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UNITED STATES OF AMERICA

FINANCIAL CRISIS INQUIRY COMMISSION

Interview with Lawrence H, Summers, Phd

The commission met, pursuant to notice, at  
2:07 p.m., Friday, May 28, 2010, in the  
Office of the Financial Crisis Inquiry  
Commission, when were present:

- PHIL ANGELIDES, Chairman
- CHRISTOPHER P. SEEFER, Esquire
- BROOKSLEY BORN, Commissioner
- WENDY EDELBERG,
- DOUG HOLTZ-EAKIN, Commissioner
- LAWRENCE H. SUMMERS, Phd  
Director for the National  
Economic Counsel, and Assistant  
to the President, for Economic  
Policy
- DONALD VERRILLI, Esquire,  
White House General Counsel.
- ALSO ATTENDING,  
Marne Levine

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Roberto Gonzalez  
George Mariso  
Michael Gordon  
Gary Cohen  
Greg Feldberg  
Ron Borzekowski  
Randall Dodd  
Scott Ganz

1 PROCEEDINGS

2 (2:00 p.m.)

3 MR. SEEFER: Dr. Summers, thank you very  
4 much for coming in today. My name is Chris Seefer,  
5 of the Financial Crisis Inquiry Commission. We were  
6 established by a statute called the Fraud  
7 Enforcement and Recovery Act of 2009 last May, and  
8 it tasks us with figuring out the various causes of  
9 the financial crisis by the end of this year.

10 In that regard, we are talking to many people  
11 that we hope can help us understand various causes,  
12 and of course we have identified you as 1 person to  
13 talk to. Thank you very much for coming in.

14 As you can see, we do have a court reporter, so  
15 you've probably been through this drill before, I'll  
16 try not to speak over you and vice versa, so we can  
17 get a clear record. If you need a break, just say  
18 so and we'll take a break. I know you wanted to  
19 make a statement before you got started.

20 MR. VERRILLI: Yes, thank you Chris. I'm Don  
21 Verrilli, of the White House Counsel's Office, and  
22 I'm here today representing the interests of the  
23 White House. As you know, Dr. Summers is a senior  
24 white house official, and one of the President's  
25 closest advisers.

1           The White House has agreed to make Doctor  
2 Summers available for the purpose of this interview  
3 today in recognition of the commission's important  
4 mission. But we all need to recognize that even  
5 agreeing to a step like this interview is an  
6 extraordinary accommodation for this or any White  
7 House to make.

8           We have had what I think are very productive  
9 discussions with commission staff, regarding the  
10 interview, and based on those discussions we are  
11 confident and we hope to share a sense with you that  
12 the interview can go forward in a way that helps you  
13 accomplish your important work, and that respects  
14 the interest of the Presidency.

15           Specifically, it is our understanding, based on  
16 those discussions, that the interview today will  
17 focus on the historical record and not on current  
18 administration policy or current events that the  
19 administration is confronting or may have to  
20 confront. We have an agreement about that?

21           MR. SEEFER: Yes.

22           MR. VERRILLI: All right then, thank you.

23           MR. SEEFER: So Doctor Summers, our  
24 statute tells us to look at 22 different areas. I'm  
25 going to frankly ask you about several of those

1 areas. But before I do, I really just wanted to  
2 broadly get your opinions to start on what you feel  
3 were the primary causes of the financial crisis.  
4 And then I'll ask more specific questions after we  
5 hear that.

6 DR. SUMMERS: The beginning for me, the  
7 right way to think about this financial crisis or  
8 for that matter any major accident, to think in  
9 terms of a number of factors which came together to  
10 cause the crisis. In all likelihood, in the absence  
11 of most of them, history would have plaid out quite  
12 differently.

13 So I like to think of the factors in 4 broad  
14 clusters. The first is the macroeconomic  
15 environment. A combination of overconfidence caused  
16 by a period of low volatility. Low interest rates,  
17 very low interest rates, very substantial capital  
18 inflows into the United States, relating to both  
19 external economic conditions in the countries, and  
20 to U.S. budget policy. The relatively easy  
21 availability of credit contributed to a  
22 macroeconomic environment that was prone to  
23 speculative excess, broken asset and debt markets.

24 Second, obviously these are related, you had  
25 quite a pervasive pattern of excessive leveraging

1 and risk taking. At 1 level that's a reflection of  
2 what's surely a factor in most human failure, greed,  
3 irresponsibility, and cupidity. At another level  
4 it's a reflection of the incentive arrangements that  
5 were poorly aligned, with respect to the  
6 compensation of individuals, with respect to awards,  
7 open to institutions. At another level, it was  
8 reflects failures of regulation both gaps that  
9 allowed leveraged decisions to be made without  
10 serious review or allowed commitments to be made,  
11 where such an equivalent to leverage, guarantees and  
12 the like, without serious regulatory review. And  
13 failures by regulators to fully assess risk in  
14 situations where they were engaged in review. So a  
15 situation speculative excess, combined with a  
16 situation of excessive leverage created an  
17 environment that was very easy for crisis to  
18 develop. If you would like, a very, very dry  
19 forest. The third factor was a set of evolutions  
20 in our system that had made it more brittle, made it  
21 brittle, and without the resilience that it had  
22 earlier. It could be argued for some significant  
23 interval, perhaps through the 1990s, that our  
24 systems, the argument that Al Greenspan had made at  
25 that time, had a resilience that came from credit

1 being provided on the 1 hand by banks, and on the  
2 other hand through the capital markets. And that  
3 there was some tendency when the banking system got  
4 in trouble as it did in the early '90's, for capital  
5 markets to take up the slack. And when capital  
6 markets got in trouble, for the banking system to  
7 take up the slack.

8 The ways in which securitization evolved, the  
9 ways in which the shadow banking system evolved,  
10 particularly as regards mortgages, ways in which the  
11 derivatives markets evolve, created a system that  
12 was very brittle, in the sense that there were a  
13 large number of no's. Failure at any 1 of which  
14 called the broad stability of the system into  
15 question. And so the jump from crisis to systemic  
16 collapse came to be a much shorter one.

17 A fourth factor was the lack of satisfactory  
18 tools for crisis resolution that placed public  
19 authorities in a situation where it was challenging  
20 to act rapidly, decisively and legally. And that  
21 faced them with, even if they were able to get the  
22 legal authorities that they might wish, with  
23 agonizing dilemmas's between on the 1 hand chaos,  
24 confusion and potential collapse. And on the other  
25 hand the indiscriminate infusion of large quantities

1 of taxpayer money, with associated risks for  
2 taxpayers and associated moral hazard consequences  
3 down the road.

4 So while there are many, many aspects and  
5 contributors, for me the broad list of the macro,  
6 without a problematic macroeconomic environment, we  
7 likely would have survived many of the other  
8 problems that we would've had with the problematic  
9 macroeconomic environment, but without excessive  
10 leverage and failures of regulation consequences.  
11 Quite likely it would have been less serious, even  
12 with a flawed macroeconomic environment and  
13 excessive leverage, without the degree of  
14 brittleness and non-resilience that had emerged, we  
15 would've had a better outcome. And even with all 3  
16 of those, we might well have been in a much stronger  
17 position if we had more satisfactory mechanisms for  
18 containing failure.

19 I might just finally emphasize, because I  
20 realize that I didn't say it again. When I spoke of  
21 excessive leverage, the examples I used in my tone,  
22 emphasized in financial institutions. Of course  
23 excessive leverage by households, by businesses and  
24 the decisions to extend excessive leverage to  
25 households and to businesses are also part of the

1 leverage story.

2 MS. EDELBERG: Can I just ask 1 follow up  
3 question? So what I keep coming back to is comments  
4 like Chairman Bernanke's. Where he said early on  
5 when we said our housing market turned, the sub  
6 prime crisis was contained. And what did we know at  
7 that time, and what did we not know at that time?

8 And the reason I keep coming back to that is  
9 that I can't help but think, given how many smart  
10 people were, would have had every incentive to avoid  
11 a financial crisis, that what led to the financial  
12 crisis was things they didn't see, or connections  
13 that they didn't see.

14 So with that in mind, I look at your list and  
15 there are a number of these things that we knew in  
16 2005. We knew what was happening in the  
17 macroenvironment, we arguably knew a huge amount  
18 about leverage. It could be that there were parts  
19 of leverage that we didn't understand, but we could  
20 have understood them if we had looked in financial  
21 institutions. We certainly saw what was happening  
22 with undervalued ratios, and we understood what was  
23 happening in the regulatory environment. I would  
24 argue.

25 The part that I see on your list that I don't

1 know that we appreciated in 2005, I'm trying to roll  
2 back some time before the crisis, is the brittleness  
3 of the system. Is that fair?

4 DR. SUMMERS: Well I think it's, I made 2  
5 or 3 points. First, the brittleness would have  
6 mattered less if the other factors that led the  
7 resilience of the system to be tested, had not been  
8 present. So even if your point was completely  
9 right, it wouldn't follow that I should ascribe the  
10 crisis only to the brittleness.

11 Second, I think it's in some ways simpler to  
12 think about the problem activities of investors  
13 who's motivation wasn't to fix the situation, but  
14 only to evaluate it. And who were therefore operate  
15 with fewer constraints. Obviously very large amount  
16 of money were lost by people who had considerable  
17 experience and considerable successful experience.

18 Hindsight is 20/20, and I think in retrospect  
19 it's clear that the macroeconomic environment was  
20 highly suspect in the ways that I described. I  
21 actually was I who fairly early in this 2006/2007  
22 gave some warning about various aspects of the  
23 macroenvironment, it corresponded to my judgment.  
24 But it wasn't that it was an obvious judgment, a  
25 completely obvious judgement. While it seems

1 obvious today, is I gave those warnings at that  
2 time, I was aware that it was a quite common, and  
3 really very widely held view that when the Dow  
4 reached the 6000 range in 1996 that it had a bubble  
5 element as well. And ex post, that judgement  
6 appears not to have been the right one.

7 So I think the judgment of when you have a  
8 bubble, all these looks much easier ex post than it  
9 does ex ante. Any moments in markets there are  
10 bears and the ones who were bears at the moment the  
11 ex posts were peaks, tend to look like they were  
12 very wise. So I don't think that the fact that  
13 somethings were out there is quite as definitive.

14 I think an element, I think a very, very  
15 important element in understanding the crisis, and  
16 it's somewhere between like the second and third  
17 factors on my list, was that people who buy low  
18 investment grade credit or junk credit, believe it's  
19 going to be credit worthy and believe it's going to  
20 work out, or they wouldn't buy it. But they do so  
21 with the understanding that failure is a  
22 possibility, and based on a consideration of the  
23 possibility of failure and the risks associated with  
24 it. The investment in top grade securities, AAA  
25 securities, AAA tranches, in various kinds of

1 collateralized instruments, comes with relatively  
2 little consideration of risk, because it's just  
3 assumed to be safe.

