The Official Transcript

First Public Hearing of the

Financial Crisis Inquiry Commission

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COMMISSIONERS

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WITNESSES: PANEL ONE

LLOYD C. BLANKFEIN, CHAIRMAN AND CEO, GOLDMAN SACHS GROUP, INC.

JAMES DIMON, CHAIRMAN AND CEO, JPMORGAN CHASE & COMPANY

JOHN J. MACK, CHAIRMAN OF THE BOARD, MORGAN STANLEY

BRIAN T. MOYNIHAN, CEO AND PRESIDENT, BANK OF AMERICA CORPORATION

WITNESSES: PANEL TWO

MICHAEL MAYO, MANAGING DIRECTOR AND FINANCIAL SERVICES ANALYST, CALYON SECURITIES (USA) INC.

J. KYLE BASS, MANAGING PARTNER, HAYMAN ADVISORS, L.P.,

PETER J. SOLOMON, FOUNDER AND CHAIRMAN, PETER J. SOLOMON COMPANY

WITNESSES: PANEL THREE

MARK ZANDI, CHIEF ECONOMIST AND CO-FOUNDER, MOODY'S ECONOMY.COM

KENNETH T. ROSEN, CHAIR, FISHER CENTER FOR REAL ESTATE AND URBAN ECONOMICS,UNIVERSITY OF CALIFORNIA, BERKELEY

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C.R. 'RUSTY' CLOUTIER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MIDSOUTH BANK, N.A., PASTCHAIRMAN, INDEPENDENT COMMUNITY BANKERS ASSOCIATION

CHAIRMAN ANGELIDES:

The meeting of the Financial Crisis Inquiry Commission will come to order. There is a quorum present, and so we will now proceed with this first of our public hearings. Good morning to everyone and thank you for being here. I'm honored to welcome you, as we start this series of public hearings, into the causes of the financial and economic crisis that's gripped this entire country. I thank Vice Chairman Thomas for his extraordinary cooperation and partnership. I applaud the dedication of my fellow commissioners, and I'm grateful to all of our witnesses for giving us their testimony and sharing their wisdom.

We've been given a critical mission, one that goes far beyond any party or even policy agenda to conduct a full and fair inquiry into what brought America's financial system to its knees. We're after the truth, the hard facts, because it's our job to provide an unbiased accounting of the actions that led to devastating economic consequences for so many American families. We'll follow the evidence wherever it leads. We'll use our subpoena power as needed. And if we find wrongdoing, we will refer it to the proper authorities. That's what the American people want, that's what they deserve, and that's what this commission is going to give them.

Some already speak of the financial crisis in the past tense, as some kind of historical event. The truth is it is still here and still very real. Twenty-six million Americans are unemployed or can't find full-time work or have given up even looking for jobs.

Over 2 million families have lost their homes to foreclosure in the last three years. Millions more have a very legitimate fear that they will. Retirement accounts and life savings have been swept away, vanished like some day trade gone bad.

People are angry. They have a right to be. The fact is that Wall Street is enjoying record profits and bonuses in the wake of receiving trillions of dollars in government assistance while so many families are struggling to stay afloat has only heightened the sense of confusion.

I see this commission as a proxy for the American people, their eyes, their ears, and possibly also their voice. This forum may be the only opportunity to have their questions asked and answered. This forum may be our last best chance to take stock of what really happened so that we can learn from it and restore faith in our economic system. If we ignore history, we're doomed to bail it out again. And so expect our witnesses before us to be forthright. We need candor about the past so we can face the future.

Today's hearing is the beginning, not the end, of our questioning. We'll hold hearings throughout the year and take testimony from hundreds of individuals. Witnesses called to testify today are likely to come before us again as this investigation and inquiry unfolds. Those who haven't yet been asked to appear should be confident of this: We intend to thoroughly question individuals and institutions relevant to our inquiry.

Let me close with this thought. My father grew up in the Great Depression. Like so many of his generation, he was shaped by sacrifice, hardened by economic hardship and war, keenly aware of the financial recklessness that made his life and the life of so many others so much harder than it needed to be. His generation learned the lessons of financial disaster so that the country could avoid it for decades. Let us learn the lessons of our time. Let us be diligent and thoughtful today so that our financial and economic system can fully rebound and enrich and sustain Americans for the years to come.
Mr. Thomas?

VICE CHAIRMAN THOMAS:

Thank you very much, Mr. Chairman.

I'd ask unanimous consent that my written statement be made a part of the record, and I just want to thank all of the commissioners. We've been doing a lot of that seven-eighths of the iceberg underwater, and people are now going to see the one-eighth that you usually see above water.

I think all of us are conscious of the fact that these hearings, notwithstanding the drama of the hearings, is not the fundamental work that is before us. It is, as you indicated, asking the questions the American people would like answered and doing it in a way in which we increase the understanding, the comprehension of what happened, obviously, for the purpose of not having it happen again.

