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## To the Edge: Legality, Legitimacy, and the Responses to the 2008 Financial Crisis (Book Review)

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by time,” to quote a character from the film *Miller’s Crossing*.<sup>5</sup> It might be possible that the answers to our problems today lay beyond our own narrow history.

Roth does levy some thoughtful criticisms that every administrator at an institution of higher education ought to consider. For example, he is fairly dismissive of emphases on both technical and vocational programs, as well as the specialized research institution. While I do think there is a place for vocational development and specialized research, it is interesting that many small liberal arts colleges today, attempting to answer current problems, are moving away from their traditional arts and sciences roots to become either technical and vocational institutions (158, 190) or specialized research institutions where faculty no longer educate students liberally, but instead focus on their own research agenda (104).

A second poignant criticism regards student evaluations and the power they have to change the educational experience for the worse (136-137). Roth writes, “[T]he great bulk of the information [that university officials] use to determine the quality of teaching is the satisfaction of the students as expressed on surveys. In his introduction to the 2002 edition of *The Academic Revolution*, Jencks puts it this way: ‘So instead of giving students what grownups think the students need, most teaching institutions are under considerable pressure to give students what they want’” (137).

Despite my criticisms of *Beyond the University*, Roth has written an important and engaging book that speaks to some of the most important problems in higher education today. As a college president, criticizing certain trends that are particularly popular among college administrators, he shows that he swims

upstream, for which he ought to be applauded. This book ought to be required reading for any administrator considering a move to technical and vocational education, or a push towards emphasizing research and grant-winning. It is also recommended for anyone interested in knowing at least one strand of the development of higher education in American history. I hope this fine book prompts discussion across American colleges about the ultimate purpose of higher education.

### Endnotes

1. Regarding the latter point, I’m thinking specifically of Notre Dame’s 10-year curriculum review’s proposal of dropping philosophy and theology requirements. See: <http://www.washingtonpost.com/news/grade-point/wp/2015/02/17/notre-dame-is-reviewing-its-curriculum-which-could-have-far-reaching-effects/>.
2. G.K. Chesterton, *The Collected Works of G.K. Chesterton: Chesterton on Dickens* (San Francisco: Ignatius Press, 1989), 425.
3. As quoted by Charles Singleton in his translation of Dante’s *Divine Comedy*. See Dante Alighieri, *The Divine Comedy: The Inferno*, translated, with a commentary, by Charles S. Singleton (Princeton: Princeton University Press, 1970), 371.
4. Rebecca Newberger Goldstein, *Plato at the Googleplex: Why Philosophy Won’t Go Away* (New York: Vintage Books, 2014).
5. *Miller’s Crossing*. DVD. Directed by Joel Coen and Ethan Coen. Twentieth Century Fox Film Corporation, 1990.

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*To the Edge: Legality, Legitimacy, and the Responses to the 2008 Financial Crisis*. Philip A. Wallach. Washington, D. C.: Brookings Institution Press, 2015. 319 pp. ISBN 978-0-8157-2623-4. Reviewed by Jack R. Van Der Slik, Professor Emeritus, Political Studies and Public Affairs, University of Illinois-Springfield.

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For me, *To the Edge* is a headache to read. That is not because it is overly long. Its seven chapters are wrought in 218 pages. Nevertheless, the subject matter of corporate finance and regulation is highly complex. A plethora of laws, regulations, agency titles (with acronyms), corporate titles, and terminology from corporate and government finance litters the text. The book is about the Great Recession in the American economy that commenced in 2008 and the ways that government policy makers and regulators sought to deal with the causes and consequences of a plunging economy. The scholar addressing this inquiry, Philip Wallach, is a Princeton Ph.D. in politics,

interested in the regulatory statutes of the American administrative state. To reckon with his subject matter, the reader must penetrate the inner workings, indeed shifting sands, of the nation’s governmental and corporate bureaucracies.

Even the headline issues were difficult to understand from the onset of the economic crisis. After earlier economic tremors, in March 2008 the country’s seventh-largest investment bank, Bear Stearns, approached financial insolvency. In an elaborate arrangement primarily engineered by Henry Paulson, then Secretary of the Treasury, and Ben Bernanke, chairman of the Federal Reserve, the government provided

federal loan incentives to press J.P. Morgan Chase Bank to acquire Bear Stearns and provide liquidity to Bear Stearns' customers. Half a year later, Lehman Brothers, the nation's fourth-largest investment bank, suffered liquidity problems. This time the government response was different. Judging that the consequences and liabilities of a Bear Stearns-like solution were distinguishable from the Lehman case, Secretary Paulson let it be known that no government aid was forthcoming. The result was that Lehman's Board of Directors unanimously voted for bankruptcy on September 15, 2008.

