

# Strengthening Government's Ability to Deal with the Financial Crisis

By Thomas H. Stanton

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The nation needs a vibrant, healthy financial sector. Banks and other depository institutions provide safe locations for savings and these funds are used to provide loans to businesses that provide many of the jobs in the economy. However, the United States is now experiencing the worst financial crisis in more than 75 years. In the past year, large financial institutions have failed or required assistance from the government. The crisis has also spread to global financial markets, requiring coordinated action by world leaders in an attempt to protect savings and restore the health of the markets.

As the administration and Congress take actions to address the immediate financial crisis, determining how to place the government's response on a stronger organizational footing is a key step to reducing the likelihood that the nation will experience a similar financial crisis in the future. In his report, Stanton points out the need to address past policies' inconsistencies, lack of transparency, and shortcomings in organizational capacity. In order to do so, he recommends a number of steps to:

- Ensure a perception of legitimacy of the response effort
- Enhance government's institutional capacity to respond effectively
- Supplement current policies to ensure the flow of credit and assist communities to cope with foreclosed homes

Once the full dimensions of the current financial crisis were recognized, federal policymakers responded with rapid and massive support for the financial markets. They struggled to contain problems that seemed to spread uncontrollably from one sector to another and from one failing institution to another. They considered speed more important than organizational niceties.

The government's ultimate response can be divided into three stages:

- Stage One: The first stage consisted of the largely ad hoc steps taken by the Federal Reserve and Treasury and other agencies to act quickly to try to mitigate problems as they developed in the financial markets. This stage is largely behind us.
- Stage Two: The second stage, demarcated by the advent of the Obama Administration, should involve assessing the government's response to make it more systematic and routine and establishing much-needed prudential supervision and protection against systemic risk (i.e., risk that affects the entire financial system) in the future.
- Stage Three: The third stage will involve trying to unwind the government's involvement and return many financial activities largely to private sector control.

Once it recognized the seriousness of the crisis, the Federal Reserve applied monetary policy tools, extended credit to support financial markets, chartered new bank holding companies, and joined with Treasury to decide how to resolve major failing institutions. The Federal Reserve intervened quickly and allocated more than one trillion dollars to help stabilize key financial sectors. Federal Reserve Chairman Ben S. 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.

The Department of the Treasury also played a major role in the government response. Secretary of the Treasury Henry M. Paulson, Jr., participated in virtually all discussions with respect to resolving major troubled institutions, including decisions concerning Bear Stearns, Fannie Mae and Freddie Mac, AIG, and Citigroup. Especially after enactment of the Emergency Economic Stabilization Act of 2008 (EESA), Treasury possessed an array of policy tools that it used in innovative ways, including support for the Federal Reserve, provision of capital to healthy financial institutions, provision of capital to significant failing institutions, and convening meetings with other organizations to resolve problems.

Other significant federal actors included the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange



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Commission (SEC), the Federal Housing Finance Agency (FHFA), the Federal Housing Administration (FHA), and the U.S. Department of Education (ED). Other federal agencies could play a significant role in responding to the crisis, depending on how the crisis further evolves and the policy response that is considered most appropriate.

### **Recommendations**

It is now necessary to place the government's response on a stronger organizational footing. Past policy inconsistencies, lack of transparency, and shortcomings in organizational capacity need to be addressed. Recommendations fall into three categories: restore public confidence, increase governmental capacity, and increase support for the credit markets.

#### **Restore Public Confidence in Fairness of the Response Effort**

- Recommendation One: Ensure the Perception of Legitimacy
- Recommendation Two: Assist Communities to Cope with Foreclosed Homes

#### **Increase Government Capacity to Respond Effectively**

- Recommendation Three: Authorize and Ensure Capacity of the Federal Reserve to Monitor and Address Systemic Risk
- Recommendation Four: Increase Treasury's Capacity to Implement Policy Decisions More Consistently and Effectively and with Greater Accountability to Federal Officials
- Recommendation Five: Ensure that the Federal Housing Administration (FHA) has the Capacity to Support the Mortgage Market without Sustaining Major Losses
- Recommendation Six: Ensure that the Department of Education has the Capacity to Support the Federal Student Loan Market
- Recommendation Seven: Create a Financial Stability and Credit Staff in the Office of Management and Budget to Develop Policy Options for More Effective and Coordinated Government Actions

- Recommendation Eight: Create or Strengthen Interagency Working Groups to Bring the Resources of Multiple Agencies to Bear on Addressing the Crisis in a Coordinated Manner

#### **Increase the Flow of Credit**

- Recommendation Nine: Ensure the Flow of Credit to Major Economic Sectors

Acting quickly on these recommendations is essential at this point in time. The federal government must restore public confidence that the government's response is fair and legitimate. The theory of the free enterprise system was supposed to be that entrepreneurs who served the market well would be rewarded while less capable firms and their leaders would fail. Yet, government has embarked on a massive program to shore up insolvent financial firms with infusions of capital. Perceptions of fairness and legitimacy are needed so that the political process provides policymakers the capacity, in terms of authority, resources, and discretion, to address the crisis as it continues to expand.

The federal government now needs to ensure that tools are in place at the Federal Reserve to monitor for risk across the financial system and apply measures to reduce the likelihood of future major financial crises. It is also important to increase the capacity of organizations such as Treasury and the FHA that must play significant roles in the government's response. A core theme of this report is that a strong organizational infrastructure is needed; otherwise the effective implementation of policy decisions is very much at risk.

### **Conclusion**

There are two major issues that need to be addressed in the second stage of the government's response:

- **Enhance organizational capacity** of the Department of the Treasury, OMB, and at other agencies such as FHA, to ensure that they can effectively carry out their responsibilities in times that would tax even the strongest organizations.