Thank you, Chairman.

CHAIRMAN ANGELIDES:

Thank you, Mr. Vice Chairman.

And now, we will go to the witnesses on our first panel. Let me say that it will be the common and customary practice of this commission in public hearings to swear witnesses in terms of their testimony. So this is not unusual. And with that, though, I would like to ask each of the witnesses to be sworn. And I'd like to ask that you stand so that we may swear you in, as is I said, the common practice.

Do you solemnly swear or affirm under the penalty of perjury that the testimony you are about to provide the commission will be the truth, the whole truth, and nothing but the truth to the best of your knowledge?

ALL:

(OFF-MIKE) I do.

CHAIRMAN ANGELIDES:

Thank you so very much.

Now, gentlemen, thank you very much for being here today. We appreciate you coming here. We appreciate you sharing your views with us. I should tell everyone here that each of the witnesses today has submitted written testimony which will be available on our Web site, which is FCIC.gov. It is also, I believe, available in the room today.

We have asked each of the panelists to make opening statements of no more than 10 minutes. And so I think we'd like to proceed with that. I will signal you when there is one minute to go so you can wrap up. And so let's do this then. I think, with that, I'd like to start with Mr. Blankfein. We're going to go in alphabetical order.
Mr. Blankfein, please proceed.

BLANKFEIN:
Thank you, Chairman Angelides, Vice Chairman Thomas, and members of the commission. Thank you for the opportunity to contribute to the commission's work to understand the causes of the financial crisis.

Goldman Sachs was established 141 years ago. We are an institutional-focused firm providing investment banking, market making, and investment management services to corporations, institutions, governments, and high-net-worth individuals. As an underwriter, we help our clients access equity in debt capital markets in order to grow their businesses. As an adviser, we assess and facilitate strategic options for mergers and acquisitions. We provide the necessary liquidity as market makers to help ensure that buyers and sellers can complete their transactions and securities markets can function efficiently. And as an asset manager, we help public and private pension funds, corporations, not-for-profit organizations, and high-net-worth individuals plan, manage, and invest their financial assets for the long term.

To begin on a more general point, any examination of the financial crisis should set out with an understanding of some of the global economic and financial dynamics of the last

two decades. The growth in the amount of foreign capital, 10 years of low long-term interest rates, and other factors coalesced over many years to create a sustained period of cheap credit and excess liquidity. This in turn generated a desire to find new investment opportunities with higher returns. Many of the best were thought to be in residential housing.

One contributing factor to the attractiveness of the housing market was public policy's active support of the expansion of homeownership, recognizing the societal benefits. For our industry, it is important to reflect on some of the lessons learned and mistakes made over the course of the crisis. At the top of my list are the rationalizations that we made to justify that the downward pricing of risk was different. While we recognize that credit standards were loosening, we rationalized the reasons with arguments such as:
the emerging markets were growing more rapidly, the risk mitigants were better, there was more than enough liquidity in the system.

A systemic lack of skepticism was equally true with respect to credit ratings. Rather than undertake their own analysis, too many financial institutions relied on the rating agencies to do the central work of risk analysis. Another failure of risk management concerned the fact that risk models, particularly those predicated on historical data, were too often allowed to substitute for judgment.

Next, size mattered. Whether you owned $5 billion or $50 billion of supposedly no-risk super-senior debt in a CDO, the likelihood of loss rate would appear to be the same. But the consequences of a miscalculation were obviously much bigger if you had a $50 billion exposure. Third, risk monitoring failed to capture the risk inherent in off-balance sheet activities such as structured investment vehicles, or SIVs. It seems clear now that financial institutions with large off-balance sheet exposure didn't appreciate the full magnitude of the economic risks they were exposed to. Equally worrying, their counter parties were unaware of the full extent of those vehicles and therefore, could not accurately assess the risk of doing business.

Fourth, assets at certain institutions weren't valued at their fair market value, the price at which willing buyers and sellers transact. One consequence was that losses weren't seen early enough, so risks weren't curtailed. A second consequence was that bank balance sheets became suspect. As a result, lending between counterparties froze.

Fifth, financial institutions simply didn't have enough capital to meet the extraordinary market environment that arose after a long period of benign conditions.

Lastly, the role we play in the capital markets is to support economic growth. Some of the activities we undertook contributed to the prevailing mood of the time. We didn't know it then or even today when it actually crossed over into bubble territory. But we lent money out too cheaply and in certain loans, without the traditional safeguards. We didn't recognize early enough that risk was being mispriced. We made too many liquid investments, particularly in real estate. And we were too concentrated in certain areas, namely leveraged loans. Given the competitive focus on maintaining market share, we didn't see as clearly as I would have hoped the excesses, so we didn't raise a hand and ask whether some of those trends and practices that became commonplace really served the financial system's interests. Going forward, I hope that one of the improvements made will be the creation of a mechanism by which the industry and regulators can step back, try to assess if markets have gone too far and consider what needs to be done.

