DOES NATIONAL FINANCIAL RECOVERY
REQUIRE AN ETHICAL PARADIGM SHIFT?

Robert I. Cusick

Thank you for inviting me here today. It is refreshing and stimulating to me to be with a group of people who really care about conflicts of interest, particularly people who don't work with me. While my particular discipline is government ethics, we all have a great deal in common.

Over the past few months we all have been overwhelmed with news of financial recession, huge public debt, widespread social problems resulting from job losses, and foreclosures which have produced both anxiety and anger across the county and among our international trading partners. There is a prevailing sense that no one really knows what to do, that we must listen to the best financial experts and hope that our economic experts and our political system are up to the job of bringing us back to a position of strength in the international economy and economic stability at home. For many months we have lived under a foreboding cloud of numbers.

Before banks failed, before they admitted that billions of dollars of their putative wealth were toxic assets, before AIG's reputation crumbled, before our national debt expanded so drastically ---- there was another failure, one that was not to be measured in numbers. But there is much more to the story than numbers. There was an ethical failure of enormous proportions, much of it connected to conflicts of interest. Corporate directors and officers and investment bankers who could gain so much from ethical compromise found it easy to mischaracterize the real risk of investment vehicles, to misrepresent lending practices, to expose companies and the shareholders they putatively served to risks contrary to their fiduciary duties. Short term gains – or at least the appearance of gains were more important rather than long term integrity.

Numbers, points on the board were everything. Incentives to financial executives were structured around this model, and they did not work. Hubris and arrogance found a fertile field in the absence of firm ethical standards as integrity eroded. Such leaders as existed in the financial industry allowed themselves to be distracted by "innovative" new products, higher short term profits and pleasing numbers. They did not lead with integrity – the integrity to acknowledge the illusion of wealth they had built. To this day, the former Chairman of AIG refuses to accept any responsibility for the calamity that befell his company and which was abandoned at the doorstep of American taxpayers. Trust in these institutions now has failed, and loss of trust is a very destructive thing.

Let me be clear. I am not an economist; I do not speak for the administration. I regulate no one in the private sector. But, the work I do produces a certain way of thinking and it is from that perspective that I speak.

The Office of Government Ethics has existed for over thirty years to prevent and help resolve conflicts of interest within the Executive Branch. We want government to be trusted, and trusted for good reasons. It is the people's business. We also recognize that trust in government is not just a rational conclusion to be hoped for; it has a significant emotional component as well and must be earned. The recent explosion of anger at the private sector over staggering losses, incomprehensible bonuses and excuses ought to cause private sector leaders to reflect on the fact that trust in them operates the same way.

When I was preparing for my Senate confirmation hearing, I wondered if someone might ask me, "Just what is government ethics?" I had found no generally accepted definition (except the old cliché about it being an oxymoron), so I developed my own. Here it is: Government ethics is that system of laws and procedures that tends to ensure that official government decisions are informed by the public interest and not corrupted by private interests. The core of that system is the identification and disclosure of conflicts, which is followed closely by measures to remove or remedy the conflicts. Accountability and transparency are the cornerstones of our effort.

Why do we at OGE care about conflicts of interest? Surely some people in government can act with sufficient detachment from their own interests to make principled decisions that are not corrupted by a desire to feather their own nests. There are altruists. Some, anyway. But which ones are those? Which people and which decisions? Our human experience and instinct tells us that we cannot know. We might guess correctly in one instance and miss by a mile the next time. Not every conflict will require a measure to render it harmless, but we cannot know which ones these will be. That is why transparency is essential in any conflicts-prevention effort. It would be much *easier* to appoint government officials without studying possible conflicts of interest. But because public trust is the lifeblood of democracy it would not be easier to govern. Yet, many businesses in the private sector hire people all the time with little thought to even looking or caring about the possible personal conflicts of interest of their employees.

- Conflicts of interest produce many detrimental effects.
- Conflicts tend to neutralize or impair free market forces.
- Conflicts tend to increase prices.
- Conflicts tend to result in contract awards to those who may not be the most competent or who produce products of less than the best quality.
- Conflicts tend to distort budget planning and make economic analysis less predictive.

- Conflicts tend to bestow economic power based on relationships rather than objective analysis of who is the most effective.
- Conflicts often require rationalization of inappropriate risk-taking.
- Conflicts may be cloaked in complexity (*as, by the way, are credit default swaps, securitized debt investment packages and the investment strategies of hedge funds in the private sector*.)

