emergency loans based upon the questionable troubled assets (sub-prime mortgages) of banks and non-banks; to purchase billions of dollars of “agency debt” issued by Freddie Mac and Fannie Mae; and to propose, stand-up, and implement a \$700 billion fund to inject cash into the failing financial giants American Insurance Group (AIG), Citibank, Bank of America, and others.

The Bush Administration’s most significant impact upon the financial regulatory bureaucracy has been through the dramatic actions of Paulson and Bernanke. These two leaders not only stretched and flexed the regulatory authority of the Federal Reserve Board and the US Treasury Department on a day by day basis throughout 2007 and 2008, Paulson and Bernanke also forged an alternative regulatory system—what has been labeled the “shadow regulatory system”—to absorb the risks of the “shadow banking system.”⁴⁸ The core of this alternative system is the Troubled Asset Relief Program (TARP), initially proposed by Secretary Paulson to Congress in the Fall of 2008 in a three-page memo. The TARP fund provides the Treasury Department the authority to spend \$700 billion to stabilize the financial system. Legislation authorizing the TARP also created the Office of Financial Stability (OFS) to implement the TARP, and the Congressional Oversight Panel (COP) to insure the accountability of the TARP program.⁴⁹

Within the Fed, alternative entities have also been created to implement temporary lending programs. The term auction facility (TAF) was established to auction off billions of dollars in fixed amounts of credit with specific terms (loan limits) to institutions in need of liquidity, and the term securities lending facility

⁴⁸ Paul Krugman’s book, *The Return of Depression Economics and the Financial Crisis of 2008*, (WW Norton 2008) details the shadow banking system, or a parallel system that is less regulated with loose capital standards and more opportunity for risk taking. The ways in which the recent regulatory responses and bailouts have assisted this alternative system—absorbed much of the risk that was supposed to define this system—is discussed by Russ Roberts in a January 22, 2009 posting on Café Hayek, available on the Web at: <http://cafehayek.com/2009/01/the-shadow-banking-system.html>, as well as other blog and web sites.

⁴⁹ The Emergency Economic Stabilization Act of 2008, PL 110-343.

(TSLF) was established to encourage lending and borrowing in Treasury securities markets.⁵⁰ Getting the money out the door into the hands of banks and non-banks (and auto companies), and insuring the money is spent appropriately and effectively requires, in short, bureaucracies within bureaucracies.

Hundreds of billions of dollars have been spent from this fund by Treasury to support failing banks, insurance companies, and auto companies. With the acceptance of TARP money has come regulations on executive compensation, limitations on quarterly dividend payments to shareholders, requirements to participate in federal foreclosure prevention programs, and other restrictions on business activities for TARP recipients, clearly spreading the reach of the new 'shadow regulatory system'. TARP money has also put new incentives and dynamics in place.

As this is written, consequences are complicated, and implications are unclear. On the one hand, the most recent report on TARP by the COP notes the perverse incentives that TARP money creates for the recipients and the inherent advantages created by the fund as well:

Since the inception of the TARP, 211 banks, thrifts, and specialty lenders have raised a total of \$264.3 billion in capital from the private markets. One hundred and thirty of these institutions were TARP recipients. Banks' ability to raise capital in the private markets shows that investors are regaining confidence in the banking sector. However, investor confidence may reflect the assumption of an implicit guarantee hanging over the financial system. Investors saw that the government stepped in to support institutions such as Bank of America without wiping out shareholder stakes. This may signal to the markets that shareholders in large institutions are protected from total loss of their investment.⁵¹

This implicit guarantee, for banks and non-banks, is similar to the implicit guarantee long benefiting the mortgage firms of Freddie Mac and Fannie Mae. The implied guarantee reduces the cost of borrowing for the recipient companies, particularly companies considered too big to fail, and creates the incentives for greater risk-taking if the government will be there to prevent financial collapse.