In light of these lessons, it is important to consider principles for our industry and for policy makers as we move towards reform. Risk and control functions need to be completely independent from the business units. And clarity as to whom risk and control managers report is crucial to maintaining that independence. To increase overall transparency and help ensure that book value really means book value, regulators should require that all assets across a large financial institution with a capital markets business be accounted for on a fair value basis. Also, all of the exposures of a financial institution should be reflected through its P&L. In this vein, valuation of capital standards across

risky assets, regardless of the form or legal entity in which they are held, must be consistent.

One of the largest stresses placed on Goldman Sachs and other firms during the height of the crisis was the possibility that we were managing risk in the same way other institutions, which were severely hampered or later failed, had managed their risks. Getting the market to recognize that our balance sheet was well marked and that our reported capital levels were accurate was one of our most significant challenges.

Without question, direct government support was critical in stabilizing the financial system. And we benefitted from it. The system clearly needs to be structured so that in the future private capital rather than government capital is used to stabilize troubled firms promptly before a crisis takes hold. The two mechanisms that seem to hold the most promise for addressing this goal and addressing too-big-to-fail are ongoing stress tests, which are made public, and contingent capital possibly triggered by failing a stress test. These two elements could also be the core of a strong but flexible resolution authority.

Certainly, enhanced capital requirements in general will reduce systemic risk. But we should not overlook liquidity. If a significant portion of an institution's assets are impaired and illiquid and its funding is relying on short-term borrowing, low leverage will not be much comfort. Regulators should lay out standards that emphasize prudence and the need for longer-term maturities depending on the assets being funded. Institutions should also be required to carry a significant amount of cash at all times ensuring against extreme events.

Lastly, I wanted to briefly discuss our firm's experience during 2008 and 2009. While we certainly had to deal with our share of challenges during the financial crisis, Goldman Sachs was profitable in 2008. As I look back to the beginning and throughout the course of the crisis, we couldn't anticipate its extent. We didn't know at any moment if asset prices would deteriorate further or had declined too much and would snap back.

Having to fair value our assets on a daily basis and see the results of that marking in our P&L forced us to cut risk regardless of market or individual views, estimates or expectations. Throughout 2007 we were committed to reducing certain of our risk exposures, even though we sold at prices many in the market, including at times ourselves, thought were irrational or temporary.

After the fact, it was easy to be convinced that the signs were visible and compelling. In hindsight, events not only looked predictable, but sometimes looked like they were obvious or known. The truth is that no one knows what is going to happen. And that recognition defined our approach to risk management.

We believe key attributes of our strategy, culture and processes were validated during the extraordinary events and macro-economic uncertainty of the past year. But they have also prompted change within our firm.

Over the last 18 months our balance sheet has been reduced by a quarter, while our capital has increased by over a half. Our Basel I and tier one capital ratio has increased to 14.5 percent through earnings generation and the number of capital offerings. Our pool of liquidity was relatively high at the onset of the crisis, but we carry a great deal more cash on our balance sheet than ever before to deal with contingencies.

While we believe our firm has produced a strong relationship between compensation and performance, we have announced additional reforms in this area. At our shareholders meeting last year we outlined specific compensation principles. Consistent with those principles, in December, we announced that the firm's entire management committee will receive 100 percent of their discretionary compensation in the form of shares at risk, which cannot be sold for five years. In addition, we announced that the five-year holding period on shares at risk includes an enhanced recapture provision that will permit the firm to recapture the shares in cases where the employee engaged in materially improper risk analysis or failed sufficiently to raise concerns about risk.

Finally, our shareholders will have an advisory vote on the firm's compensation principles and the compensations of its named executive officers at the firm's annual meeting of shareholders in 2010.

Once again, we appreciate the opportunity to assist the commission in your critical role. And I look forward to your questions. Thank you.

CHAIRMAN ANGELIDES:
Thank you very much. Thank you so much.
Mr. Dimon?

DIMON:
Chairman Angelides, Vice Chairman Thomas and members of the commission, my name is Jamie Dimon and I am chairman and chief executive officer of JPMorgan Chase and Company. I appreciate the invitation to appear before you today.
If we are to learn from this crisis moving forward, we must be brutally honest about the causes and develop a realistic understanding of them that is not overly simplistic. The FCIC's contribution to this debate is critical, and I hope my participation will further the commission's goals.

I'd like to start by touching on some of the factors I believe led to the financial crisis. Of course, much has been said and much more will be written on the topic, so my comments are summary in nature. As we know all too well, new and poorly underwritten mortgage products helped fuel housing price appreciation, excessive speculation and far higher credit losses. When the housing bubble burst, it exposed serious flaws in mortgage underwriting, and losses flowed from the chain from mortgages to securitizations to derivatives based on these products.