4         And so when the failure of what has previously  
5 been assumed to be safe comes into doubt, you can  
6 get a very substantial panic reaction. It's as if  
7 somebody has said, somebody has used the analogy, it  
8 would take a very little bit of botulism, the  
9 smallest risks to change life quite profoundly if  
10 people wondered about the integrity of the water  
11 supply which they had previously completely relied  
12 on as being safe. So that was in part a source of  
13 the brittleness, and that brittleness has elements  
14 in the structure of the financial system.

15         But it also has elements in what the size of  
16 the bubble turned out to be. It also has elements  
17 in how much leverage there was, because if there had  
18 been less leverage, even with the bursting of a  
19 bubble, the previously safe securities wouldn't  
20 have. So I understand why you are going to the  
21 question of brittleness, but at least in my view, to  
22 really trace it through, and to capture this aspect  
23 of the previously safe not being the gestalt  
24 changing, with respect to the previously safe.  
25 You'd have to look to all 4 of the factors that I

1 talked about.

2 MR. SEEFER: Understanding your point  
3 about folks that invest in AAA's and perhaps don't  
4 consider losing anything to panic, one of the  
5 factors in our statute is looking at the credit  
6 rating agencies, and in fact our next hearing is  
7 going to be on credit agencies. What are your  
8 opinions about the role they played in the crisis?

9 DR. SUMMERS: There are aspects that I  
10 know more about, there are aspects that I know less  
11 about. There are probably no aspects that I know  
12 enough about. Credit ratings would be an aspect  
13 that I know less about.

14 There is no question that the credit rating  
15 agencies made huge errors, and that uncritical  
16 reliance on the credit rating agencies, while credit  
17 rating agencies were making huge errors, was an  
18 important aspect of the problem. And obviously the  
19 credit rating agencies and those who in regulation  
20 make use of their product, I'm talking about this,  
21 phrases like investment grade, have a lot of  
22 soul-searching to do.

23 I would make 2 other remarks. The first is  
24 that I think they sort of go in opposite directions.  
25 The first is that, and again, I think you will find

1 people who can speak to this, speak to what I am  
2 about to say much in much more nuance than I can.  
3 You'll find that there was some activity of the  
4 credit rating agencies which is like what most  
5 people's image of what a credit rating agency does.  
6 I issued a bond, you rate the bond, and after I've  
7 issued the bond you evaluate the bond.

8         There came to be at least a substantial amount  
9 of activity, particularly in the synthetics area,  
10 where it is at least frequently alleged that the  
11 rating agency was a partner or at a minimum a close  
12 advisor, or was more actively involved and rather  
13 more extensively compensated in the design and the  
14 rating process. And that obviously raises more  
15 serious kinds of questions.

16         At 1 level, you know the distinction can't be  
17 drawn with precision. If I evaluate and you rate,  
18 If I issue and then you rate. Suppose I issue it  
19 this way, how would you rate it? Suppose I issue it  
20 that way, how would you rate it? How does iterative  
21 question asking differ from cooperating in the  
22 design? There are clearly some difficult  
23 distinctions in that area. But I think one has to  
24 think that where there is more extensive  
25 involvement, that's an area that requires I think

1 particular scrutiny, I think it receives particular  
2 scrutiny at least in some versions of the financial  
3 legislation now under consideration.

4 The other point I would make though, goes in a  
5 somewhat different direction, just in assessing  
6 credit rating agencies. Is that you have a number  
7 of specialized entities concerning credit risk and  
8 is the credit rating agencies. Another who's  
9 difficulties also have contributed in a non-trivial  
10 way to the crisis is the bond insurance agencies.  
11 And the bond insurance agencies did dismally in many  
12 cases. And the 1 thing that you can say about the  
13 bond insurance agency is that their failure was not  
14 due to the incentive problem that the credit  
15 agencies had. They were in a position where they  
16 were on the hook if a bond they insured failed. So  
17 they had massive incentives to avoid it, and made  
18 many of the errors that the credit agencies made.

19 So my instincts would be that it may slightly  
20 oversimplify what I think is a very deep problem to  
21 attribute it in a dominant way to incentive  
22 problems, rather than to intellectual problems,  
23 given the pervasiveness of the problem, even where  
24 there were very strong incentives to avoid.

25 Now again, particularly in the synthetics

1 cooperative area, I think there were real questions  
2 that can be asked about the arrangement. The issues  
3 are a place where I have had a little bit of an  
4 occasion to think about these issues. Similarly,  
5 there are some similarities with the set of issues  
6 involved in the work of accountants auditing,  
7 designing tax policies, doing consulting business,  
8 how one draws lines. There is a place where these  
9 things have been fairly substantially considered.

10 MR. SEEFER: So am I understanding you  
11 correctly that when it comes to the Ambacs and the  
12 MBIAs and I guess we can throw AIG in there when we  
13 talk about the bond insurers, that there was more a  
14 function of I guess a lack of intellectual  
15 firepower, so to speak?

16 DR. SUMMERS: Intellectual firepower, I  
17 think I would rather make the slightly more narrow  
18 statement that corresponds to what I have some  
19 chance of knowing. Which is it wasn't an incentive  
20 problem, in the sense that they have very strong  
21 incentives to do right. It was a judgment error,  
22 whether the judgment has to do with the  
23 unsatisfactory quality of information they received,  
24 or the intellectual judgments they made about that  
25 information, I don't have a basis for making any

1 judgment at all about that question.

2 MR. SEEFER: I understand that, another  
3 area that we're looking at, another area that the  
4 statute tells us to look at, is the role of  
5 executive compensation and compensation packages in  
6 general. And whether it's Ambac, MBIA or AIG or any  
7 other company, there are still compensation  
8 incentive structures where the managers incentives  
9 may not necessarily be aligned with the company. I  
10 mean have you thought about it at all, for the  
11 Ambac's and the MBIA's and the AIG's?

12 Let me go back to your 4 factors, and ask you  
13 about what you wrote, what you said in a speech  
14 before the Brookings Institution on March 13th of  
15 2009. And in there you were talking about how  
16 there's 2 kinds of economic downturns. One, you  
17 know, monetary policy and rising inflation, and then  
18 of course the financial crisis, the spontaneous  
19 correction of financial excess, as you said. You  
20 talked about how we get 2 or 3 of these a century,  
21 and I'm wondering if you just think, given these 4  
22 factors, that if you had the fourth factor, if you  
23 did have satisfactory tools for regulation by  
24 government, could we avoid these financial crises s  
25 2 or 3 times a century?

1 DR. SUMMERS: In my tone, as I spoke to  
2 the 4 factors, was to suggest that I thought that  
3 with any one of them fixed you would make the  
4 situation substantially better, and that would be my  
5 belief. If you're going to have fires, it is  
6 vastly, vastly, vastly better to have an effective  
7 fire department than not to have an effective fire  
8 department. But it doesn't quite follow, if you  
9 just have an effective fire department it's okay to  
10 have fires.

11 So I don't want to be heard as suggesting that  
12 with satisfactory resolution authority everything  
13 else can be allowed to rip, and that you won't have  
14 serious problems. I do think that with the right  
15 kinds of resolution authority the risk of a crisis  
16 becoming systemic and coming to the brink of  
17 bringing the system to the brink of breakdown could  
18 be quite significantly attenuated.

19 MR. SEEFER: Let me ask you some follow  
20 ups on your 4 factors. Several of them are in our  
21 statute, not surprisingly are within your 4 factors  
22 so far. In the article that you and Mr. Geithner  
23 wrote in the Washington Post on June 15th of last  
24 year, "A New Financial Foundation" it was called.  
25 And 1 of the first things you talked about in terms

1 of the macroenvironment was the global imbalance of  
2 savings, which is 1 of the first things we are  
3 supposed to look at in the statute.

4 Any further comment on how that contributed to  
5 the financial crisis, other than the way you  
6 explained and described in the first factor?

7 DR. SUMMERS: I think you have 2 or 3  
8 aspects. There is an aspect which is that when  
9 money is cheap it's more attractive to borrowers.  
10 And the very substantial availability of funds from  
11 countries that for a variety of reasons were seeking  
12 to accumulate liquid reserves, and the posture of  
13 monetary policy reflecting concerns about deflation  
14 led to money being cheap, which in turn encouraged  
15 borrowing to buy, which in turn encouraged higher  
16 asset prices. I think that's 1 aspect.

17 A second, and I think logically not completely  
18 independent, but somewhat separate aspect is that a  
19 very large demand for safe assets called forth a  
20 desire to supply them, which in turn drove the  
21 creation of the apparently safe assets, which were  
22 subject to the gestalt changes that I described, and  
23 also drove the rather large and substantial  
24 activities around tranching, and the creation of  
25 synthetic securities, which may, given the absence

1 of transparency and with problems in regulation,  
2 contributed to the brittleness of the system.

3 CHAIRMAN ANGELIDES: Can I just ask a  
4 question?

5 MR. SEEFER: Of course.

6 CHAIRMAN ANGELIDES: Can I probe this for  
7 a minute? Which is obviously you've identified that  
8 there is a demand for the safe assets, perhaps 1 and  
9 that's spurred the creation of a whole set of  
10 products to satisfy that demand. But I keep  
11 thinking about the other end of the chain. Which is  
12 at the other end of the chain, at least the first  
13 set of products, before you got into the synthetics  
14 and mezzanine CEO's. What is it that drove American  
15 consumers to borrow so substantially? What were the  
16 driving factors there? Now, not to give the answer,  
17 but obviously if someone is offering you cheap money  
18 for the option, money, I can see that. But was it  
19 that people were over their skis, in terms of being  
20 able to meet their needs, wages were flat, money was  
21 cheap. People saw the ability to borrow to buy  
22 assets that they thought had appreciation? What  
23 were the driving factors at the other end?

24 DR. SUMMERS: I'm not sure that I can  
25 articulate them neatly into categories, but I guess

1 I could suggest several. First, there was optimism  
2 founded on recent experience. House prices, for  
3 that matter car prices, had been robust for a  
4 substantial period of time. The set of phenomena  
5 the economists were calling, "The great moderation"  
6 had led households to a sense that their incomes  
7 would be relatively robust. By and large those who  
8 had borrowed had . . . it had turned out reasonably  
9 well for a quite long period of time. And in  
10 general, this is a sort of nonscientific  
11 generalization, but financial messes, both for  
12 individuals and firms and for countries tend to made  
13 when there's a ton of behavior that takes the form  
14 of doing today what you wish you had done yesterday.  
15 When people buy things that have just gone up,  
16 because they've just went up, that's what causes  
17 bubbles. When people borrow, because people who  
18 borrowed a decade ago and it ended up working out  
19 well for them, that tends to be when you get  
20 over-leveraging. So I think there was an element in  
21 the household system.