Also teetering on insolvency as the 2008 financial crisis deepened were the federal government's sponsored enterprises known as Fannie Mae and Freddie Mac, quasi-governmental lenders for home mortgages. Legally private corporations but created as federal institutions central to the mortgage market serving American homeowners, they were too big to be allowed, by the federal government, to fail. Thus to save these government-sponsored enterprises, Congress passed the Housing and Economic Recovery Act of 2008 (HERA) at Paulson's and the Bush administration's urging. Responding to stock-price declines in Freddy and Fanny shares due to investor fears about insolvency, Paulson used the new law to put Fanny and Freddie under government conservatorship. Among the details of the solution, the Treasury committed \$100 billion to each of them, later raising the allocations to \$200 billion, thereby backing the net worth of the firms and stanching downward market pressure on the prices for Fanny and Freddie stocks.

The world's fifth-largest insurance company, American International Group (AIG), was also stuck in the home mortgage business. One of its divisions, by writing "credit default swaps" that insured the value of mortgage-backed securities, went underwater when the housing market downturn revealed that the mortgages underlying these securities were seriously overvalued. AIG was obligated to huge losses. As property and security values plummeted, AIG exhausted its liquid funds and bankruptcy was imminent. Where could it access a capital infusion? After private sector attempts to generate a financing package fell apart, the Federal Reserve came up with a secured loan through the Federal Reserve Bank of New York for \$85 billion, but on very demanding terms (government ownership and 12.5% interest). AIG's board approved the deal.

To illustrate how the fever of declining asset values can spread, he considers the money market mutual funds (MMFs). For depositors, accounts in MMFs were considered a safe preserver of financial value. But

when Lehman went down, F, Reserve Primary Fund (a major MMF), suffered a huge loss. When it was required by law to make the loss public, a run on its funds began, and the run created panic in the MMF market. The MMF loan business sustains short-term financing for large corporate firms, for example, providing timely cash for their payrolls. In short, the panic threatened to seize up a sector of the credit market that would endanger a wide range of corporate enterprises. The Federal Reserve created a short-term solution by dispersing funds to banks in order to purchase MMF assets so that they could satisfy investor redemptions. The program put \$150 billion into this specialized market in its first ten days, successfully stanching the need for investor redemptions and thereby reducing redemption demands to normalcy.

Despite measures already described, the mortgage market continued to deteriorate. Paulson and Bernanke expressed their need for more resources of money and discretion to President Bush, who agreed to a congressional proposal. The central element, remembered as TARP (Troubled Asset Relief Program), was to allow Treasury to buy devalued mortgage assets from banks and investment firms. The initial proposal was rejected with bipartisan opposition. The reaction prompted the worst ever one-day drop on the Dow Jones Industrial Average—778 points. Terror in the financial sector stimulated changed views in Congress. In the first week of October 2008, the Emergency Economic Stabilization Act became law, funding TARP with \$700 billion and giving tools of discretion to Bernanke and Paulson. In a rapid fashion, the Treasury directly injected capital into banks by taking ownership of preferred shares of stock. It directed \$125 billion to nine major banks and a like amount to smaller needy but healthy banks.

In a less anticipated move, TARP funds became the emergency source of funds to General Motors and Chrysler. An ambivalent President Bush responded to the ailing auto builders headed toward what he called a "disorderly bankruptcy" in the time between the election and President-elect Obama's inaugural. Bush said, "I believe that good policy is not to dump [on Obama] a major catastrophe in his first day of office." From TARP, short-term loans were made to facilitate restructuring at GM and Chrysler in an attempt to prevent both layoffs and bankruptcy. The Obama administration put in place an Auto Task Force, which oversaw subsequent orderly bankruptcies, resulting in Chrysler eventually being reorganized, then partnering with Fiat. In 2014, Fiat completed its acquisition of Chrysler. A reshaped GM also made a successful

recovery. The auto bail-outs made taxpayers unsecured creditors to these public corporations. It should be added that the Treasury began selling its stake in General Motors in 2013 and completed the sale of its last holding in December, reportedly losing \$9 billion on an investment of \$49.5 billion (183).

The government's reported loss regarding General Motors triggers the question, what did the crisis responses by the federal government cost the American taxpayer? Perhaps the most authoritative judgment about the cost of TAROO cost is that of the Office of Management and Budget in 2014: an estimated \$39 billion. Following a labored discussion of the question, Wallach argues that "any grand total calculated for the government's crisis responses will say as much about the author's assumptions as about the underlying facts.... [W]e can nevertheless say with certainty that the responses cost less than most observers initially expected, so that citing the dollar costs of the bailouts became a less compelling critique of the administration as time went by" (185).

