Strengthening our Public and Private Institutions: A National Imperative[1]

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It is a great honor to join you today to present the Elmer B. Staats lecture. Elmer Staats served in many important public service positions, including fifteen years as Comptroller General of the United States from 1966 to 1981. Our good friend and colleague and teacher George Frederickson presents a thoughtful review of Elmer Staats and his career in a paper, "Government Ethics in Practice." Mr. Staats was an ethical and disciplined person who can serve as a role model for us all.

Elmer Staats helped shift the focus of the GAO (then called the General Accounting Office) from pursuit of fraud and wrongdoing to a preventative approach and application of organization and management reviews to help make government work better. George concludes, "…we see in [Elmer Staats'] ethics and his example the belief that it is through institutions that morality can be defined and ethics practiced."[3]

Introduction and Overview

In talking about the financial crisis today I would like to adopt a similar institutional and preventative perspective. While we do need to pursue fraud and wrongdoing, perhaps the most important task before us is to understand the expensive lessons of the crisis for our public and private institutions and how to avoid these mistakes in the future.

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[1] This presentation is based on a forthcoming book, *Why Some Firms Thrive While Others Fail: Governance, Management, and the Financial Crisis* (Oxford University Press, 2012). Portions of this presentation have appeared in an article, "Constructive Dialogue," *The American Interest*, November/December 2011.

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[3] H. George Frederickson, "Elmer B. Staats: Government Ethics in Practice," chapter 9 in Cooper, T.L., and Wright, D.N., eds. 1992. *Exemplary Public Administrators: Character and Leadership in Government.* San Francisco: Jossey-Bass, pp. 215-241, at pp. 238-9.

And the financial crisis was immensely expensive, with pervasive effects on the broad U.S. population. Perhaps 10 million households may lose their homes to foreclosure.[4] House prices declined to the point where almost one-quarter of homes are worth less than the mortgages on the property. The unemployment rate doubled and millions of people lost their jobs. Median household wealth fell by 25 percent from 2007 to 2009 for a loss of about $ 17 trillion.[5] Real median income in 2010 fell to its lowest level in 13 years, and the poverty rate rose to its highest level in 17 years.[6] Graduating students have much more difficulty finding appropriate work than a few years ago. Much of this damage might have been avoided, or at least mitigated by better governance, risk management, and better management generally in both the public and private sectors.

Today I would like to share with you the thirty minute version of a book I've written about differences between firms that successfully weathered the crisis and those that did not. (If all goes well, the book, *Why Some Firms Thrive While Others Fail: Governance, Management, and the Financial Crisis*, should come to your friendly bookstore or internet provider next June). How did financial firms contribute to the crisis and why did government fail to prevent it? What do we need to know about our public and private institutions to try to avoid expensive crises in the future?

Most importantly, we learned that, left unchecked, market forces can wreak havoc with organizations, the national economy, and even the global economy. Former Federal Reserve Chairman Alan Greenspan, no friend of government interference in the workings of private firms, reflected in 2008 that, "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."[7]

Chairman Greenspan's statement recognizes institutional failures leading to the crisis: market forces and the actions of private companies failed to work efficiently and effectively to protect the financial system from calamity. Rather, untrammeled pursuit of revenues, profits, and market share, helped drive major financial firms into ruin, with serious costs for the rest of us as well.

While government's response prevented a complete financial meltdown, its actions before the crisis were seriously inadequate to protect against an economic debacle. Not unrelated is the fact that the financial, insurance and real estate sector was by far the greatest source of campaign

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[4] Congressional Oversight Panel, "A Review of Treasury's Foreclosure Prevention Programs," December Oversight Report, December 14, 2010, p. 4 ("8 to 13 million foreclosures expected by 2012.")
[5] Jesse Bricker, Brian Bucks, Arthur Kennickell, Traci Mach and Kevin Moore, "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009",working paper, Board of Governors of the Federal Reserve System, March 2011; Office of Management and Budget, *Budget of the United States for Fiscal Year 2011*, p. 7 .
[6] U.S. Census Bureau. Income, Poverty, and Health Insurance Coverage in the United States: 2010, September 2011
[7] Alan Greenspan, testimony before the House Committee on Oversight and Government Reform, hearing transcript, "The Financial Crisis and the Role of Federal Regulators," October 23, 2008, p. 33.