⁵⁰ Chairman Ben S. Bernanke. 2008. "Federal Reserve Policies in the Financial Crisis," Remarks at the Greater Austin Chamber of Commerce, Austin, Texas, December 1, 2008. Available on the Web at: <http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm>

⁵¹ Congressional Oversight Panel, December Oversight Report, *Taking Stock: What has the Troubled Asset Relief Program Achieved?* December 9: 3. Available on the Web at: <http://cop.senate.gov/documents/cop-120909-report.pdf>

The challenge for the federal government is figuring out how to manage the associated risk. As Marvin Phaup has described the phenomenon, “Federal guarantees of private obligations do not eliminate risk. They shift its incidence, or who bears it, from investors to taxpayers who are less likely to be able to manage it.”⁵²

According to the COP, TARP has gone a long way in shifting the risk to taxpayers through the emergent regulatory structure. The problem is the lack of clarity about the overall goals and capacities of this new shadow regulatory system, and how it will wind down, if at all, at the conclusion of the crisis. Ultimately, the drive of fund recipients to leave the operating conditions of TARP money acceptance may conclude the program. Beginning in June of 2009, recipients began repaying portions of TARP money, according to Federal Reserve Board repayment rules, and this December Bank of America paid the Treasury Department the entire \$48 billion it received under TARP.⁵³ Legislation pending in Congress would end the possibility of taxpayer bailouts in the future based upon the too-big-to-fail premise, but that remains a significant premise with a large bureaucratic footprint at the moment.

Crisis and the Permanent Bureaucracy

Efforts by Bernanke and Paulson created a breathtaking response to the financial crisis in terms of the money mobilized to address the crisis, the extent of government investment in global financial firms, the creativity of methods in providing support, and the extent of an alternative bureaucracy forged to support and regulate the previously unregulated but deeply entwined segments of the financial markets. As Bernanke noted in a speech in 2008:

By way of historical comparison, this policy response stands out as exceptionally rapid and proactive. In taking these actions, we aimed not only to cushion the direct effects of the financial turbulence on the economy, but also to reduce the risk of a so-called adverse feedback loop in which economic weakness exacerbates financial stress, which, in turn, leads to further economic damage.⁵⁴

⁵² Marvin Phaup. 2009. “Federal Use of Implied Guarantees: Some Preliminary Lessons from the Current Financial Distress.” *Public Administration Review* 69 (4): 651 – 59.

⁵³ Joe Rauch. 2009. “BoFA Finishes TARP Repayment,” *Reuters* (December 9). Available on the Web at: <http://www.reuters.com/article/idUSTRE5B15YD20091209>

⁵⁴ Chairman Ben S., Chairman. 2008. “Federal Reserve Policies in the Financial Crisis,” Remarks at the Greater Austin Chamber of Commerce, Austin, Texas, December 1, 2008. Available on the Web at: <http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm>

For the Bush Administration, the irony is that in this rapid response to the financial crisis, an Administration committed to high performing but limited government created an emergent regulatory structure to protect the shadow banking system from collapse—and taking the overt banking system and the broader economy with it. The congressional response currently under way will be extensive, addressing some of the concerns raised here about risk-taking and firms that are too-big-to-fail, consumer protection, and explicit regulation of the shadow industry.

At this point, it is useful to return to the question of crisis and presidential impact on the bureaucracy. As in the case of the terrorist attacks on 9-11, Presidents must respond to crises. The response is a test of presidential management of the permanent bureaucracy, yet presidents do not get to choose the tests or the timing. In the case of homeland security, the first test of the Bush Administration's organizational response to 9-11 was Hurricane Katrina. A bureaucracy reluctantly forged by Administrative priorities and leadership in response to terrorist attacks focused tremendous resources on preventing, preparing for, responding, and recovering from terrorism, but the test of these capacities was a storm that devastated New Orleans and the surrounding areas.

On the other hand, while the DHS response to Katrina has been judged a massive failure, the Bush Administration's impact on the permanent bureaucracy has been monumental. The creation of DHS, alone, is the second-largest government reorganization in history, and the shifting of resources and priorities over time has been dramatic. Similarly, whether one judges the Bush Administration response to the financial crisis as a creative and effective effort to stave off economic collapse, or an ad hoc disorganized effort to prop up Wall Street firms, the long-term impact on the federal bureaucracy will also be dramatic.

The extension of federal participation into the financing of AIG, BOA, and other major firms, the development of regulations that accompany the financial support, the offices created to implement and oversee the regulations, and the consequently more comprehensive reorganization of the financial regulatory bureaucracy will have long-standing impact. The Bush Administration may not be remembered for its PMA or use of PART to focus the permanent bureaucracy on performance and effectiveness, but it will be remembered for the reorganization and growth of the permanent bureaucracies of homeland security and regulatory finance.