22 Second, we had the innovativeness and to some  
23 extent the greed and irresponsibility of lending  
24 institutions combined with inadequate regulation.  
25 In the spring of the year 2000, Andrew Cuomo and I

1 issued a report on predatory and subprime lending  
2 practices, that talked about no doc loans, talked  
3 about loans with adjustable rates with inadequate  
4 disclosure of the adjustment. It talked about a  
5 variety of the other practices that became famous.  
6 So it had to do with household decisions, but you  
7 know there is a saying about life insurance, that  
8 it's sold, not bought. And something similar can be  
9 said about a fair amount of lending activity. So  
10 the absence of satisfactory consumer financial  
11 regulation, coupled with a plausible story as to why  
12 consumers were better off borrowing created strong  
13 incentives for the excess borrowing on the consumer  
14 side.

15 MS. EDELBERG: I want to ask a quick  
16 question on global imbalances.

17 CHAIRMAN ANGELIDES: Just 1 small point.  
18 So how much of any of it was driven by flat wages,  
19 need to borrow versus the optimism, the wishing you  
20 had done yesterday what you're about to do now, the  
21 availability of product?

22 DR. SUMMERS: You know it's-

23 CHAIRMAN ANGELIDES: And I don't know if  
24 there is any, I have asked the staff whether that  
25 can really be quantified.

1 DR. SUMMERS: Here is why I am having  
2 trouble answering. It's a terrific question, but  
3 I'm having a little trouble answering. On the 1  
4 hand if wages had risen, if you had a period when  
5 real wages were rising significantly, I'm sure there  
6 would've been less need for borrowing and there  
7 would have been more wherewithal to repay. And by  
8 the way, if the environment with rising wages and  
9 higher incomes, there would have been more upwards  
10 pressure on housing prices, which would have also  
11 averted some of the problems.

12 So at 1 level I agree with you, and I should  
13 say-

14 CHAIRMAN ANGELIDES: I don't know-

15 DR. SUMMERS: The reason why I didn't put  
16 more emphasis on it, is because it related to the  
17 argument that was made a little bit earlier. The  
18 type of argument that was made a little bit earlier.  
19 Wages were, wages have been relatively stagnant for  
20 middle-class families for a long time. And so I'm  
21 not sure that wages that were stagnant and had been  
22 stagnant are so much a cause of the problem. On the  
23 other hand you can argue that in a period when  
24 investment was particularly strong, federal budget  
25 position was better in the 1990s, You did see some

1 significant wage growth. Perhaps if that whole  
2 pattern had continued, that too would have  
3 contributed to reducing these problems.

4 MS. EDELBERG: So on global imbalances,  
5 global imbalance confuses me for a couple of  
6 different reasons. And you seem like a good person  
7 to get clarity from. So I can understand why  
8 monetary policy would've made it cheap to borrow in  
9 the U.S. Short-term, and Vince Rinehart has this  
10 argument, that it's actually the steepness of the  
11 yield curve that matters, and that makes some sense  
12 to me. But I don't understand why monetary policy  
13 or really even certain parts of the world economy  
14 saving a lot of money means that they have to bring  
15 that money into the U.S, and invest it in assets  
16 that are part of an asset bubble. And part of what  
17 I'm looking at there, is I'm looking at the gross  
18 flows, which is the net flows. And money has gone a  
19 lot this way, money has gone a lot that way. This  
20 doesn't seem like it's an inevitability. That the  
21 global imbalances create an asset bubble within the  
22 U.S. And that it's monetary policy to blame,  
23 partly.

24 DR. SUMMERS: Well again, I think it was  
25 the nature of the way I laid out the factors to

1 suggest that it was the 4 of them coming together  
2 that caused the crisis. Which is to say that no 1  
3 of them made the crisis inevitable.

4 MS. EDELBERG: Right.

5 DR. SUMMERS: So in that sense-

6 MS. EDELBERG: I'm sorry, I meant the  
7 asset bubble.

8 DR. SUMMERS: -I relate to what you are  
9 saying, if you, and I don't doubt that with nothing  
10 different in the rest of the world, if there had  
11 been more responsibility and better risk management  
12 systems, stronger regulation, that led to less  
13 leverage and better judgments by financial  
14 intermediaries, that it would've had a significant  
15 effect on the pattern that emerged in asset prices.  
16 So that's certainly right as well.

17 If the question is though why is large  
18 accumulation of reserves by China for example,  
19 relevant to this whole phenomenon, I'd come back to  
20 2 factors, to the 2 things that I tried to get at  
21 before. That ceteris parabus, other things equal,  
22 there's higher, it's a higher level of savings in  
23 the world, and there is a tendency for real interest  
24 rates to be equalized around the world, you'll have  
25 lower real interest rates, which contribute to more

1 mortgages, and that many of the savers, to use, I  
2 don't know who's phrase it was, first Keynes I think  
3 and then Frank Amagliani's phrase. Preferred  
4 habitat. If you had a substantial increase in  
5 saving on the part of those who had a preferred  
6 habitat, in safe liquid securities, then that's  
7 going to affect the relative pricing of safe liquid  
8 securities, which in turn is going to influence the  
9 incentive to create them, which in turn is going to  
10 influence the EPG, Treasury Bills, AAA tranches.  
11 Which in turn is going to influence the demand for  
12 the assets with which they can be attached,  
13 mortgages and ultimately housing.

14 MR. SEEFER: You mentioned the paper that  
15 you and Mr. Cuomo came out with in the spring of  
16 2000, when you were talking about irresponsible  
17 lending practices and predatory lending, and you and  
18 Mr. Geitner mentioned the same thing, in the June  
19 15th, 2009 Post article, and surprise, surprise, our  
20 statute tells us to look at the role of fraud and  
21 abuse in the financial crisis.

22 CHAIRMAN ANGELIDES: Is there a statute  
23 that they tell us not to look at?

24 MR. SEEFER: And I believe that you are also on  
25 record as saying, "If we would've had a Consumer

1 Protection Agency it would've been able to protect  
2 against these subprime abuses."

3 So I guess I have a two-part question. One,  
4 generally do you have opinions on the role of fraud  
5 and abuse, in particular predatory lending in the  
6 crisis, and why do you think having a Consumer  
7 Protection Agency will help, since I think we've had  
8 some failures in regulation which contributed to the  
9 crisis too?

10 CHAIRMAN ANGELIDES: Or maybe the question  
11 is why it might have helped-

12 MR. VERRILLI: I prefer the Chairman's  
13 formulation of the question.

14 CHAIRMAN ANGELIDES: That's fine, that's  
15 fine. It was inadvertently effective.

16 DR. SUMMERS: If you look at certain areas  
17 where you see the greatest problems emerge in the  
18 housing market, you also see the highest fraction of  
19 mortgage activity that would fall within the kinds  
20 of categories that Secretary Cuomo and I had  
21 identified in our predatory loans document, you  
22 would have no down payment loans without documented  
23 income, substantial adjustability in rates, that was  
24 poorly disclosed, inadequate appraisal practices,  
25 questionable compensation arrangements, involving

1 all participants, the realtors and so forth.

2 So I think the nexus between some of the most  
3 problematic elements of the housing market in the  
4 lending practices suggested by the pervasiveness of  
5 the lending practices, and their particular  
6 pervasiveness in the places where the housing market  
7 was most serious.

8 With respect to the question consumer financial  
9 regulators, I think there are probably 3 arguments.  
10 First, when you have consumer responsibility in the  
11 agencies, whose primary mission and criteria for  
12 success is safety and soundness, inevitably there  
13 will be some tendency to prefer things that  
14 contribute to profitability to things that might  
15 interfere with profitability. Even with the best  
16 motives and judgment.

17 Second, you have a substantial amount of  
18 consumer lending activity, an activity that placed  
19 substantial pressure also on activity in banks took  
20 place outside the banking system. And it is to be  
21 expected that activities placed in banking agencies  
22 can place consumer lending and banking agencies,  
23 however you define those agencies, more attention  
24 would be paid to banks than will be paid to  
25 non-banks, as in fact proved to be the case.

1           Third, there is just a cultural if you like,  
2     feature around those who are appointed to the  
3     positions and those who are at political level  
4     decisions, and those who choose to spend their  
5     career in the civil service positions, that when the  
6     primary mission is around monetary policy, or when  
7     the primary mission is around safety and soundness,  
8     those who will end up with the responsibility will  
9     be people who have more experience in and more  
10    passion for what is the primary mission.

11           That's why over time we as a country have come  
12    to have large numbers of independent regulatory  
13    agencies, rather than place all the responsibility  
14    with some focus in the mission. So those seem to me  
15    to be the reasons why one would expect that  
16    established in December, the Occupational Health and  
17    Safety Administration will lead to more focus on  
18    occupational health and safety than placing the  
19    responsibility of the Commerce Department whose  
20    mission is to promote America and economic growth,  
21    one can give a large number of similar examples.

22           So those are the judgements that have lead me  
23    for quite some time to favor a Consumer Protection  
24    Agency.

25                           MS. EDELBERG: I'm sorry, I just want to

1 make sure I understand. And I'm not talking about  
2 any of the legislation that's being proposed, just  
3 thinking backwards. Would you include, so when you  
4 said monetary policy, my ears perked up. Are you  
5 saying, does that even include the Federal Reserve?  
6 Right? That the Federal Reserve with its primary  
7 goal of monetary policy, then the people who are  
8 rising up through those ranks were most focused on  
9 that primary mission, and not on regulation, and  
10 perhaps that was true at Treasury, perhaps that was  
11 true at other?

12 DR. SUMMERS: Well I think that was, I  
13 mean my comments really went, the Federal Reserve,  
14 and there are people in this room that probably know  
15 more about the structure from year 1. Probably know  
16 more about the details of the structure of the  
17 Federal Reserve than I do. But I think it would be  
18 fair to say that the Federal Reserve employs a  
19 substantial number of people whose mission is around  
20 helping to calibrate and set monetary policy,  
21 including monetary policy with a view towards  
22 financial stability. It employs a substantial  
23 number of people whose work is focused on various  
24 aspects of financial market conditions and financial  
25 suitability, including in particular the supervision

1 of financial institutions. And it employs a  
2 significant, but I suspect quite a bit smaller  
3 number of people whose mission is around consumer  
4 protection or the enforcement of anti-discrimination  
5 statutes and the like.