Excessive leverage by many U.S. investment banks, foreign banks, commercial banks, and even consumers pervaded the system. This included hedge funds, private equity firms banks and non-banks using off-balance sheet vehicles. There were also several structural risks and imbalances that grew in the lead-up to the crisis. There was an over reliance on short- term financing to support illiquid long-term assets, and over time, certain financing terms became too lax. Another factor in the crisis was clearly a regulatory system. I want to be clear I do not believe the regulators. While they obviously have a critical role to play, the responsibility for companies' actions rest solely on the companies' management.

But we should also look to see what could have been done better in the regulatory system. We have known that our system is poorly organized with overlapping responsibilities. Many regulators did not have the statutory authority they needed to address the failure of large global financial companies. Much of the mortgage business was not regulated or lacked uniform treatment. Basel II capital standards allowed too much leverage in investment banks and other firms and not incorporate liquidity at all. The extraordinary growth and high leverage of the GSEs also added to the risk.

We also learned that our system has many embedded pro-cyclical biases, a number of which proved harmful in times of economic stress. Loan loss reserving methodologies caused reserves to be at their lowest levels at a time when high provisioning might be needed the most. Certain regulatory capital standards are also pro-cyclical, and continuous downgrades by credit agencies also required many financial institutions to raise more capital.

When all is said and done, I believe it will be found that macro economic factors will have been some of the fundamental underlying cause of the crisis. Huge trade and financing imbalances caused large distortions in interest rates and consumption.

As for J.P. Morgan Chase, the last year and a half was the most challenging period in our company's history. I'm immensely proud of the way our employees continued to serve

our customers through this difficult time. Throughout the financial crisis, we never posted a quarterly loss. We served as a safe haven for depositors. We worked closely with the federal government. And we remained an active lender.

I would like to describe some of the regular business practices that we believe protected us leading up to and during the crisis. If we weren't doing these things right going into the crisis, it would have been too late to start once the crisis began. J.P. Morgan Chase did not unduly leverage our capital or rely on low-quality capital. We've always used conservative accounting and vigilant risk management, built up strong loan loss reserves, and maintained a high level of liquidity. We always believed in maintaining a fortress balance sheet. We continually stress test our capital liquidity to ensure that we can withstand a wide range of highly unlikely but still possible negative scenarios. We did not build up our structured finance business. While we were large participants in the asset-backed securities market, we deliberately avoided large risky positions like structured CDOs. We avoided short-term funding of liquid assets and did not rely heavily on wholesale funding. In addition we essentially stayed away from sponsoring SIVs and minimized our financing of them.

Even before 2005 we recognized that the credit losses were extremely low, and we decided not to offer higher risk, less tested loan products. In particular, we did not write payment option ARMs.

As I said before, we did make mistakes. There are a number of things we could have done better. First, we should have been more diligent when negotiating and structuring commitment letters for leverage to indicate loan transactions. In response we have tightened our lending standards as well as our oversight of loan commitments we make. Second, the underwriting standards of our mortgage business should have been higher. We have substantially enhanced our mortgage underwriting standards, essentially returning to traditional 80 percent loan to value ratios and requiring borrowers to document their income. We've also closed down most—almost all of the business

originated by mortgage brokers where credit losses have generally been over two times worse than the business we originate ourselves.

Even so, we remained relatively strong throughout the crisis so much so that we were called upon to take actions to help stabilize the system. Over the weekend of March 15, 2008, the federal government asked us to assist in preventing Bear Stearns from going bankrupt before the opening of the Asian markets on Monday morning. On September 25th, we acquired the deposits, assets and certain liabilities of Washington Mutual from the FDIC. Later we learned that we were the only bank that was prepared to act immediately following the largest bank failure in U.S. history.

In addition we continued to lend and support our clients' financing and liquidity needs throughout the crisis. Over the course of the last year, we've provided more than $800 billion in direct lending and capital raising for investor and corporate clients. For example, we helped provide state and local government financing to cover cash flow shortfalls. We are the only institution that agreed to lend California $1.5 billion in its time of need. And even though small business loan demand has been down, we have maintained our lending levels to small business. In November of last year, we announced plans to increase lending to small businesses by $4 billion, to a total of $10 billion this year. For the millions of Americans feeling with the effects of this crisis, we are doing everything we can to help them meet their mortgage obligations. In 2009 we offered approximately 600,000 new trial loan modifications to struggling homeowners through our own program as well as through participation in government programs like the U.S. Making Home Affordable initiative.

Our capabilities, size and diversity of business have been essential to our withstanding the crisis and emerging as a stronger firm. It is these trains that have put us in a position to acquire Bear Stearns and Washington Mutual. Some have suggested that size alone or the combination of investment banking and commercial banking caused the crisis. We disagree. If you consider the institutions that failed during the crisis, some of the largest

and most consequential failures were stand-alone investment banks, mortgage companies, thrifts and insurance companies.