The existence of conflicts of interest creates a disincentive for transparency in the need to conceal the conflict or obscure it. It is the enemy of transparency.

The United States Office of Government Ethics is likely the largest institution devoted to prevention of conflicts of interest in either the public or private sectors. Every twelve months, over twenty-six thousand officials of the executive branch of the federal government must file publicly available financial disclosure statements. Similarly, over two hundred and eighty-five thousand executive branch officials must file confidential financial disclosure statements which are subject to intra-agency review. To lie or misrepresent on one of these disclosure forms is a federal felony crime and there are people presently serving time in prison for such offenses. Moreover, at the most senior levels of the executive branch, those persons requiring Senate confirmation must file publicly available forms for review by both agency ethics officers and by OGE. There are about eleven hundred such positions as to which we must certify to the Senate that the nominee will not have a conflict of interest if the Senate votes to confirm him or her in a particular position. We take that certification responsibility very seriously.

This analysis is quite position specific. For example, a senior Department of Defense official cannot own stock in Lockheed Martin or Boeing, and a senior Health and Human Services official cannot have holdings in the health care or drug sectors, but the converse might not be so. Transportation officials cannot own airline stocks and Agriculture officials cannot own stock in food growers and distributors. I am oversimplifying this, but the point is clear enough. The American people should be able to trust public officers not to act in official matters based upon their private sector interests. Federal officials and their spouses and dependent children frequently are required to divest themselves of financial interests which constitute a conflict of interest. These are not always as obvious as those cited above. For example, do you have any idea how much Coca-Cola the Department of Defense buys?

And it is not just equity or debt interests we review. We review both for-profit and non-profit directorships, relationships with former clients, and money being received from private sector employment which an official is leaving. As an official's career proceeds, our regulations closely limit gifts and gratuities, and toward the end, offers of or efforts to obtain private sector employment. These can be conflicts as well.

This system, with some adjustments, has worked for thirty years throughout which the distinction between the private sector and the public sector was clear to most people. In the course of the past fifteen years, the increasing use of contractors by the Federal Government to accomplish some of its work has blurred the edges of this distinction and the ethical paradigm. Even the Federal statute which requires "inherently governmental activities" to be carried out by Federal employees (who are bound by the government ethics system) is not uniformly honored in government agencies and these duties are given over to employees of private companies who do not work for you, but for private companies, and are not bound by government ethics rules. As David Walker, former Comptroller General of the United States, has said:

> There's something civil servants have that the private sector doesn't, and that is the duty of loyalty to the greater good—the duty of loyalty to the collective best interest of all rather than the interest of a few. Companies have duties of loyalty to their shareholders, not the country.

This problem with government contractors has at last been recognized and the early stages of remedying it are under way in Congress and in the Office of Management and Budget. Even large government defense contractors have tried to get out in front of the problem by establishing the Defense Industry Initiative, a group of contractors committed to ethical self-regulation more consistent with government principles. David Walker focused on the problem. It is one of ethical duty. Who you think you are has a great deal to do with what you consider your ethical duty to be. As a nation we have not paid enough attention to this distinction.

National financial recovery efforts may produce a visible change in the ethical paradigm in government over the next few years because we have seen that lapses in private sector ethical duties certainly impact public sector interests. For example, is AIG (American International Group) really the private sector when the federal government owns eighty percent of it? Are federal officials who supervise lending to AIG or Citibank, or General Motors or Chrysler still able to act with ethical clarity when the federal government is almost indistinguishable from a private citizen as a shareholder? Should they think only as a government official or should there be a mix of private investor-like thinking as well? Exactly where is the distinction between private citizen thinking and government thinking?

Some examples that used to be clear are not so anymore. A year ago, OGE analysts and lawyers would not have identified a prospective Treasury appointee with $400,000 on deposit in a bank as having a possible conflict of interest. But the role of government has evolved. If that official might participate in discussions about whether to "bail out" a bank – or not – then personal accounts in excess of the FDIC's $250,000 guarantee can present a possible conflict of interest. Perhaps doing the right thing in saving the bank would be the same whether the official had deposits there or not, but the distinction between the public and private interest is not as clear as it once was, so the need for transparency is acute. OGE and six thousand ethics officials across the Executive Branch are working their way through this shifting analytical sand. My point is that conflicts can occur in both the public and private sectors, but until now it has been thought to be most pernicious in the public sector where it produces distrust. As Ralph Waldo Emerson said more than a century ago, “Distrust is a very expensive thing.” There is no doubt he was right. Advocates for good government insist that public service requires, and is, a public trust.