6 My comment was to suggest that the orientation  
7 of the institution was heavily enough to the first  
8 2, to make you wonder about the third. But I think  
9 you may have been seeking to see whether I was  
10 expressing a view about the second, relative to the  
11 first. And I was quite consciously not saying  
12 anything about that.

13 MR. SEEFER: Obviously 1 area we're  
14 looking at was the growth in subprime loans and  
15 broader non-traditional mortgage loans over time,  
16 and the reasons for that growth. And areas that  
17 we've been looking at include the originate to  
18 distribute models, securitization, whether that was  
19 creating demand for all the GSEs, and other things  
20 that escape my mind right now. But do you have any  
21 opinions on the causes of the growth of the non  
22 traditional mortgage product in the decade of the  
23 2000s?

24 DR. SUMMERS: As you noted, a great deal  
25 of the growth took place in the 2000s, took place in

1 particular over a period when I wasn't in  
2 government, wasn't in the financial markets and  
3 wasn't especially watching. So you'll have access  
4 to the people with a keener sense than I.

5 My impression is that in a period of quite  
6 robust housing price performance, default rates on  
7 almost every kind of loan had been very low for a  
8 long time. And therefore it appeared profitable if  
9 the experience of the previous period continued to  
10 hold. To make loans, even loans underwritten to  
11 less rigid criteria than had been the case  
12 previously.

13 Entrepreneurs sought to do that. The  
14 additional public policy, subsidy to the activity  
15 that was provided by the fact that the GSE's were at  
16 a certain point significantly encouraged by being  
17 given low income credit, or credit towards their  
18 affordability goals, to hold these loans was  
19 obviously a reinforcement, both in a direct  
20 financial sense, and probably a broader moral sense  
21 to this kind of activity.

22 What fraction of the. . . to what extent they  
23 bear responsibility, that the GSE extension in, to  
24 what extent that's responsible for a large part of  
25 the growth in subprime predatory, or small part of

1 the growth in subprime predatory is a question in  
2 your place. I would think was an important one, but  
3 not 1 where I know enough to presume to venture a  
4 view.

5 I think it is legitimate to explore the extent  
6 to which we may, there are other aspects that are  
7 appropriate to explore here. I have raised  
8 questions during the time I was at the Treasury  
9 about the magnitude of the implicit subsidy through  
10 the aura of government credit support, and how large  
11 a subsidy that was to the GSEs. Some of which flow  
12 to their shareholders, but some of which flowed to  
13 the nation's housing market, and flowed therefore  
14 into housing. And the magnitude of that all  
15 increased, both as their activities expanded quite  
16 substantially, and as their leverage increased.  
17 There were efforts I made some, Chairman Greenspan  
18 made some in the very late '90's and the early 2000s  
19 to address the questions that were raised by the  
20 GSE.

21 There is a broader question to be asked which  
22 goes to the very substantial benefits that our  
23 society generates from being a society in which  
24 families are enabled in many circumstances  
25 encouraged to own their own homes on the 1 hand.

1 But on the other hand homes are large, permanent  
2 rather illiquid assets, and home ownership may not  
3 be appropriate as an objective for people in all  
4 circumstances. Certainly, the suggestion has been  
5 made, in so far as it caused gazes to be averted  
6 from some of the more egregious subprime practices,  
7 so far as to cause some lack of scrutiny of the GSEs  
8 at a certain point I think it was problematic around  
9 the approach we as a country take, in terms of the  
10 degree of encouragement of home ownership.

11 But the other hand we have derived enormous  
12 benefit as a country from home ownership. There's  
13 all kinds of evidence on the benefits for children,  
14 and families that own their own homes and so forth.  
15 So I think it is an area that needs very  
16 considerable thought and there obviously were some  
17 excesses in the kinds of ways credit was provided,  
18 but I wouldn't presume to judge where the right  
19 balances were.

20 MS. EDELBERG: Should we be thinking of  
21 putting the subsidy to the GSEs in the same category  
22 as all of the subsidies to home ownership in the tax  
23 code? Whether it's the relative tax rates for  
24 homeowners, versus renters, the fact that you can  
25 write off mortgage interest?

1 DR. SUMMERS: Just so we're all clear

2 MR. VERRILLI: That would be great.

3 MS. EDELBERG: My question was totally  
4 theoretical.

5 DR. SUMMERS: Just so I'm not being  
6 misunderstood. The GSEs currently are in  
7 conservatorship, so you are in a rather different  
8 framework than we were previously.

9 With respect to the previous question, there  
10 are sort of 2 questions, to analyze the GSEs, and I  
11 don't know whether 1 was written while you were the  
12 CBN director or not, Commissioner Holtz-Eakin, but  
13 CEO has periodically written reports that say in  
14 careful ways what I am about to say.

15 To reach the question you first have to decide  
16 how large the subsidy was to the GSEs, which depends  
17 on the judgment of what their creditworthiness is,  
18 and how to think about their creditworthiness in the  
19 absence.

20 Second, in so far as you have formed views on  
21 how large the subsidy is, you need to decide to  
22 what extent it's being passed on to homeowners, and  
23 to what extent its sticking to their shareowners.  
24 My suspicion is that analysts would tend to judge  
25 that the GSE subsidy, while important in a number of

1 respects, was probably not huge, relative to the tax  
2 subsidy. Or to take another issue that is vexed,  
3 the aspects associated with the deductibility of  
4 property taxes.

5 MR. SEEFER: You found stickiness though?

6 CHAIRMAN ANGELIDES: Yet the bulk of the  
7 subsidy went to the shareholders, a de minimis base  
8 point reduction, in Morgan Chase.

9 MR. SEEFER: Turning back to causes for  
10 the increase in non-traditional mortgage products.  
11 Another thing we've looked at since we first asked  
12 you this question. In 2003, you saw the big refi  
13 boom, and then after that the feds started to  
14 tighten. I think you saw, I think relatively more  
15 home purchase loans that you did refis. In your  
16 opinion did monetary policy and other factors in  
17 that part of the decade contribute to the increase  
18 in non-traditional mortgage loans? Do you think it  
19 had any role?

20 DR. SUMMERS: Monetary policy was itself  
21 responsible to a whole range of macroeconomic  
22 conditions, including a set of issues associated  
23 with the pressure of capital inflows, in intervals  
24 when short-term interest rates rose for some time.  
25 But there was less impact on long-term rates than

1 many expected. But I was not watching markets  
2 closely enough for me to have an opinion that would  
3 be particularly helpful for you.

4 MR. SEEFER: According to a transcript  
5 that I saw at least of an April 22nd 2010 PBS news  
6 hour, it was about you. You know that you said that  
7 there was no question, you know, that things had  
8 happened on Wall Street, where the reason we had  
9 this financial crisis and you mentioned a couple of  
10 things. Mistakes on Wall Street, the mortgage area,  
11 the subprime bubble, house price appreciation, loans  
12 that borrowers could not afford, and you said that  
13 credit errors on Wall Street brought financial  
14 institutions to the brink of insolvency.

15 Can you maybe give us a little more color on  
16 the mistakes that were made in the mortgage area,  
17 and then in credit errors that were made on Wall  
18 Street? Or was the transcript wrong?

19 (Laughter.)

20 DR. SUMMERS: No, the transcript was I  
21 assume right. That always makes me nervous when  
22 people read back things I've said. But that one  
23 actually felt fine.

24 (Laughter.)

25 As you were reading it back, no, I'm just not

1 sure that I've got a lot to add to what I've been  
2 saying. There were obviously very substantial  
3 misjudgments of the risks associated with  
4 mortgage-backed securities that were made by many  
5 financial institutions to purchase those securities,  
6 and as a consequence lost very large amounts of  
7 money. And those errors, as a matter of logic could  
8 have been averted by, if the houses on which  
9 mortgage were written had not collapsed in value,  
10 then there couldn't have been those errors.

11 If there had been limits on the leverage, and  
12 the initial equity in those houses, then even if the  
13 houses had collapsed, there would have been much  
14 less money lost, if the guys who held  
15 mortgage-backed securities or contemplated holding  
16 mortgage-backed securities, had foreseen the risks  
17 associated with them, and paid appropriate prices,  
18 they wouldn't have lost large volumes of money that  
19 would've been a major source of risk associated with  
20 the system. And if they have been prudent in their  
21 diversification and in the extent of their  
22 risk-taking, the magnitude of the consequences of  
23 their errors on the first 3 points would have been  
24 less serious for the health of the financial system.

25 MR. SEEFER: Obviously it's always hard to

1 call a peak, and you know very few people are  
2 successfully calling peaks and troughs, but I really  
3 want to ask though, why were there such serious  
4 errors in judgement given the underlying quality of  
5 the collateral, I mean you had . . . and there were  
6 a lot of, it seems to me, yellow and red lights  
7 going off. Home prices rising at 10, 11, 15 percent  
8 a year. I think certainly a level of knowledge about  
9 the type of instruments in the market, no doc loans,  
10 very high debt to income ratios, extraordinary, no  
11 proven ability, no respective ability to pay. So  
12 loans really made on rapidly escalating collateral  
13 prices, without ability to service the loans.

14 Knowledge which I guess to many people wasn't  
15 available, that we really did have a . . . you now  
16 hear no one could have anticipated a 30% decline in  
17 national house prices. Of course many of these  
18 securities become impaired by mid 2007, when house  
19 prices have dropped off 1 or 2%, and we had a 2%  
20 drop in the '90 to '93 area. Of course mostly  
21 driven by regional drops.

22 I guess just fundamentally, if you step back,  
23 why was there such, do you think, a lack of  
24 understanding, a lack of due diligence, the  
25 magnitude of error about the underlying

1 collateral?

2 Dr. SUMMERS: I think you would be much  
3 better advised to ask those who made these errors.  
4 To ask those who made these errors what they're  
5 thinking and their judgments on that question would  
6 be much, much more valuable than my judgment. I  
7 think it seems incredible in retrospect, but much  
8 always seems incredible in retrospect. The fact  
9 that something that was very commonly said in those  
10 days on a national basis, house prices had never  
11 come down. It had never happened over a 50 year  
12 period, and people thought therefore that meant that  
13 it wouldn't happen. It is a substantial  
14 contributor. I'm not able, I don't think I ever  
15 knew, and certainly don't know now the precise  
16 dynamics of the pricing of these securities. I  
17 suspect that when they failed in 2007, even if house  
18 prices had not fallen much yet, the decline in  
19 mortgage-backed securities reflected what was at  
20 that point a reasonable expectation that there would  
21 be significant declines in housing prices. So it's  
22 not that they were so leveraged that they were  
23 vulnerable, that they were that incredibly  
24 vulnerable to a period of stagnant house prices.