contributions to federal candidates and parties, contributing almost half a billion dollars in the election cycle 2007-2008 alone.[8] The financial services industry too often used its clout to lobby for government policies that ultimately hurt rather than benefited major financial firms. Classic was the way Fannie Mae and Freddie Mac fought for years against more capable supervision that might have saved them from making the bad decisions that destroyed the companies in 2008. The political strength of the industry impeded other supervisory actions as well, such as the effort of regulators to try to limit excessive lending concentrations in nontraditional mortgages or commercial real estate.

Surviving Firms and Unsuccessful Firms

I served for a year on the staff of the Financial Crisis Inquiry Commission where much of my focus was on governance and risk management. The Commission obtained large volumes of documents, examined hearings, books and reports, and interviewed CEOs, risk officers, bankers, traders, and others. I studied a dozen major firms, including four that survived the crisis and eight that did not. We also interviewed present and former regulators who had been charged with protecting safety and soundness of financial institutions and the financial system.

What did we find? Leo Tolstoy opens his novel *Anna Karenina* with the observation that all happy families are alike and each unhappy family is unhappy in its own way. In the financial crisis we found the opposite pattern: surviving firms each had their own way to manage the crisis; unsuccessful firms were remarkably alike in their inability to cope and in the mistakes they made.

I studied four surviving firms: JP Morgan Chase, Goldman Sachs, Wells Fargo, and Toronto Dominion Bank. JP Morgan Chase's story is of preparing the company in advance to be strong enough to take advantage of long-term opportunities. Goldman's is of firm-wide systems and capacity to react quickly to changes in the environment (and then tripping heavily over reputational risk). Wells is a company with a culture of customer focus and restraint. And Toronto Dominion Bank provides the simple lesson: if you don't understand it, don't invest in it. Each of these firms applied strong governance, good management, operational competence and discipline, but with different approaches. Some of these firms have had serious problems, reputational and otherwise, but the point here is that they had successful strategies for weathering the crisis.

And then there were the others. They went out of business, required massive amounts of government aid to stay afloat, or entered into mergers to end their existence as independent companies. These unsuccessful firms included government-sponsored enterprises, Fannie Mae

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[8] Center for Responsive Politics, "Finance/Insurance/Real Estate," available at http://www.opensecrets.org/industries/background.php?cycle=2010&ind=F, accessed April 28, 2011.

and Freddie Mac, investment banks, Bear Stearns, Lehman Brothers, and Merrill Lynch, commercial bank holding companies including Citigroup, Wachovia, and UBS, an insurance company, AIG, and thrift holding companies, Countrywide, IndyMac, and WaMu. With variations, they exhibited similar shortcomings in organization, governance, and management.

In contrast to the four surviving firms we studied, other major financial institutions had become so unwieldy that they were virtually impossible to manage as integrated enterprises. While managers and shareholders may have profited from the agglomeration into organizations of a trillion dollars in size or more, it is not clear that this massive size benefited market efficiency or the financial system.

We forget how large our financial conglomerates actually are. Citigroup, with 350,000 employees and nearly 2,500 subsidiaries, was the largest complex financial institution.[9] AIG, smaller than most of the major firms, comprised some 223 companies that operated in 130 countries and had 116,000 employees.[10]

Many of these firms grew during years of prosperity but neglected to update their information systems to be able to manage across the entire enterprise.[11] This was especially true of firms that grew through acquisitions. They also often lacked a common operating culture; Citigroup CEO Charles Prince used to joke that Citigroup had not one good culture, but rather five or six good cultures. One part of Citigroup cut back its exposure to the mortgage market without sharing this information with other parts of Citi that continued to increase their exposure. Citi was not only "too-big-to-fail," but also too big and too complex to manage.