Our economy needs financial institutions of all sizes, business models and areas of expertise to promote economic stability, job creation and customer service. America's largest companies operate around the world and employ millions of people. These firms need banking partners to operate globally, who offer a full range of products and services and provide financing in billions of dollars. But let me be clear. As I've said before, no institution, including our own, should be too big to fail. We need a regulatory system that provides for even the largest financial firms to be allowed to fail in a way that did not put taxpayers or the broader economy at risk. Shareholders, management and unsecured creditors should bear the full cost of failure.

The great strength of any organization—indeed, our country—lies in our ability to face problems, to learn from our experiences and to make necessary changes. I would like to thank the commission for their contribution to this process and commitment to identifying the causes of the crisis. We stand ready to assist the commission in any way we can. Thank you for the opportunity to testify before you today.

CHAIRMAN ANGELIDES:

Thank you very much, Mr. Dimon.

Mr. Mack?

MACK:

I'm ready to go.

Chairman Angelides, Vice Chairman Thomas, distinguished commissioners, my name is John Mack. I'm the chairman of Morgan Stanley. I also served as Morgan Stanley's CEO from June of 2005 to '09. And I'm pleased to have the opportunity to address you today.

The past two years have been unlike anything I've seen in my 40 years in financial service. Unprecedented illiquidity and turmoil on Wall Street saw the fall of two leading franchises and the consolidation of others. We saw credit markets seize, the competitive landscape remade, and vast governmental intervention in the financial sector. And the consequences have obviously spread far beyond Wall Street. Millions in America today are struggling to find work. They've lost homes. They watched their retirements evaporate their savings.

I believe the financial crisis exposed fundamental flaws in our financial system. There is no doubt that we as an industry made mistakes. In retrospect it's clear that many firms were too highly leveraged. They took on too much risk, and they didn't have sufficient resources to manage those risks effectively in a rapidly changing environment. The financial crisis also made clear that regulators simply didn't have the visibility, tools or authority to protect the stability of the financial system as a whole.

Let me briefly walk you through what happened from Morgan Stanley's viewpoint and our response to the crisis. As the commission knows, the entire financial service history was hit by a series of macro shocks that began with the steep decline in U.S. real estate prices in 2007. Morgan Stanley, like many of its peers, experienced significant losses related to the decline in the value of securities and collateralized debt obligations backed by residential mortgage loans. This was a powerful wake-up call for this firm, and we moved quickly and aggressively to adapt our business to the rapidly changing environment. We cut leverage. We strengthened risk management. We raised private capital and dramatically reduced our balance sheet. We increased total average liquidity by 46 percent, and we entered the fall of '08 with $170 billion in cash on our balance sheet. Thanks to these prudent steps, we were in a better position than some of our peers to weather the worst financial storm, but we did not do everything right.

When Lehman Brothers collapsed in early September of '08, it sparked a severe crisis of confidence across global financial markets. Like many of our peers, we experienced a classic run on the bank as the entire investment banking business model came under

siege. Morgan Stanley and other financial institutions experienced huge swings and spreads on the credit-default swaps tied to our debt and sharp drops in our share price. This led clearing banks to request that firms post additional collateral causing further depletion of cash resources.

In an effort to stem the panic, Morgan Stanley moved up its announcement of its strong third-quarter earnings to September the 16th, but our stock remained under heavy pressure. It lost nearly a quarter of its value the following day, falling from 28.7 to 21.75. Despite these strong results, it continued to trade low and, finally, traded as low as $6.71. This crisis of confidence in the market had a chain reaction to the broader economy as lower prices for financial assets undermined confidence and led to lower prices throughout the rest of the economy. This period was marked by rampant rumors and speculation.

My management team, like those of my peers here, worked around the clock to address these rumors and provide investors, clients, and employees accurate information.
We also worked closely with our regulators to keep them informed and achieve the right result for the markets and the economy. Our position began to stabilize after Mitsubishi agreed to invest $9 billion in our firm as part of a broader strategic alliance. Morgan Stanley also converted to a bank-holding company providing direct oversight and access to the Federal Reserve.

The U.S. government announced its TARP investment a short while later, which also helped stabilize the broader market. And the SEC instituted a temporary ban on shorting financial stocks. Morgan Stanley appreciates the many steps the government took to prevent the collapse of the financial system and the support provided by American taxpayers. I believe every firm in the industry and the broader financial markets as a whole benefited from this support. As you know, Morgan Stanley has since repaid our TARP funds providing taxpayers a 20 percent annualized return on that investment.

We learned an important lesson from 2008 crisis and have adapted our business to help prevent something like this from happening again. One of the clearest lessons was that many firms simply carried too many leverage. As I mentioned, Morgan Stanley moved aggressively, beginning in '07, to reduce leverage cutting it in half from 33 times at the end of '07 to 16 times by the third quarter of '09. We raised a total of $14 billion in capital from private sources maintaining one of the highest tier one capital ratios. We've also taken a number of steps to diversify our revenue and funding sources, including through an expansion of our wealth-management business and extending maturities on our debt. We have made important changes, systemic changes to our business practices, including scaling back proprietary trading. Morgan Stanley also devoted significant resources over the last two years to further strengthen our risk-management policies and procedures. This including naming a new risk officer early in 2008 and adding about a hundred more people to the risk-management process.