25 There are a set of questions about mortgages.

40

1 There are then a set of questions that I don't feel  
2 at all authoritative on. But I think are perhaps  
3 relevant to your broader inquiry, having to do with  
4 how these judgements were made. Judgements about  
5 risk made by the people who were doing the trading?  
6 Were the judgments made independently? How is the  
7 process of coming to judgment supervised? These are  
8 all questions in terms of, there is an element of  
9 understanding the cognitive aspect of why an error  
10 was made, and then one has an explanation of what  
11 the cognitive pattern is. There's still the  
12 question of what kinds of scrutiny were applied to  
13 the judgments when they were made. And there is the  
14 question of what kind of conviction, how much was  
15 put at risk around this.

16 And then I think there's also an aspect which I  
17 touched on earlier, which goes to the question of  
18 resilience. Which is the consequences for the  
19 system of 1 financial institution making mistakes  
20 alone is very different than the consequences for  
21 the system of multiple financial institutions making  
22 the same mistakes. Because then when it comes time  
23 to unwind, everybody is unwinding in the same  
24 direction. That goes to various incentive problems.  
25 Keynes wrote famously about it being better to be

1 wrong conventionally, than right unconventionally.  
2 I'm not sure whether that's right or not, but I'm  
3 sure if you are going to be wrong, it's better to  
4 be wrong conventionally, then to be wrong  
5 unconventionally.

6 That leads to a fair amount of band-wagoning.

7 MS. EDELBERG: So now is the perfect time  
8 for this question. We have been struggling with  
9 common shock versus liquidity shock? Well no,  
10 there's 2 different shocks. So there is the  
11 question of-

12 MR. VERRILLI: I'm sorry, I'm just asking  
13 Dr. Summers whether he wants a break.

14 DR. SUMMERS: No, I'm okay. I can go for  
15 the whole session.

16 MR. VERRILLI: Just let us know.

17 MS. EDELBERG: Okay. So 1 of the things  
18 that we're struggling with is that a lot of  
19 financial institutions get in trouble all at once,  
20 and there's a question as to whether that's in  
21 trouble all at once. I guess that's part of the  
22 hypothesis, that they got in trouble all at once.  
23 And part of this hypothesis is, they got in trouble  
24 all at once because they were all basically exposed  
25 to either the same asset, which was the mortgage

1 shock, or actually they were all exposed to the  
2 same utter dependence on liquidity and they were  
3 basically just all exposed to a liquidity shock.

4 Or there was some shock, there was little bit  
5 of E coli in the system, and we actually had  
6 contagion and it spread through, due to  
7 interconnectedness. Does that seem like a fair,  
8 yes? So we are trying to differentiate between  
9 those 3 stories.

10 DR. SUMMERS: I know this sounds like a  
11 wiseguy answer, I don't mean to give a wiseguy  
12 answer. I can't really walk across the street  
13 without both my right shoe and my left shoe, and so  
14 I don't quite know how to answer. Is it my right  
15 shoe that causes me to walk across the street, well  
16 yes. Does my left shoe cause me to walk across the  
17 street? Yes. Is it both my shoes? So I think the  
18 answer is that all of those were present. I think  
19 it is certainly the case that many of the same  
20 judgments were reached in many financial  
21 institutions. And so when those judgments proved to  
22 be problematic, the problems were common to many  
23 institutions.

24 Second, when the errors were propagated, the  
25 fact that the institute judgments were common to

1 many institutions meant that it was difficult to  
2 unwind the securities. In the speech that you  
3 referred to earlier, I spoke about a variety of  
4 different vicious cycles that kicked in 2 or 3  
5 times a century. The first of those was  
6 de-leveraging, leading to Sally, leading to more  
7 de-leveraging. And so you have a kind of contagion  
8 that comes from that, reinforced by losses make  
9 lending more difficult, make losses on other capital  
10 assets.

11 And then you have the elements of illiquidity  
12 that clearly were coming from rising credit spreads  
13 coming from changing macroeconomic conditions. So I  
14 don't know that you can ... if all 3 were important  
15 and all 3 were importantly, at least to my mind,  
16 interconnected and I don't know that you can  
17 precisely say what their relative importance was.

18 CHAIRMAN. ANGELIDES: Can I?

19 MS. EDELBERG: Yes.

20 CHAIRMAN ALGELIDES: Another question that  
21 is related in a way is this. The dot com bubble was  
22 about a 5 or 6 trillion dollar shock, the housing  
23 bubble was about a 5 to 6 trillion dollar real  
24 shock, the latter appears to have cruised to  
25 financial crisis, the former did not, why?

1 DR. SUMMERS: The largest simple  
2 explanation of it-

3 CHAIRMAN ANGELIDES: We're doing our dirty  
4 laundry, these are the debates we've been having.  
5 We're letting you adjudicate all of them.

6 MR. SEEFER: Or suck you in, 1 of the 2.

7 DR. SUMMERS: In many ways it's an  
8 incomplete answer, but I think the first sentence  
9 is that if Larry Summers loses a dollar then he's a  
10 dollar poorer. As a consequence, he will spend  
11 less, maybe he'll spend a nickel less, that way  
12 he'll lose the dollar over his life. Maybe he'll  
13 just feel he's got to get it back this year, and  
14 he'll spend a dollar less.

15 If a bank that has a tier 1 capital ratio of 5%  
16 feels a need to maintain that 5% tier 1 capital  
17 ratio loses a dollar, then they have to rein in \$20  
18 of balance sheet activity, and so it's the  
19 difference between the nickel when the assets sit  
20 proximately within an individual who is going to  
21 spread it over time, and the \$20 when the assets are  
22 sitting heavily at a levered financial institution  
23 that I think is the beginning of understanding why  
24 it's so much more serious.

25 COMMISSIONER HOLTZ-EAKIN: So that was my

1 first answer too, I was leveraged, I wasn't. So my  
2 next question is, why? Why didn't we see this sort  
3 of derivatives and financial innovation against the  
4 dot com stock bubble that we saw against the housing  
5 bubble?

6 DR. SUMMERS: Can I ask for clarification  
7 here?

8 COMMISSIONER HOLTZ-EAKIN: Sure thing.

9 DR. SUMMERS: I guess the leverage was  
10 inherent in the nature of, of course some of that  
11 stock would have been leveraged, correct? Not  
12 nearly to the same extent.

13 COMMISSIONER HOLTZ-EAKIN: That's where  
14 I'm going next.

15 DR. SUMMERS: Okay. I think that would  
16 be. It's been a while since I was a more pure  
17 academic, and thought about-

18 COMMISSIONER HOLTZ-EAKIN: Welcome to my  
19 club.

20 DR. SUMMERS: Thought about these kinds  
21 of questions Doug, but I think 2 aspects that I  
22 might want to think about are the volatility, at  
23 least as it was judged as of that time, associated  
24 with stocks, was very substantially greater than the  
25 volatility associated, I mean any theory of leverage

1 would emphasize that you lever more that which is  
2 less volatile. And the volatility of stocks was  
3 quite different.

4 Second, the leverage associated with commercial  
5 real estate. I think that's probably the most  
6 important thing. Second thing is people like to  
7 live in their homes. People like to begin living in  
8 their homes that they are going to own at a  
9 relatively young age, before they have accumulated  
10 sufficient assets to buy it. And therefore the  
11 substantial leverage derives from the desire to live  
12 in a house before one is in a position to buy the  
13 house for cash. In contrast, the dominant, sort of  
14 the dominant role of housing is to be lived in. A  
15 dominant role ultimately is of stocks, is to prepare  
16 for one's retirement or to save. So if you look at  
17 the leverage of stocks in the United States, the  
18 feasible amount of leverage is much less than it  
19 would be on houses. Nobody can borrow 80 percent on  
20 their stocks, because of the different volatility,  
21 but for the most part, stocks are not levered to the  
22 extent that they could. To the extent that they  
23 could be levered, reflecting judgements about risk  
24 and return and savings for retirement, and the  
25 degree of volatility that would be associated with a

1 levered portfolio isn't something that most people  
2 would be likely to want. You do see substantial  
3 leverage in the small business area, and you've seen  
4 some of the kinds of adverse developments, vicious  
5 cycles in community banks and the like.

6 MS. EDELBERG: But that gets us into  
7 foreclosure crisis, some part of our foreclosure  
8 crisis. At least the 1 before you get the feedback  
9 effect from the economy tanking. But that doesn't  
10 necessarily get us ... so I can understand  
11 households leveraging, typically leveraging their  
12 home gets us maybe more foreclosures. But it  
13 doesn't get us why the financial system didn't  
14 figure out how to leverage the dot com bubble. And  
15 certainly at the time there was lots of rhetoric  
16 about how we're in a new economy, stock prices are  
17 never going to come down, it's a brave new world.  
18 So why didn't the financial system figure out how to  
19 do this? Why did they only do this with housing? Is  
20 that it?

21 Dr. SUMMERS: Well I think part of the  
22 answer to that, partly volatility-

23 MS. EDELBERG: You said volatility-

24 DR. SUMMERS: Volatility. You know I  
25 think relative to what's actual volatility. It's

1 often said that people have a tendency to confuse  
2 price discovery with price volatility. And so you  
3 see in the stock market a price every day, it goes  
4 up 100 points or it goes down. You don't see the  
5 price of your house everyday. If there was a mark  
6 to market price for your house everyday, it would  
7 appear quite volatile. Not seeing that price, you  
8 probably think of the differences in volatility as  
9 being rather less than... think of the difference in  
10 volatility as being even greater than it in fact is.

11 CHAIRMAN ANGELIDES: Can I ask one last  
12 question, and then I will leave all of you to finish  
13 this up, and then I will eagerly await reading the  
14 whole transcript. But I would like to ask you 1  
15 question. So looking back, as we all know,  
16 hindsight is 20/20. Very few of us are perfect at  
17 calling things, right time, right place. If you  
18 were to look back at your service during the Clinton  
19 Administration and you were to look at frankly  
20 mistakes or errors or things you would have done  
21 differently that may have been foundational. Not to  
22 causing the crisis, but may have been contributors  
23 to. What do you think are the biggest markers you  
24 look back on? And I say that not just  
25 personally, it's not a gee, would I Larry, if you

1 look back in terms of policies undertaken in the  
2 late 90's, were there policies undertaken that may  
3 have accelerated, exacerbated, sewn the seeds in  
4 some way of this that, on reflection, part of this  
5 process is to reflect back at what we did and should  
6 have done differently. Hopefully with the mind of  
7 making different judgements in the future.