What cannot be gainsaid is that the measures crafted by Paulson and Bernanke during the Bush administration, and continued under Geithner and Bernanke during the Obama administration, did prevent a financial collapse that might have become truly catastrophic. As a political commentator myself, I think that it is remarkable to note how peripheral to the presidential election in the fall of 2008 the crisis was. Its issues were largely ignored during the campaign. After the transition from Republican Bush to Democrat Obama, there was no sharp reshaping of the crisis responses. To the contrary, Obama continued what Bush set in motion, retaining Bernanke at the Federal Reserve and moving Geithner from the Federal Reserve in New York to Treasury Secretary.

It is true that the crisis responses did necessarily pick economic winners and losers. J.P. Morgan Chase was a winner because Paulson engineered a bargain price for its acquisition of Bear Stearns. Yet all of Lehman's interested parties lost in its unaided collapse. AIG executives and investors suffered a great deal, but the company survives. So do General Motors and Chrysler, though hugely changed. But Ford, taking no federal funds, could have been a huge winner had GM and Chrysler bankruptcies been harsher. What about homeowners with mortgages who suffered value losses because overvalued mortgage-backed securities put the housing market into a downward spiral? Ordinary savers, trying to live on interest earnings, took a haircut as interest rates plummeted to near zero, where the rates have persisted to the present day.

The complexity of Wallach's explanatory task is exacerbated by the need to identify agencies, programs, and financial terminology relevant to the story. To Wallach's credit, he did his best to account for and identify the agencies and programs relevant to the story told in this book. There is, for example, a four-page, fifty-two item, alphabetically ordered "glossary of crisis laws and programs," listed by their acronyms (from "ABCP: Asset-backed commercial paper; short term bonds backed by physical assets" to "WaMu: Washington Mutual Bank.") Wallach's footnote citations fill over 80 pages of the book—pages 223 to 306—with 952 footnotes, most of them citing more than one source.

*To the Edge* actually celebrates the success of nimble policy administration because in reality, the American economy was close to total disaster, one that was arrested by incentives to incorporate America from the Treasury and the Federal Reserve. Prudently, Wallach does not expend much effort parsing out blame for the origins of the crisis of 2008. His critical observations about how the federal government responded are simplified by applying the term "ad hococracy." He faults policymakers for improvising crisis responses, some quite arbitrary, with tenuous statutory support. Of course, that opinion was not rare in the financial community. To this day there are cases pending. For example, former AIG Chairman Maurice Greenberg is still in federal court contesting the fairness of the government take-over of his company without "just compensation" (see June 15, 2015 issue of the *The New York Times*). Indeed, Wallach gets the title for his book from former Federal Reserve chairman, Paul Volcker, who saw the Fed's actions as extending "to the very edge of its lawful and implied powers" (54). Wallach has an easier time delineating the stretching of legal boundaries than he does with differentiating legitimacy/illegitimacy standards apart from the law.

Before departing his rendition of the crisis and its aftermath, Wallach offers some prescriptions for how government should arrange policy for the "next time" such an economic challenge emerges. His expressed hope for a "more active legislature" sounds rather like dutiful constitutionalism instead of realistic advice. Congress does not do well at anticipating long-term future challenges, but, as in this case, it does need legal authority in times of crisis. Wallach's strongest pitch is for "an accountable slush fund" (213 ff), of \$50 or \$100 billion for the Secretary of the Treasury to spend with discretion in times of exigency. Imagine the Tea Party response to that proposition. What congressional members, seeking reelection, would defend a vote in favor of such a proposal?

Wallach has given us a seriously directed, thoroughly documented rendition of a complicated, government-managed calming of the U.S. Great Recession. On the whole Paulson, Bernanke, Geithner, and their governmental minions, though guilty of choosing winners and losers with some arbitrariness, contained the disaster to the benefit of and greater good for most Americans. We who seek public justice on moral standards can question specifics, but on the whole, public peace was preserved by the steady hands of those in governmental authority. Relatively mild protests from the right (Tea Party) and left (Occupy Wall Street) necessitated no tanks in the streets. Curiously, the elected politicians did not divide by party but coalesced in support of prudent policy measures

from first a Republican administration and then a Democratic one.

This book is not an easy read, but Wallach has devised his own eleven-page summary of its essentials in a recent essay, “Democratically Accountable Adhocracy? The Challenges of Legitimizing the Responses to the 2008 Financial Crisis,” available online at The Brookings Institute’s website.<sup>1</sup> Readers of this review may find Wallach’s essay as much as they care to know about Wallach’s recommendations.

#### **Endnote**

1. [www.brookings.edu/research/papers/2015/06/17-legitimizing-financial-crisis-adhocracy-wallach](http://www.brookings.edu/research/papers/2015/06/17-legitimizing-financial-crisis-adhocracy-wallach)