We have enacted changes to how we pay our employees and ensure that compensation is linked even more closely to performance and does not encourage excessive risk taking. We were the first major U.S. bank to enact a claw-back for a portion of year-end compensation in 2008, one that exceeded TARP requirements. We have since strengthened this provision further so we can claw back compensation for up to three years if investments or trading positions produce subsequent losses.

We've also enacted a new, multi-year performance plan that makes a portion of senior executives' year-end compensation contingent on reaching certain three-year performance goals. And we're increasing a portion of year-end compensation that's deferred to all employees.

Finally, as CEO, I recommended to the board that I receive no bonus in 2009 because of the unprecedented environment in which we are operating and the government's extraordinary financial support to our industry. This was the third year in a row that I recommended no bonus to my board.

Morgan Stanley is also doing its part to get our economy moving again. We are working with businesses to raise capital to invest in job growth. We are working with families to modify mortgages we service so families can stay in their homes. By the end of November '09, Morgan Stanley's loan servicing subsidiary had active trial modifications in place for 44 percent of borrowers who are over 60 days delinquent and eligible for the administration's Home Affordable Modification Program. This was the highest percentage of any servicer participating in the HAMP program. We believe this is both business imperative and public important.

The financial crisis laid bare the failures of risk management of individual firms across the industry and around the world, but also made clear that regulators simply don't have the tools or the authority to protect the stability of the financial system as a whole. That's why I believe we need a systemic risk regulator with the ability to ensure that excessive risk taking never again jeopardizes the entire financial system. We cannot and should not take risk out of the system. That's what drives the engine of our capitalist economy. But no firm should be considered too-big-to-fail.

The complexity of the financial markets, financial products exploded in recent years, but it's clear that regulation and oversight have not kept pace. While many of these complex products were designed to spread out risk, they've often had just the opposite effect, obscuring where and to what degree that risk was concentrated.

Regulators and investors need to have a fuller and clearer picture of the risk posed by increasingly complex products as well as their true value. We should also aim to make more financial products fungible to ensure they can be transferred from one exchange or electronic trading system to another. I believe we need to establish a federally regulated clearing house for derivatives or requiring reporting to a central repository. This will create truly efficient, effective, and competitive markets in futures and derivatives which would benefit investors and the industry as a whole.

Finally, today's financial markets are global and interconnected. Our regulatory regime needs to be as well. The U.S. must work with countries across the globe to coordinate and synchronize risk. At Morgan Stanley, we're grateful for everything the federal government and the American taxpayer did to support our industry and to help bring stability back to the markets. We recognize our industry has much to do and to regain the trust and confidence of taxpayers, investors, and public officials.
Thank you.

CHAIRMAN ANGELIDES:
Thank you, Mr. Mack.
Mr. Moynihan?

MOYNIHAN:
Thank you, Chairman Angelides, Vice Chairman Thomas, and other members of the commission. I welcome the opportunity to help provide some information on important matters you're investigating. As you know, I assumed my role of CEO of Bank of America on January 1st, and prior to that time, I ran the consumer areas of the company. In leading our consumer business, I had a first-hand knowledge and a recognition of the hardships that many hard-working families and small businesses experience across America.

Together, the financial services companies, our elected leaders, and regulators must continue to work to understand what occurred in the financial crisis and apply these lessons so that it simply does not happen again.

Over the course of the crisis, we, as an industry, caused a lot of damage. Never has it been clearer how poor business judgments we have made have affected Main Street. This commission's work is important because the lessons are not going to be simple. This crisis had a multitude of causes that are not easily summarized. It is important that we understand the breadth of the causes so we can learn the right lessons and apply the appropriate policy to remedy them for the future.

We have seen, in our view, four crises unfold: a mortgage crisis, a capital markets crisis, a global credit crisis, and a severe global recession. The mortgage crisis originated with the dramatic expansion in the availability of mortgage credit through subprime lending and aggressive mortgage terms even in prime products. This led to a greater debt burden for consumers. Lenders, prompted by lower interest rates, rapidly rising home prices, and large amounts of capital available, made credit available to borrowers who could not previously qualify for a mortgage or extended more credit to a borrower who could or perhaps should—would not be able to handle. The national policy to expand American homeownership was also popular and created tailwinds. No one involved in the housing system—lenders, rating agencies, investors, insurers, consumers, regulators, and policy makers, foresaw a dramatic and rapid depreciation of home prices.