8 DR. SUMMERS: Well I think the financial  
9 reform bill, without getting into its details, that  
10 is under discussion today reflects something that is  
11 fairly close to my thinking, and I suspect the  
12 thinking of many of us who served in the Clinton  
13 administration.

14 As to what type of structure best reduces the  
15 risk of financial crisis, if we had been more  
16 successful in calling, in recognizing the need for,  
17 foreseeing the need for, applying political pressure  
18 for and in legislating the kinds of measures that we  
19 have now judged and we now see as essential, I think  
20 that would have put the country in a better position  
21 than it was, coming into this crisis.

22 I say that with the recognition of on 1 hand  
23 this bill proved to be not perfect, that's always  
24 the case, and with the recognition that markets  
25 changed very, very dramatically during the 2000 and

1 after period. So it would in some areas probably  
2 have required great foresight. And with the  
3 knowledge that the political constellation, in terms  
4 of the appetite of Congress for regulation in  
5 various areas was quite different in the 1990's.

6 But I guess when I asked myself what I would  
7 have wished, it goes back to the kinds of proposals  
8 that we are now putting forward.

9 MR. ANGELIDES: Well sir, just to probe  
10 that, just a little. So the "Shadow Banking  
11 System", a system of relatively unregulated or  
12 lightly regulated institution, many depend on short  
13 term money. Did people see that there would be  
14 risks inherent in that system or just not identify  
15 with that point? The calculation on derivatives was  
16 that there wouldn't be the kind of growth in the  
17 marketplace? And again, it's very hard to be  
18 prescient. Was it mostly that they were unseen  
19 risks, or that the political calculus just isn't  
20 there to move on risks unless they become wholly  
21 evident?

22 DR. SUMMERS: I think others would have to  
23 sort of go back and try to... I think it may be  
24 useful to do this kind of thing to think of risks  
25 that were present but not recognized. Risks that

1 could clearly have been foreseen and risks that  
2 really substantially emerged after 2000.

3 And I think, I don't doubt that there were  
4 elements of all 3. I'm not sure that I could  
5 distinguish in a careful way what the proportions of  
6 those 3 categories of risk were.

7 CHAIRMAN ANGELIDES: Okay, 1 last one on  
8 this. In terms of, for example, risks recognized  
9 and not acted upon, can you identify any of those  
10 from the '90s and 1 other, looking back, the most  
11 substantial risk present, but not fully recognized?

12 DR. SUMMERS: Well I think the risks that  
13 were probably recognized, I'm not sure that I  
14 understand the 2 parts. Well the first was  
15 recognized and not fully acted on. What was the  
16 second?

17 CHAIRMAN ANGELIDES: And that was present,  
18 but at the time not recognized, but looking back and  
19 saying, okay, that's the 1 where winding this clock  
20 back, that was a ticking time bomb?

21 DR. SUMMERS: You know, I think that with  
22 respect to risks that were recognized but not fully  
23 acted on, I think the sets of risks associated with  
24 the mortgage market and housing finance were  
25 recognized by many, and not... the system didn't act

1 as fully on them as we would have liked, or than  
2 many would have wished.

3 I'm not sure that I can give an answer, in  
4 terms of risks that were recognized that were there  
5 at the time, but not recognized. There are clearly  
6 a set of issues around derivatives, where it's very  
7 clear that by 2008 our regulatory frame work with  
8 respect to derivatives was manifestly inadequate.

9 It's clear that there were derivatives extant  
10 in the 1990s. It's clear that the derivatives that  
11 proved to be by far the most serious, those  
12 associated with credit default swaps increased 100  
13 fold between 2000 and 2008, and it's clear that  
14 some, including Commissioner Born warned about  
15 derivatives very strongly in the 1990s. And so  
16 whether derivatives constituted an area where the  
17 situation evolved very substantially, the warnings  
18 that we gave this area needed to be continually  
19 watched, weren't heeded as credit default swaps  
20 rose, or whether an alternative way to think about  
21 it would be that there was a risk there that was  
22 foreseen at the time, that was not adequately  
23 perceived at the time.

24 A question of interpretation on which different  
25 people will take different views.

1           CHAIRMAN ANGELIDES: I appreciate it very  
2 much. Thank you, and I'm sorry for having to exit,  
3 but as I said, I know that my colleagues here will  
4 ask better questions than me, and I look forward to  
5 seeing the transcript. Thank you very much.

6           DR. SUMMERS: Thank you, Mr. Chairman.

7           CHAIRMAN ANGELIDES: Thank you.

8           MS. EDELBERG: Do you have any questions  
9 on derivatives? This seems like a good time.

10          MR. SEEFER: That's actually, I was going  
11 to say a perfect segway.

12          CHAIRMAN ANGELIDES: I wandered it in for  
13 you.

14          MR. SEEFER: One of the things that we're  
15 asking everybody on derivatives is just their  
16 general opinion of what role do you think, if any,  
17 derivatives played in the financial crisis? Whether  
18 there as a cause, whether as a problem or anything?  
19 And then not just predatory derivatives, but any  
20 kind of derivatives.

21          DR. SUMMERS: You know I think the  
22 overwhelmingly, clearly the events at AIG and AIG's  
23 use of credit default swaps to take on a set of  
24 risks that then proved to threaten its viability,  
25 which, given it's interconnection, threatened major

1 systemic risk, was obviously a critical aspect of  
2 understanding the crisis.

3 There are issues it seems to me a variety of  
4 issues to explore there, where I'm just not into -  
5 what my duties have been for the last 18 months -  
6 into the details enough to make judgments.

7 Clearly if their unregulated derivatives  
8 affiliate had been extensively regulated in the way  
9 proposed in 1999, but was never something Congress  
10 was prepared to act on, that might have offered the  
11 prospect of reducing the risks.

12 There are many who argue that the real source  
13 of the problem was AIG's desire to take risk and the  
14 lack of comprehensive risk regulation of AIG. And  
15 so even if somehow there hadn't been derivatives,  
16 they would've taken the risk, and if their overall  
17 risk taking had been regulated, it would have worked  
18 their way into the problem.

19 There are others who argue that if their  
20 derivatives activities had been non-bilateral, had  
21 been through appropriate clearing arrangements, that  
22 involved the appropriate posting of margin, it would  
23 not have been possible to build up the risk  
24 positions that were built up. And I think all those  
25 positions have a certain logic to them, and the

1 approach that we've taken with respect to  
2 derivatives in the legislation, that many people  
3 have taken, since they are a matter of public  
4 record, is really to address all the possibilities.

5 To insist on comprehensive regulation of AIG,  
6 and others systemically important financial  
7 institutions, which should independent of any  
8 regulation of particular instruments have offered  
9 the prospect of eliminating or attenuating that  
10 problem. And also to require any major financial  
11 participants, the use of substantially enhanced  
12 transparency, and the use of appropriate clearing  
13 arrangements. So that however I judges that  
14 historical question, there is an element of belt and  
15 suspenders in the regulatory approach of this  
16 proceeding.

17 There is an important set of issues which I  
18 don't have a clear set of views on. Having to do  
19 with, aside from the situation at AIG, what were the  
20 roles of derivatives activity, both in leading to  
21 runs of various kinds on major financial  
22 institutions at difficult moments in complicating  
23 the process of workout in leading to market  
24 breakdowns. My impression is that many people at  
25 least feel that in terms of the continued operating

1 and functioning of derivatives, markets, that was  
2 less of a major problem that many people would've  
3 expected, given the magnitude of all of the other  
4 problems.

5 But no doubt, derivatives issues played an  
6 important role in the thinking with respect to many  
7 different aspects of the work out of the crisis.  
8 And as I say, the judgment we've come to is that a  
9 sort of belt and suspenders approach, that gets at  
10 derivatives is part of risk regulation of  
11 institutions, and gets at derivatives markets per  
12 se, offers the best prospect of success, and clearly  
13 for some variety of reasons, I think there is a  
14 sense that the, that credit default swaps in  
15 particular raised questions.

16 There are questions that I think are very  
17 important for financial regulation that are not just  
18 systemic risks questions. Issues going into  
19 transparency, in their execution, issues with  
20 respect to manipulation and market integrity. And  
21 there are a set of issues that have arisen for some  
22 time, with respect to, in the equity area that with  
23 the rise of credit default swaps, now exist in the  
24 credit default swap area of control rights divorced  
25 from economic or their non-coincident with economic

1 interests.

2 ALL of those require, and I believe are  
3 receiving regulatory attention. As a consequence,  
4 all of this has arisen really over quite a  
5 remarkable developments, in terms of these markets  
6 where some of these instruments, particularly credit  
7 default swaps just about doubled every single year  
8 from 2000 on.

9 MR. SEEFER: Let me ask you, in terms of  
10 what you said about if AIGFP would have been  
11 regulated as proposed in '99. Well the CFMA passed  
12 and that wasn't the case.

13 DR. SUMMERS: Excuse me.

14 MR. SEEFER: Sure.

15 DR. SUMMERS: You didn't mishear me, but I  
16 think you may have misunderstood CFMA. The proposal  
17 that I referred to is a proposal that would have  
18 regulated the risk taking capital adequacy and the  
19 like, with respect to derivatives affiliates.

20 CFMA went in various ways to the ability to  
21 regulate the market, the market and the process of  
22 trading on derivatives, as distinct from the  
23 financial position of affiliates or the entities  
24 that traded derivatives.

25 MR. SEEFER: Thank you. What I wanted to

1 ask you, in terms of the regulation not of the  
2 market but of the entity. AIG was regulated, the  
3 OTS was it's consolidated regulator. So there was  
4 regulation and I believe they had jurisdiction,  
5 since they were a consolidated operator, to look at  
6 FP. Any opinion on the role of regulation in AIG?

7 DR. SUMMERS: Well I think it's, again  
8 there are various aspects of macro and the financial  
9 markets have been professional preoccupations of  
10 mine. Structure of financial regulation has not  
11 historically been so. You'll be able to find people  
12 with much greater expertise than I have. But I  
13 think it's fair to say that it is very widely felt  
14 that the regulation of AIG on a consolidated basis  
15 by its consolidated supervisor, DOTS, was manifestly  
16 inadequate. In addition to the results on evidence  
17 of form, the extent of scrutiny, extent of analysis  
18 and reporting. One could buttress that conclusion,  
19 although I'm not the one that's informed enough to  
20 do it.

21 My impression is that the view is quite widely  
22 held that the regulation was inadequate, if you  
23 believed that systemic regulation of such  
24 institutions was appropriate. That the regulation  
25 was inadequate, even without reaching the judgment

1 about the results of the regulation.