Weak governance compounded organizational shortcomings at many firms. Overbearing CEOs too often dominated weak boards that failed to uphold the duty of respectfully challenging management to provide feedback and probe limitations of proposed management initiatives. Former senior UK Treasury official Paul Myners charged that, "The typical bank board resembles a retirement home for the great and the good: there are retired titans of industry, ousted politicians and the occasional member of the voluntary sector." Such people, he noted, are unlikely to have the knowledge needed to provide guidance for a large complex financial

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[9] Herring, Richard and Carmassi, Jacopo (2009), "The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety & Soundness," Chapter 8 in Allen N. Berger, Phillip Molyneux and John Wilson, editors, *The Oxford Handbook of Banking*, write that "Among the 16 international financial conglomerates identified by regulators as large, complex financial institutions (LCFIs), each has several hundred majority-owned subsidiaries and 8 have more than 1,000 subsidiaries."

On the other hand, Commission staff learned in interviews with federal regulators that many of these subsidiaries and affiliates were small institutions, acquired in a process of accretion, which had little financial significance.

[10] GAO, "Troubled Asset Relief Program, Status of Government Assistance Provided to AIG," September 2009, p. 5; AIG – Form 10K for 2008, p. 7.

[11] On the impact of growth on internal controls at Fannie Mae and Freddie Mac, see, e.g., Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007.

institution in today's global economy. Paul Volcker, in his interview with Commission staff, spoke simply of "supine boards."

Another distinguishing characteristic of unsuccessful firms was their pursuit of short-term growth without appropriate regard for risk. In 2005-2007 both Fannie Mae and Freddie Mac decided to increase their purchases of subprime mortgages just as home prices peaked and declined.[12] Other firms – Lehman and WaMu – also decided to increase risk around the same time, while some firms – Countrywide, AIG, Citi – simply continued their pursuit of market share without regard to changing market circumstances.

Organization and Management of Financial Supervisors

So where were the regulators? The United States is perhaps unique in the world in the organizational complexity of financial supervision and regulation. Firms could choose not only whether they desired a federal or state charter but often also which federal regulator they preferred. For firms such as AIG, Washington Mutual, IndyMac, and Countrywide, the Office of Thrift Supervision (OTS) seemed to be the most congenial regulator.

This created a race to the supervisory bottom. Regulators worried that, if they tightened up, a firm would simply leave and place itself under authority of a more lax regulator. That happened in early 2007 when Countrywide changed its regulator from the Fed and Comptroller of the Currency to the much more amenable Office of Thrift Supervision. The threat of losing a major regulated company continues to hang over regulators today.

While some supervisors were alert and concerned, their voices were muffled by organizational complications that made effective financial supervision difficult at best. Fragmentation of authority among multiple regulators created substantial governance problems, not only with the distribution of power and authority, but also with the flow of information. Fragmentation made coordination difficult both among regulators and even within the Federal Reserve System itself. Supervisors described a process of trying to work around those obstacles so they could do their jobs.

Federal Reserve Board Vice Chair Janet Yellen expressed frustration at an unwieldy interagency process for trying to rein in risky forms of lending:

> "[T]his kind of process that I think we have had where it takes six different regulators…to negotiate in what I gather is an excruciating process over many

[12] See, e.g., Fannie Mae Strategic Plan 2007-2011 'Develop Segments – Develop Breadth,'" undated, approximately end of June 2007; Freddie Mac, "Freddie Mac's Business Strategy," March 2-3, 2007; both available at fcic.law.stanford.edu/. See also, Thomas H. Stanton, "The Failure of Fannie Mae and Freddie Mac and the Future of Government Support for the Housing Finance System," *Journal of Law and Policy,* vol. 18, no. 1, 2009

> years, to do something in the end that is probably too little, too late. To my mind, that process fails."[13]

When the federal banking agencies finally issued commercial real estate guidance in 2006, it was late and unhelpful. Dr. Yellen said, "I felt when this guidance came out you could take this, and rip it up and throw it in the garbage can; it wasn't a tool that was of any use to us in controlling this risk."[14]

The housing and credit bubbles and apparently benevolent economic conditions of the early 2000s also created problems. Supervisors had a hard time trying to rein in CEOs of companies that seemed to be making money hand over fist. How does a supervisor tell a company to stop activities that appear so profitable?