When the nation did experience this rapid depreciation in home prices, the first that had been experienced since the Great Depression, many of these loans became very unfavorable and the option of refinancing disappeared leading to defaults. The second crisis came in investment banks in the capital markets area. Investment banks not only had underwritten mortgages, but they had retained significant amounts of the risk by holding interest and providing backup liquidity for mortgage-related securities they had sold.

Investment banks created products based on these mortgage assets. The risk of these assets spread. This happened when a monoline insurer guaranteed the mortgages or a structured investment vehicle brought the mortgage securities and having the money-market funds to purchase that commercial paper from those vehicles.

Third, the stress of the financial crisis began to spread beyond the investment banks and mortgages to other fixed income products and to more market participants. This destabilized the financial institutions and non-financial institutions that had little to do with the U.S. or the mortgage market. This contagion was, in fact, global. Without

government intervention to restore liquidity to capital markets, the risk of global economic collapse was very real.

The final crisis and perhaps the most daunting is that we have a severe economic recession going on. While some would say that the financial crisis caused the recession, the experts will analyze that for the coming years to establish the exact causal relationship. But one thing is clear. The U.S. economic growth in the first decade of this century was funded in part by home price appreciation and the ability of homeowners to access the equity in their homes to use for spending. In addition, home mortgage and home equity financing helped drive residential construction activities, which contributed to the economic expansion. The history of past economic cycles and this cycle shows that an economic expansion built on excessive debt or leverage will end in a recession, no matter what triggers it. And this one surely did.

This crisis has taught us some very valuable lessons. And let me highlight a few of those that are in my written testimony. First, this credit starts and ends with sound underwriting, a clear assessment of the borrower’s ability to repay the loan. Rating agencies or credit bureaus are no substitute for diligent and independent risk analysis. Second, capital is important. And the leverage of investment banks and other market participants was untenable. While the leverage requirements for a bank holding company may have been better, banks and others should, and undoubtedly will, hold more capital going forward.

Third, liquidity is the key. Liquidity allows an institution to meet marginal calls, fund redemptions or pay depositors without having to sell illiquid assets at discounts, which could lead to further losses. And fourth, current accounting rules need to be reviewed. Current rules require banks to reduce reserves against loan losses in good times and build them in bad times. In addition, mark-to-market accounting can become disjointed when there’s no real market for many products.

Before closing let me say a few words about compensation. At Bank of America, our compensation guidelines are set by a board of directors. The goal of any compensation program and the program at Bank of America is to attract and retain the talent we need to make the businesses profitable. In 2008, our company actually earned more than $4 billion. But that was far short of what we believed we should have done for our shareholders. Neither my predecessor as CEO nor any of the top leaders in the company, myself included, received a bonus for 2008. For the executives at the next level down, our bonuses were cut more than 80 percent. Our 2009 compensation pools have not been finalized. We anticipate that the compensation levels will be higher than they were in 2008, but certainly not back to the pre-crisis levels.

We have implemented many different programs, including claw backs and greater deferrals that you've seen referenced in the press and other places. And all of our activities comply with the work that we've done through the various regimes, the TARP regime and the paymaster, Feinberg, and others. We understand the anger felt by many citizens because institutions that received federal investments 15 months ago are now recovering and pay their employees reflect this recovery, especially in investment banking and trading areas. And in response to that criticism I'd make a few points.

First, at Bank of America we are grateful for the taxpayer assistance we have received. I am pleased to report that we've paid back 100 percent of those funds, $45 billion, along with nearly $3 billion in dividends and other payments to taxpayers. Second, the vast majority of our employees played no role in the economic crisis or losses. They have worked hard during this crisis to help their customers and clients and extend more than three- quarters of a trillion dollars in the four quarters leading up to the third quarter of '09. Third, while some employees were asked to leave the company over the past couple of years, we believe our 300,000 employees are a valuable part of our future. And we need to pay them competitively to ensure that we can keep them so they can help our clients.

In conclusion, I want all of you and the American people to know that I fully understand and appreciate the gravity of the crisis that we are now just coming through. We are grateful for the courage shown by government leaders to take bold, unprecedented action to preserve the financial system. We support regulatory reform efforts designed to prevent any recurrence of this episode. But most of all, we as managers have to run our companies never to let this happen again. Thank you for your time. And I'd welcome any questions you might have.

CHAIRMAN ANGELIDES:

Thank you very much, Mr. Moynihan.

Thank you very much, all of you, for your thoughtful statements. We are now going to move to questions. And we have got a lot of ground to cover, so I'm going to ask that you be as, obviously, incisive and compelling as possible, but brief, succinct, direct answers.

I'll start the questioning today. And what I'd like to do is I'd like to start by asking some questions about specific types of business practices and risk management practices that may have contributed to the financial crisis as a way of making this tangible and real. And I want to pick up on your comment, Mr. Dimon, here. I'd like to be brutally honest. Mr. Blankfein, I'm going to start my questioning with you today. And I want to actually pick up on your comment in your testimony about the fact that there were—and—and I think I'm paraphrasing this correctly. That there were financial products and practices that may have served no, essentially, good or productive purpose in the financial system.