2 COMMISSIONER BORN: May I ask a couple of  
3 follow-up questions on things that Larry has already  
4 talked about a little bit. On the credit default  
5 swap funds, some of the issues we're looking at, and  
6 I wondered if you had thought about these things and  
7 had an opinion on them.

8 One, whether credit default swaps tended to  
9 fuel or accelerate the securitization process,  
10 because AIG was insuring through CDS the top AAA  
11 tranches, and thereby allowing them to be AAA rated  
12 and to seem like very secure investments?

13 DR. SUMMERS: I don't have expertise to  
14 make that judgment, either in terms of detailed  
15 knowledge of what it was that AIG was insuring. I  
16 suppose the question would arise, would there have  
17 been other ways. Without insuring them, they could  
18 have written a letter of guarantee on them. Which  
19 would have been tantamount to insuring them.

20 So whether one should think of that in terms of  
21 a credit default instrument or not, I think it is at  
22 least something one would want to study. But I  
23 don't know enough about it to have a view. I think  
24 that's part of it.

25 COMMISSIONER BORN: Well the second

1 hypothesis we're looking at is, there were  
2 instruments called synthetic CDO's, which were  
3 composed either entirely or partly of credit default  
4 swaps, rather than mortgage-backed securities. They  
5 were in essence credit default swaps on existing  
6 mortgages or existing mortgage-backed securities or  
7 existing CDOs. And we are looking at whether that  
8 amplified the market for securitization and thereby  
9 made it a larger market, and continued it for a  
10 longer period of time, after the mortgage market was  
11 really shutting down, so there weren't  
12 mortgage-backed securities available to fund these  
13 things?

14 DR. SUMMERS: I don't have enough granular  
15 knowledge of the quarter by quarter evolution of the  
16 market to be helpful. I think in general, I think I  
17 need to always ask the question, if a financial  
18 market participant has for whatever reason, bad  
19 judgment in grade, misaligned incentives and  
20 intellectual misunderstanding of how the world is  
21 working, has decided to take on a certain risk,  
22 whether by regulating instruments rather than by  
23 regulating that financial institution, one is going  
24 to succeed in getting them not to take on that risk  
25 and how that's going to happen, is a question that I

1 think one always has to keep in mind in designing  
2 regulatory regimes.

3 The orientation that runs through the financial  
4 regulation bill is towards a belt and suspenders  
5 approach, as you force a lot, you regulate capital  
6 if you're systemically important, you regulate  
7 transparency in general so that people can see  
8 what's going on and see instruments where there are  
9 particular problems, you also regulate there.

10 But I would worry a little bit about the hope  
11 that by regulating instruments in a world where  
12 people can innovate, you will succeed in controlling  
13 overall risk taking.

14 COMMISSIONER BORN: Another thing that  
15 we're looking at is the need to rescue AIG. And  
16 it's potential interconnectedness with other  
17 counterparties through the credit default swaps,  
18 through other kinds of mechanisms. I wonder what  
19 your views are on that?

20 DR. SUMMERS: There are certainly 2 sets  
21 of questions that are implicit in that, in the  
22 issues that you raise, and I can distinguish between  
23 them, but I can't say a great deal about either. As  
24 a general matter, my view having been in government,  
25 having been out of government, is that when you're

1 out of government is very difficult to know all of  
2 the information, all the pressures, all the  
3 constraints, and all the opportunities on those that  
4 are making the decisions. So it's very, very  
5 difficult to second guess or ask questions. I  
6 wasn't in government at the time.

7 I would find it very surprising if a compelling  
8 argument could be made that simply allowing AIG to  
9 file for bankruptcy and letting the chips fall where  
10 they would, in a way that was done at Lehman would  
11 have been an availing strategy at that moment.  
12 With respect, that would have seemed quite hard to  
13 believe to me that, that would have been a viable  
14 option.

15 With respect to the way in which transactions  
16 were handled, and then respective decisions that  
17 were made, I have enormous respect for the people  
18 who were in authority at that time, and the sense of  
19 the fog of war that would've surrounded the  
20 decision-making at points like that. But I don't  
21 have nuanced opinions on the ways in which decisions  
22 were made or the particular structures that were  
23 adopted, or the ways in which dealings were made.

24 COMMISSIONER BORN: One last question. In  
25 terms of the runs on investment banks, other

1 institutions, do you think that there was any role  
2 played by with respect to derivatives in those runs?  
3 Do you have any views on that?

4 DR. SUMMERS: I alluded to that  
5 possibility, to say that I didn't know enough to say  
6 to be confident either yes or no. My impression is  
7 that there were probably issues involving the  
8 posting of margin bilaterally, and concern about  
9 margin being lost in the event of failure that led  
10 to runs, and contributed to the pressure on  
11 institutions, which in turn contributed to their  
12 desire to hoard cash, which contributed to the  
13 freezing of the system. And that there was, again,  
14 my impression, not my firm knowledge, is that there  
15 were behaviors that served to strike for the case  
16 for more multilateral, joint and severally liable  
17 kinds of clearing arrangements, so the kind that are  
18 contemplated in this legislation, that I might say  
19 is the kind that in the 90's, mid 90's were  
20 essentially prohibited by law. And where we worked,  
21 including in the CFMA to establish permissive  
22 frameworks that enabled the clearing houses to  
23 engage in a certain amount of suasion. Which is of  
24 course, is a step significantly short of the step  
25 that's contemplated in the current legislation.

1 Which is essentially to mandate for a wide swaths of  
2 these transactions, the use of clearinghouse house  
3 clearing arrangements.

4 MS. EDELBERG: So going to an earlier  
5 government intervention when the market was in  
6 trouble, long term capital management. So can you  
7 talk about your role in that? And then whether or  
8 not you think that any of the government response to  
9 long-term capital management created any moral  
10 hazard that had an affect?

11 MR. VERRILLI: Just in terms of the  
12 answer. Of course Doctor Summers will answer the  
13 question. There is a parallel constraint on his  
14 ability to answer during that period of time, to the  
15 extent that you're asking about his communications  
16 with President Clinton, or deliberations. That  
17 would be... I think we would have to have President  
18 Clinton's lawyer here. That would be off limits,  
19 for the same reasons as the current situation. But  
20 with that constraint-

21 MS. EDELBERG: I'll happily defer to  
22 whatever you think is,

23 MR. VERRILLI: We'll carve that part out.

24 MS. EDELBERG: Yes.

25 DR. SUMMERS: My personal role as things

1 happened was not large, because my preoccupation was  
2 on the international area, where there was plenty  
3 going on at that time. I would say that I am  
4 probably pretty familiar with . . . I think it's  
5 very important to distinguish between what went on  
6 in the LTCM context and in a variety of other  
7 contexts. Other than sandwich money at the New York  
8 Fed, no taxpayer money was involved in the LTCM  
9 case.

10 The role that was played by the official sector  
11 was a coordination role in brokering what was a  
12 mutually advantageous set of arrangements for the  
13 various participants. So if I were to think about  
14 various events that were generating of moral hazard,  
15 I wouldn't be inclined to put great weight on LTCM.  
16 A degree of financial cost, subsequent litigation  
17 and such on those at LTCM was perhaps not as large  
18 as it could imaginably have been, but was large  
19 enough that I think any operator would be at very  
20 substantial pains to avoid the fate that befell  
21 LTCM. I think LTCM did point out a variety of  
22 issues around transparency, around regulation of  
23 prime brokers. Some of which we pursued at that  
24 time, some of which are addressed in this  
25 legislation.

1 I also think I has to be slightly careful in  
2 thinking about moral hazard. Moral hazard is a bad  
3 thing, confidence is a good thing. And in a sense  
4 anything that is successful in reducing run risks,  
5 is that the provision of confidence, or is that the  
6 establishment of moral hazard? That's part of why  
7 these are such complex subjects.

8 MS. EDELBERG: Well that's fair enough.  
9 But certainly market participants, and certainly in  
10 retrospect, market participants viewed what the  
11 government did with LTCM as extraordinary government  
12 involvement. That the government took an unusual  
13 step over and above what they typically do, and did  
14 it because they thought that LTCM had some sort of  
15 systemic role in the economy, or in the financial  
16 system? Whether or not there was taxpayer money at  
17 stake. I mean there is an opportunity cost  
18 associated with government actions. They may do 1  
19 thing and not another. They chose to go in and-

20 DR. SUMMERS: No, I don't... we may have  
21 different readings of the views about the  
22 participants.

23 It was an extraordinary circumstance, and in  
24 that extraordinary circumstance government did  
25 something that was extraordinary. Perhaps not

1     surprisingly in an extraordinary circumstance  
2     government would do something that was  
3     extraordinary.

4             We were busy, we had a lot to do, I suppose.  
5     But I'm not sure the opportunity cost of a week of  
6     the Federal Reserve President and New York's time is  
7     a factor, that would loom enormously.

8             MS. EDELBERG:  No, I meant the government  
9     could actually be going around brokering deals that  
10    it thought were to the good of the economy.  
11    Elsewhere, the government chooses not to get  
12    involved in that activity, because it chooses to do  
13    other things, with it's political capital.

14            DR. SUMMERS:  I suppose, I think that's  
15    fair, and I think that 1 of the reasons for the  
16    effort, rather substantial efforts involving both  
17    the private and the public sector in the wake of  
18    LTCM, was to contemplate rather more satisfactory  
19    legal frameworks for the self executing failure of  
20    hedge funds, which were a test.  Amaranth, there  
21    were a number of failures of reasonable sized  
22    financial institutions that didn't have the same,  
23    the systemic consequences, in part because of a  
24    variety of things that were put in trade after LTCM  
25    changed settlement procedures, changed margin

1 procedures and the like.

2 There were a variety of special factors that  
3 mostly went to urgency, immediacy and externality  
4 that lead to the judgements that were made during  
5 LTCM. And while there's much that one can question  
6 in financial markets, I think it's, at least I have  
7 not heard the case convincingly made that some  
8 aspect of what happened at LTCM either set a  
9 precedent that led to a variety of misguided  
10 government interventions, or lead to a set of  
11 expectations that somehow contributed to problems  
12 down the road. But you know, perhaps there are  
13 other arguments with respect to the LTCM experience.

14 MR. VERRILLI: Just, if you could hang on  
15 for 1 second. It's about 3:15, so I just want to  
16 make sure that we know that we are coming up on our  
17 2 1/2 hour limit here. So we have a report that  
18 needs to get done, and I know you've got another  
19 that has to get done.

20 MS. EDELBERG: Sorry, I'll ask you a  
21 question on a different front. Though I do really  
22 want to know what you think about what those factors  
23 were, but I will put that aside, in leading to one  
24 of the extraordinary involvements of LTCM.