## Timeline of Major Government Actions by the Federal Reserve and Treasury Department

### DECEMBER 2007

**December 12, 2007:** The Federal Reserve Board announces the creation of a Term Auction Facility (TAF) in which fixed amounts of term funds will be auctioned to depository institutions against a wide variety of collateral.

### MARCH 2008

**March 11, 2008:** The Federal Reserve Board announces the creation of the Term Securities Lending Facility (TSLF), which will lend up to \$200 billion of Treasury securities for 28-day terms.

**March 16, 2008:** The Federal Reserve Board establishes the Primary Dealer Credit Facility (PDCF), extending credit to primary dealers.

**March 24, 2008:** The Federal Reserve Bank of New York announces that it will provide term financing to facilitate JPMorgan Chase & Co.'s acquisition of The Bear Stearns Companies Inc.

### JULY 2008

**July 30, 2008:** President Bush signs into law the Housing and Economic Recovery Act of 2008 (Public Law 110-289).

### SEPTEMBER 2008

**September 7, 2008:** The Federal Housing Finance Agency (FHFA) places Fannie Mae and Freddie Mac in government conservatorship. The U.S. Treasury Department announces three additional measures to complement the FHFA's decision.

**September 16, 2008:** The Federal Reserve Board authorizes the Federal Reserve Bank of New York to lend up to \$85 billion to the American International Group (AIG) under Section 13(3) of the Federal Reserve Act.

**September 17, 2008:** The Treasury Department announces a Supplementary Financing Program consisting of a series of Treasury bill issues that will provide cash for use in Federal Reserve initiatives.

**September 19, 2008:** The Federal Reserve Board announces the creation of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF).

**September 19, 2008:** The Treasury Department announces a temporary guaranty program that will make available up to \$50 billion from the Exchange Stabilization Fund to guarantee investments in participating money market mutual funds.

**September 20, 2008:** The Treasury Department submits draft legislation to Congress for authority to purchase troubled assets.

**September 21, 2008:** The Federal Reserve Board approves applications of investment banking companies Goldman Sachs and Morgan Stanley to become bank holding companies.

### OCTOBER 2008

**October 3, 2008:** Congress passes and President Bush signs into law the Emergency Economic Stabilization Act of 2008 (Public Law 110-343), which establishes the \$700 billion Troubled Asset Relief Program (TARP).

**October 7, 2008:** The Federal Reserve Board announces the creation of the Commercial Paper Funding Facility (CPFF), which will provide a liquidity backstop to U.S. issuers of commercial paper.

**October 8, 2008:** The Federal Reserve Board authorizes the Federal Reserve Bank of New York to borrow up to \$37.8 billion in investment-grade, fixed-income securities from American International Group (AIG) in return for cash collateral.

**October 14, 2008:** U.S. Treasury Department announces the Troubled Asset Relief Program (TARP) under the authority of the Emergency Economic Stabilization Act of 2008.

**October 21, 2008:** The Federal Reserve Board announces creation of the Money Market Investor Funding Facility (MMIFF) to facilitate the purchase of assets from eligible investors, such as U.S. money market mutual funds.

### NOVEMBER 2008

**November 10, 2008:** The Federal Reserve Board and the Treasury Department announce a restructuring of the government's financial support of AIG.

**November 12, 2008:** Treasury Secretary Paulson formally announces that the Treasury has decided not to use TARP funds to purchase illiquid mortgage-related assets from financial institutions.

**November 23, 2008:** The Treasury Department, Federal Reserve Board, and FDIC jointly announce an agreement with Citigroup to provide a package of guarantees, liquidity access, and capital.

**November 25, 2008:** The Federal Reserve Board announces the creation of the Term Asset-Backed Securities Lending Facility (TALTF), to support recently originated consumer and small business loans. The Treasury will provide \$20 billion of TARP money for credit protection.

### DECEMBER 2008

**December 19, 2008:** The Treasury Department authorizes loans of up to \$13.4 billion for General Motors and \$4.0 billion for Chrysler from the TARP.

**December 22, 2008:** The Federal Reserve Board approves the application of CIT Group Inc., an \$81 billion financing company, to become a bank holding company.

**December 29, 2009:** The Treasury Department announces that it will purchase \$5 billion in equity from GMAC as part of its program to assist the domestic automotive industry. The Treasury also agrees to lend up to \$1 billion to General Motors. This commitment is in addition to the support announced on December 19, 2008.

### JANUARY 2009

**January 5, 2009:** The Federal Reserve Bank of New York begins purchasing fixed-rate mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae.

**January 12, 2009:** At the request of President-Elect Obama, President Bush submits a request to Congress for the remaining \$350 billion in TARP funding for use by the incoming administration.

**January 16, 2009:** The Treasury, Federal Reserve, and FDIC announce a package of guarantees, liquidity access, and capital for Bank of America.

**January 16, 2009:** The Treasury Department announces that it will lend \$1.5 billion from the TARP to a special purpose entity created by Chrysler Financial to finance the extension of new consumer auto loans.

*Note: This is a greatly abridged version of the timeline of actions by the Federal Reserve, Treasury, and other federal agencies, found at <http://www.stlouisfed.org/timeline/timeline.cfm>, accessed January 21, 2009.*

- **Enhance the perception of legitimacy** by taking actions which improve the perceived fairness and transparency of decisions. The public needs to gain a sense that political leaders have a clear mission, are good stewards of the nation's economy, and will make fair decisions.

Chairman Bernanke and Secretary Paulson laid the foundation of the government's response. It is time for the new Administration to build on it and place the government's response on a more sound organizational footing. ■