American executive bonuses and the unseemly and hapless scurrying about of executives to justify them may be the nascent signs of a new business ethic in its earliest stages. The hideous disproportion between what “Masters of the Universe” on Wall Street earn and what most people would think to be a princely sum creates a social tension that may spark a new business ethic. All these enormous bonuses seem to have achieved is a constant raising of the compensation bar which the next company must meet.

But do you see what is happening here? The angry public outcry over bonuses, foreclosures, pension losses and an almost prideful lack of accountability is forcing a change not only in the level of public discourse, but in the language of public discourse. Ethics language is being heard. In a speech last week in Washington, Lloyd Blankfein, the chairman of Goldman Sachs, admitted that the industry “has disappointed customers and shareholders by taking actions that “look self-serving and greedy in hindsight.” He also admitted that, “We rationalized because our self-interest in preserving and growing our market share, as competitors, sometimes blinds us------especially when exuberance is at its peak.”

Steven Pearlstein of the Washington Post, writing about Blankfein’s speech, said there are glaring factors on Wall Street which even Blankfein overlooked. “The most important is culture……a culture that not only tolerates but almost celebrates taking advantage of customers……It's hard for anyone who grows up in an industry to see fundamental problems in its culture…[P]ay at such astronomical levels has a tendency to swell heads, inflate egos and tempt people to take undue risks of all sorts, ethical as well as financial." A culture that elevates one's own interests over the interests of shareholders is fundamentally an unethical culture.

From the point of view of government ethics, there are three essential elements in an ethical organization: A code or set of principles which is enforceable, ethical leadership of the organization, and an ethical culture that arises from the first two. I believe that for the financial recovery effort to be firmly grounded, something like this will be required. Significant ethical failures in the Executive Branch are infrequent considering its size and complexity. (I would carefully distinguish here ethical failures from honest disagreements between legitimate policy choices which government has a duty to make. Too often, disappointed politicians or interest groups label policy choices as unethical when in fact they are choices between what noted ethicist Rush Kidder calls "two rights.")

This cannot be solely a federal effort. Remember that virtually every corporation in the country is incorporated under state law, not federal law. A very high percentage of these are incorporated in Delaware. Perhaps board members need to be addressed more directly by government about their duties to shareholders. It is obvious that the level of communication between shareholders (other than large institutional shareholders) is almost non-existent. This is especially true as concerns the compensation committees of boards of directors. Particularly in the financial industry a serious effort must be made to establish standards of behavior that do not now exist. If the effort does not arise from the common sense of influential experienced members of the industry, it will surely be imposed from outside. Enlightened cooperation among government and private sector agents as well as non-profit bodies which have long tried to improve corporate governance may be more immune from lobbying pressures that bedevil legislative efforts in that sector. Ethical leaders must emerge. Statements like Mr. Blankfein's make it painfully evident that national anger and government response cannot be ignored. While we are alert to shifting needs in the public sector, the needs in the private sector will be more dramatic and wrenching. Here are some of them:

- Markedly greater transparency in lending and investment policies.
- Establishment of incentives that are more justifiable and a function of long term personal and market integrity.
- Greater government oversight of financial institutions and hedge funds.

Our rules and regulations are not easily transferable to the private sector, but the ethos that underlies them should be studied in restoring integrity of the financial system. Certainly there has been a lack of transparency and a failure of accountability in the private sector financial industry. As a matter of fact, many funds have sold themselves to clients in a way that ***emphasized*** a lack of transparency. The name Madoff is familiar to you. But dozens of investment funds pride themselves on obscuring what they do except for the result. Can this be tolerated any longer? Even prominent financial executives are admitting the need for greater regulation. They should ask themselves about what financial industry ethics may be. What conflicts have they built into or allowed to proliferate in their own business.

While most of us probably did not think about the financial industry in ethical terms and did not envision its having the power its near crash has released, it is clear that it had and has power. Recovery cannot depend on corporate structures shot through with conflicts, secrecy and disregard for the public interest. Such destructive power must be tempered by a new sense of ethics. The financial industry has created its own conflicts for itself. Ethics rarely thrives in secrecy. Ethical analysis is rarely served while participants are seated around a table stacked with shareholder cash. Ethical culture rarely grows in a group which feels itself immune from oversight.

The Dartmouth Ethics Institute likes to define ethics as “that force which binds power to responsibility.” Let us all hope for some of that.