25 Shadow banking system versus traditional

1 banking system. There is a question, 1 of the  
2 things we're wrestling with is, did different things  
3 happen to 2 different financial sectors, or did the  
4 same thing happen to both of these financial  
5 sectors? And you know, to the extent that something  
6 different happened to these 2 different sectors, was  
7 it because of the different regulatory environments  
8 that these 2 different sectors were in, or is that  
9 actually a red herring, and in fact you know, you  
10 had talked a little bit earlier about the interplay  
11 between the banking sector and capital sector, and 1  
12 used to save the other, etc. How do we think about  
13 the interplay?

14 DR. SUMMERS: You had a set of problems in  
15 the mortgage company sector for example that were  
16 not heavily caused by or causal to the banking  
17 system. So far as those were important issues, one  
18 could probably think of the 2 systems with some  
19 degree of separateness.

20 You had a set of issues arising out of  
21 securitization, where the 2 systems proved to be  
22 auction rate securities, where the 2 systems proved  
23 to be rather more closely linked than many had  
24 supposed. So I think there were elements in this of  
25 both aspects of your question.

1 MR. SEEFER: So as we wind down; too big  
2 to fail. What are your opinions on what makes an  
3 institution too big to fail, and how did it  
4 contribute to the financial crisis? In looking  
5 forward, not looking forward, and do you avoid it?  
6 Is the answer simply more capital, more liquidity,  
7 or is the answer something else?

8 DR. SUMMERS: Too big to fail refers to a  
9 situation where an institution, at least for me,  
10 refers to a situation where an institution derives a  
11 significant benefit from what the market sees as a  
12 government provided put, caused by the fact that its  
13 failure would have catastrophic consequences. And  
14 if you accept that definition, there are several  
15 ways, there's 3 broad categories of approach and to  
16 constraining too big to fail.

17 The first is by making failure less likely. So  
18 even if there is a perception that the government  
19 will come in and will support it if it fails, that's  
20 kind of not a relevant factor, because an assumption  
21 even ex governments support is that it won't fail.  
22 And the agenda for doing that is sort of broadly the  
23 regulatory agenda towards the institution, with at  
24 least 3 specific elements. Capital leverage  
25 standards, liquidity standards, and restrictions

1 which go to riskiness, which goes into everything  
2 from compensation arrangements to limitations on  
3 proprietary trade or the like.

4 Second category measures systemic measures that  
5 make failure more acceptable, clearing for  
6 derivatives, multilateral clearing for depravities  
7 is 1 such example. Measures which enable the system  
8 to survive the failure of the institution.

9 And the third is managers, is what I call or  
10 think of as local measures, can make failure a  
11 viable option. And that is resolution frameworks  
12 which provide for a framework for going through a  
13 bankruptcy type of procedure rapidly and with a  
14 minimum of uncertainty. Plan your own funeral type  
15 arrangements, is a kinder vision in this build.

16 I don't think there's any single silver bullet  
17 with respect to, too big to fail. But I think that  
18 it can be quite substantially curtailed in the ways  
19 that I just described.

20 MR. SEEFER: We are almost out of time, so  
21 1 of the things I definitely want to ask you is what  
22 haven't you told us, that you think is important for  
23 us to know? I know we've asked you a lot.

24 DR. SUMMERS: You gave me a pretty open  
25 first question, where I had a chance to touch on

1 every aspect. The only thing I would say in  
2 conclusion I guess, is something that I've said in a  
3 number of my speeches on this, if you'll permit me  
4 on that. If you'll permit the somewhat overdrawn  
5 and oversimplified analogy.

6 If you look at the history of automobile safety  
7 in the United States, it was dismal, it was  
8 terrible. And the first major contribution that the  
9 young Daniel Patrick Moynihan made to public policy  
10 was an essay he wrote on automobile safety. What it  
11 basically said in that essay was that the then  
12 prevalent approach, which was based on lots of  
13 drivers had, and lots of criminality for reckless  
14 driving. Because if we could only get people to  
15 drive safely, then we would have fewer automobile  
16 accidents. It was basically a terrible failure.

17 And he basically felt that we should move from  
18 an approach that was based on human betterment,  
19 making people better, to an approach that was  
20 directed at making the system better for people who  
21 were as they were.

22 I think with respect to the financial system,  
23 people are going to be avaricious, people are going  
24 to extrapolate from the recent past, people are  
25 going take advantage of gambles that are favorable

1 to them. People, whether in the private sector or  
2 the public sector, are going to have highly  
3 imperfect foresight. So the lesson is that the  
4 system needs to be safe for ignorance, and safe for  
5 human fallibility. And the system that has those  
6 characteristics, that's why some of the themes that  
7 I kept coming back to were capital and leverage.  
8 Why in a number of different contexts I used the  
9 phrase belt and suspenders, why I wanted to allow  
10 some overlap in regulatory functions with some  
11 separateness of the consumer.

12 And I guess as you think about causes, I would  
13 resist the temptation to take a list of causes and  
14 make judgments about their relative importance, in  
15 favor of thinking about the multiple stages at which  
16 an accident might have been avoided.

17 Was World War I caused by the assassination of  
18 the Archduke, or was World War I caused by the  
19 ascension of Germany and the difficulty of the  
20 international system to accommodate the ascension of  
21 Germany? I kind of think it's a somewhat sterile  
22 agenda to try to distinguish the respective roles of  
23 those 2 factors, rather than recognizing that a  
24 strategy for maintaining peace can usefully address  
25 the events pointed out by both of those things.

1           And I guess my thought would be that if I have  
2 not been entirely definitive in answering some of  
3 your questions, part of the reflection of the vast  
4 amounts that I don't know, and it's in part a  
5 reflection of a judgment that there are these  
6 multiple levels of causation associated with  
7 different levels of solution, that you have to think  
8 about with respect to a crisis like this.

9           MR. SEEFER: I certainly don't think it's  
10 the plan to look at the 22 sections and assign  
11 percentages at the end of the year.

12           DR. SUMMERS: Right.

13           MR. SEEFER: So thank you very much

14 -           MS. EDELBERG: But on the flip side, the  
15 perfect storm is something I think worth resisting.  
16 It suggests that it just happened. That there were  
17 so many factors, who could ... you know. I think we  
18 need to find something in between.

19           DR. SUMMERS: I'm sure I've been unclear,  
20 but I didn't think that I had been that unclear.  
21 Nothing in what I've tried to say this afternoon,  
22 and certainly nothing in my last thought should have  
23 been interpreted as any excuse for fatalism.  
24 Indeed, the notion of causation at multiple levels  
25 actually has as it's implication that there are

1 multiple independent strategies, the success of only  
2 1 of which would have been sufficient. And so it  
3 seems to me to suggest that this was a perfect storm  
4 is in some ways, it's sometimes invoked. I  
5 recognize that the notions of a perfect storm are  
6 invoked to suggest a DSX Mac and so that there can  
7 be avoidance of responsibility on anyone's part.  
8 I've got a rather different view, which is that it  
9 requires many contributing elements.

10 And if the navigation system had been better on  
11 the ship, if the systems for keeping the ship stable  
12 in waves had been better. There are multiple ways  
13 in which the accident could have been averted. And  
14 I think the more one sees it in that way, the more  
15 different avenues one is lead to pursue and the  
16 greater the prospect of doing it.

17 In contrast, I think if you take more, and no  
18 one here is doing it, the morality play view of a  
19 crisis, you are then left with the aspect, can you  
20 change the aspects of human nature that Aristophanes  
21 and Shakespeare wrote about. And that's probably a  
22 more daunting challenge than establishing  
23 multilateral clearing mechanisms. That's why I put  
24 it in the way that I did.

25 COMMISSIONER BORN: May I just ask 1 final

1 thing? I'm taking from everything that you are  
2 saying that you would not attribute the financial  
3 crisis to the sole factor of a housing problem?

4 That it may have been 1 of the issues, but  
5 obviously it came in the context of all the rest of  
6 the activities?

7 DR. SUMMERS: I like to use the metaphor  
8 when thinking about the financial crisis of a very,  
9 very, very dry forest, into which someone throws a  
10 cigarette butt. And then the question is did the  
11 cigarette butt cause the fire?

12 Well there is a sense in which the answer to  
13 that question is clearly, yes. But there is also a  
14 sense in which, I think this is your point,  
15 Commissioner. If that cigarette butt hadn't arisen,  
16 if it was a very, very, dry forest, there likely  
17 would have been a fire in any event. Look, I think  
18 a question that, and again I'm just quoting myself  
19 from things I've said in the past. That the last  
20 generation, we've seen the 1987 crisis, the stock  
21 market crash, the S & L debacle, Mexico, LTCM, Asia,  
22 Russia, the NASDAQ bubble, Enron, now this. And so  
23 what you probably think of this, this financial  
24 crisis is much more profound in some ways, but comes  
25 off a background of a financial system that has been

1 too often a source of too much instability, and I  
2 think that perspective has to inform how we think  
3 about its regulation.

4 MR. BARKER: Thank you very much  
5 Dr. Summers, for your time.

6 DR. SUMMERS: Thank you.

7 MR. VARRILLI: Thank you. And before we  
8 go off the record, I just want to say for the larger  
9 group, about 2 things first. That we appreciate  
10 very much that you were able to structure this  
11 interview in a way that worked for you and for us as  
12 well.

13 Second that Chris and I discussed the rules of  
14 confidentiality applying to your Treasury Department  
15 interviews that we all agree apply here. And what  
16 that means as far as we're concerned, is that we are  
17 going to review the transcript, decide whether  
18 anything is confidential from our point of view.  
19 Don't know whether we'll conclude that anything is.  
20 But our understanding is, until we have had the  
21 opportunity to do that, the contents of this  
22 interview and transcript, both will remain  
23 confidential.

24 MR. SEEFER: Does the record reflect that  
25 everybody is copying? Very good.

1 MR. VARRILLI: That's on the record.

2 MR. SEEFER: Okay, I guess that's  
3 correct.

4 MR. VARRILLI: That's correct.

5 MR. SEEFER: Thank you very much.

6 (WHEREUPON, the proceedings were concluded at 4:30  
7 p.m.)

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I, Charles Hoffman, do hereby certify:

That the foregoing proceedings were taken before me at the time and place herein set forth; that any witnesses in the foregoing proceedings, prior to testifying, were placed under oath; that a verbatim record of the proceedings was made by me using machine shorthand which was thereafter transcribed under my direction; further, that the foregoing is an accurate transcription thereof.

I further certify that I am neither financially interested in the action nor a relative or employee of any attorney of any of the parties.

IN WITNESS WHEREOF, I have this date subscribed my name.

Dated: June 8, 2010

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CHARLES HOFFMAN