Sometimes supervisors would wait until losses occurred before pressing a firm to improve its governance or management; but waiting for losses often meant waiting too long to correct mistakes before they crippled a firm. Thus, the Federal Reserve Bank of New York issued annual reports of inspection for the holding companies that it supervised. Reports for the years 2006, 2007, and 2008 on Citigroup, show increasingly negative ratings for Citi's quality of risk management, declining from a "2" ("satisfactory") for 2006, a year when Citi reported good returns, to a "3" ("fair") for 2007, when Citi recognized significant losses, and a "4" ("marginal") only in 2008 when Citi had already received billions of dollars of federal support. The 2007 report, issued in early 2008, is candid in its recognition that the downgrade in ratings followed rather than led the revelation of Citigroup's losses.[15]

The Power of Constructive Dialogue

The question then becomes whether, from the perspective of organization and management, there is any major recommendation that, if well implemented, could have allowed the weaker large financial firms to survive. One answer that would also be helpful in the future would be to limit the size and complexity of financial firms as a way to encourage more manageable organizations. Unfortunately, this approach seems to be a political nonstarter, given the influence of the financial sector on the political process.

A second answer would be to integrate the disparate regulatory organizations so that financial firms cannot simply shop for the most congenial supervisor. In one such approach, Senator Chris

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[13] FCIC interview with Janet Yellen, Vice Chair of the Federal Reserve Board, November 15, 2010, available at fcic.law.stanford.edu/.
[14] Ibid.
[15] The ratings are calculated from Federal Reserve Bank of New York, "Summary of Supervisory Activity and Findings, Citigroup, Inc.", transmitted April 15, 2008; and Federal Reserve Bank of New York, "Summary of Supervisory Activity and Findings, Citigroup, Inc.", transmitted January 14, 2009, available at fcic.law.stanford.edu/.

Dodd proposed consolidating safety-and-soundness regulation into a single organization in an amendment that he tried to include in the Dodd-Frank Act. His amendment failed in the Senate by a vote of 8-91 after running into what the *New York Times* called a "phalanx of industry opposition."[16]

A third answer holds more promise. Sydney Finklelstein of the Tuck School of Business at Dartmouth and colleagues analyzed decisionmaking in large organizations. They found that bad decisions required two key elements: (1) an initial flawed decision that the CEO or another influential person made, and (2) a poorly structured decision process that failed to provide facts and input to correct the mistake.[17] In the felicitous phrase of organizational development expert Jack Rosenblum, "Feedback is a gift." Doubts and dissent need to be seen as offers to rethink a preliminary decision before it potentially causes harm.

This also applies to nonfinancial firms. My book discusses decisionmaking and costly mistakes such as the BP Gulf oil spill, fatalities at the Massey Mining Company, and hospital medical errors. Failures at nonfinancial firms show the same patterns of overbearing or distracted CEOs or others (e.g., doctors) who make poor decisions without obtaining feedback, cultures that emphasize production without adequate consideration of risk, and weak regulators.

One of the critical distinctive factors between successful and unsuccessful firms is the presence or absence of what can be called "constructive dialogue." In the financial sector, successful firms managed to create productive and constructive tension between (1) those who wanted to do deals, or offer certain financial products and services, and (2) those in the firm who were responsible for limiting risk exposures. By creating a respectful exchange of views among these divergent perspectives, successful firms freed themselves to find constructive outcomes that took the best from each point of view. Instead of simply deciding to do a deal or not, successful firms considered ways to hedge risks or otherwise reduce exposure from doing the deal. Successful firms created opportunity for constructive dialogue between CEOs and their boards, and CEOs and their top managers, and between revenue producing units and risk officers.

Unsuccessful firms frequently pursued revenue-producing ventures without constructive dialogue with those concerned about risk. They disregarded input from their risk officers, such as when Freddie Mac's CEO fired his chief risk officer in 2005, just as the company greatly increased its risk-taking, or when Lehman's CEO sidelined his chief risk officer in 2007.[18] By contrast, because of their application of constructive dialogue and a robust sense of the risk-reward tradeoff, successful firms sometimes retained more capital than their competitors and

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[16] Stephen Labaton, "Leading Senator Pushes New Plan to Oversee Banks," *New York Times*, September 20, 2009.
[17] Sydney Finkelstein, Jo Whitehead, and Andrew Campbell, *Think Again: Why Good Leaders Make Bad Decisions and How to Keep it From Happening to You*, Harvard Business Press, 2008.
[18] Financial Crisis Inquiry Commission, interview with Richard Syron, August 31, 2010; Financial Crisis Inquiry Commission, Interview with Madelyn Antoncic, July 14, 2010, available at fcic.law.stanford.edu/.

many times refrained from lucrative but risky types of financial products or transactions that appeared to be making so much money for their competitors.

Senior people need to use their influence to make constructive dialogue work. At successful firms these leaders often were the CEO or top management more generally. They brought revenue-producers together with risk people and ensured that the discussion was constructive and mutually respectful and that it led to positive results. Constructive dialogue was ingrained in company culture.

For firms without effective constructive dialogue in their culture, regulators will need to require it. Constructive dialogue should be a key element for regulators to investigate in their examinations. In making major decisions, (and examiners can review these) can the company point to changes it made because of input from the board, from senior management, or from risk officers? If not, examiners likely have found an unsafe and unsound condition in the company's culture that deserves prompt attention from the board and remediation. This is a test that regulators can apply long before losses actually materialize from poor decisions. Once the focus is on processes a firm uses to make important decisions, one can design metrics for examiners to apply.

Supervisory attention to effective constructive dialogue can strengthen management and longer-term returns. Increasing firms' ability to weigh upside profitability against downside risk is, as Sydney Finkelstein and his colleagues point out, a recipe for improved decisionmaking that can help firms and their leaders increase their performance. They report, "We quickly found there are an awful lot of bad decisions out there! Indeed, in unfamiliar circumstances, such as businesses entering new markets…, flawed decisions abound."[19] Building constructive dialogue into decisionmaking at major financial firms can strengthen their capacity to navigate uncertain cyclical financial markets and reduce the tendency to make bad decisions such as Fannie Mae, Freddie Mac, Lehman, Bear, and many others made at just the wrong time, in 2005-2007.

The surviving firms too have a stake in improving decisionmaking at their weaker competitors. Investment banks Goldman Sachs and Morgan Stanley had to convert to bank holding companies to withstand financial panic in September 2008. This cost them much of the entrepreneurial latitude that they had enjoyed before the crisis. Moreover, as the economy sank into recession, millions of mortgages that were not subprime suddenly became delinquent and defaulted in serious numbers. This hit JP Morgan Chase and Wells Fargo as well as less successful firms.

Another important step may be more difficult. That is to apply constructive dialogue to relations between large complex financial institutions and their supervisors. The crisis and its costs suggest that companies need to view feedback from their supervisors too as a gift. While

[19] Finkelstein, Sydney, Jo Whitehead, Andrew Campbell, *Think Again: Why Good leaders Make Bad Decisions and How to Keep it From Happening to You*, Boston: Harvard Business Press, 2010, p. xi

regulators may not have the expertise available to large complex institutions, they do have the ability to ask simple questions, such as about the amount of capital a firm has reserved against potentially risky activities or whether the firm is lowering its standards to meet aggressive goals for growth. Feedback from regulators can improve decisions merely by posing the right questions and pursuing the answers.

Constructive dialogue is a two-way street. Regulators need to be open to input that examiners are engaging in "checking the boxes" compliance drills without understanding the real risks of the company's business, or that there are too many examiners from multiple regulators on site without a focus on the most important issues, or that particular examiners are not open to constructive dialogue. As in successful firms that relied on constructive dialogue to protect themselves in decisionmaking before the crisis, constructive dialogue can improve decisionmaking all around. It can help to improve quality both at regulators and at the firms they supervise.

A caveat is in order: constructive dialogue between a company and its government supervisor must rest on constructive tension between their perspectives. The supervisor must maintain what some call "principled intimacy" with those it regulates.[20] Without the tension, a supervisor can go the way of the Office of Thrift Supervision, and essentially be captured by regulated firms.

Constructive dialogue is an important alternative to destructive attacks on the capacity of regulators. Such attacks were commonplace with the regulator of Fannie Mae and Freddie Mac, and happen periodically with the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC).

When we attack regulators this way we are just shooting ourselves in the foot. Collective action through government appears to be the only way to limit the kinds of excessive competitive pressures that existed before the crisis, and especially in 2005-2007. Citigroup CEO Charles Prince made the argument for regulatory intervention at a dinner with Treasury Secretary Henry Paulson in 2007. Mr. Paulson recounts that the Citigroup CEO asked with respect to leveraged loans whether given the competitive pressures there wasn't a role for regulators to tamp down some of the riskier practices, and "Isn't there something you can do to order us not to take all these risks?"[21]

Mr. Prince understood that only a regulator could help to set a floor on conduct and prevent less successful firms from undertaking risky practices that distort the market and cost more prudent firms their market share.

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[20] See, e.g., Malcolm Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*, Brookings, 2000.
[21] See, FCIC interview with Charles Prince, Citigroup, Transcript, March 17, 2010, pp. 126-7 available at fcic.law.stanford.edu/.

In the end, effective supervision and regulation are essential to try to protect the financial system against failures of governance and management at large complex financial institutions. Regulators are not always right. Rather, the regulators need to be in a position to offer high quality feedback to our largest financial institutions so that, through constructive tension between regulators and the regulated firms, improved decisions result that take account of long term sustainability and not merely short term profits and bonuses.

A Call for Statesmen

Needed of course, would be support from statesmen in the financial industry who are willing to take a longer term view and support a stronger mandate and greater capacity for financial regulators. The Chairman of the Federal Reserve Board, backed by other top federal officials, might try to cultivate such statesmen among major financial institutions. The political influence of the financial services industry has already been noted. The question then becomes whether and to what extent large complex financial institutions are willing to strengthen the mandate and capacity of their regulators.

Successful firms have a major stake in improving decisionmaking, and injecting constructive dialogue into the processes of their weaker competitors. They also have a stake in increasing the mandate and capacity of regulators to provide high quality feedback to improve the decisionmaking of all large complex financial institutions. Without effective regulators, there is no way to provide the needed feedback to financial firms that lower their standards and provoke a race to the bottom. As effects of the crisis continue to weigh on our financial system and the economy, financial statesmen may be increasingly easy to find.

Improved governance, management, and organization in both private firms and government supervisors are needed to restore the ability of private companies, in Mr. Greenspan's words, to protect their own shareholders and the equity in their firms.

Before 2008, faith in markets often drove out efforts to improve the interplay between public and private institutional structures. Now it is more apparent that repair of our institutions, especially in the financial sector, is a major national imperative as the country emerges from the crisis and tries to deal with our changing global economic status.

Unfortunately, the legislation that has so far passed the Congress pays only limited attention to institutional design and manageability. Our actions so far have not sufficiently diminished the chances of another crisis occurring once we recover from this one. Indeed, government rescues of large insolvent firms coupled with the substantial compensation that CEOs and senior managers managed to retain even as their firms went under, mean that – once the economy returns to some semblance of health – incentives to take risks may be even greater than before.

Opening constructive dialogue on these issues will not be easy given the current atmosphere in Washington, but would seem well worth the effort.

Thank you.