Recently you've made a few comments. And I'd like to just read you a couple of quotes. You said in November of last year, "Listen, there was a lot of negligent behavior and proper bad behavior that has to be fixed and sorted through. We don't take ourselves out of that. I include ourselves in that." You also said, "We participated in things that were clearly wrong and we have reasons to regret and apologize for." What I'd like to ask you is can you tell me very specifically what are the two most significant instances of negligent, improper and bad behavior in which your firm engaged and for which you would apologize. (BUZZER SOUNDS) That's a vote.

BLANKFEIN:
Oh I see. I'd say the—the biggest—the biggest—and I referred to this in my—in my oral testimony just now. I think we in our behavior got up—got caught up in—and this is a general remark, I'll get specific in a second got caught up in and participated in and therefore, contributed to elements of froth in the market. So, for example, in leverage finance, which was our biggest exposure, we are a top service provider to the private equity world. We are—we are a top mergers and acquisitions firm in connection with rendering that advice for mergers and acquisitions. We helped finance those transactions.

Increasingly those transactions took on higher and higher leverage, which they could not have but for the willingness of financiers to participate in that. And we were a major financier. And moreover, we held those positions for too long, too much concentration in our books. In other words, we sold them down. And if you go through a continuum of people who have had these positions I don't think—you know, relative to our size, we had more than we should have had. And therefore, we had to—when you go back and look at them, too much leverage in transactions and too much concentration remained from that leverage on our books.

CHAIRMAN ANGELIDES:
OK. Would you characterize—looking back on this now—and obviously, hindsight's 20/20. But would you look back on some of the financings as negligent or improper?

BLANKFEIN:
Again, in the context of the world that we were in—and when you use terms like that, I always think about standards of behavior and in the context. I think those were very typical behaviors in the context that we were in.

CHAIRMAN ANGELIDES: Let me ask you, have you done any kind of internal investigation, kind of large sweep of your activities? And is that—what did you find? And is that something we could have?

BLANKFEIN:

I'm not—you know, if we have something, of course, we will identify it for you and you can have it. I'm—I'm not referring to a specific. I'm referring to the fact that we look at our risks and we look at our positions. And in the tensions and crisis area, we looked at the—at our balance sheet and the amount of illiquid positions on our balance sheet. And that's what I'm referring to.

CHAIRMAN ANGELIDES:

Well, if, in fact, you have done an internal audit investigation to kind of look at the practices, the mistakes that occurred, we'd like to be able to have that, review it. Obviously, your attorneys, I'm sure, will want to review it before.

BLANKFEIN:

Absolutely.

CHAIRMAN ANGELIDES:

But perhaps there's some things we can follow up. Let me move on now. Let me talk about—you know, the issue of conflicts comes up in many respects in the marketplace.

BLANKFEIN:

Sure.

CHAIRMAN ANGELIDES:

It comes up in compensation. It comes up in trading practices. And I want to ask you about a very specific instance as a way of getting to how things worked and how things might be changing in the future. Based on the review of public documents, as you know, your firm sold a significant amount of subprime mortgage-related securities. And it appears, at least according to public documents and other reports, that you may have simultaneously betted against the securities you sold to clients. According to the reports, you sold about $40 billion in 2006, 2007. In December 2006, I think, you came to the

conclusion the mortgage market was heading south and you began to reduce your own positions.

And many of the securities that you sold to institutional investors, other folks went bad within months of issuance. Now, one expert in structured financing said, "The simultaneous selling of securities to customers and shorting them because they believe they are going to default is the most cynical use of credit information that I've seen." Do you believe that was a proper legal, ethical practice? And would the firm continue to do that practice? Or do you believe that's the kind of practice that undermines confidence in the marketplace?

BLANKFEIN:
Well, the way it's—let me—the short answer is this is the practice of a market maker. And I would like to explain this. But the answer is I do think that the behavior is improper, and we regret the result—the consequence that people have lost money in it, but I just want to explain—and this is a very important—and I appreciate the opportunity to do this because there's so much press swirling around this that I really want—I really need to explain.

In our market-making function, we are a principal. We represent the other side of what people want to do. We are not a fiduciary. We are not an agent. Of course, we have an obligation to fully disclose what an instrument is and to be honest in our dealings, but we are not managing somebody else's money.

When we sell something as a principal—which is what we are as a market maker—the next minute, that item will have gone up—in which case we'll wish we hadn't sold it that minute—or it will go down—in which case, we'll actually be glad we did for our own P&L and sorry for the person who bought it. But we are market makers in that.
In most of these cases, the person who came to us came to us for the exposure that they wanted to have.

CHAIRMAN ANGELIDES:

But Mr. Blankfein, you are actually creating these securities. And let me just tell you, as someone who's been in business for half my career, the notion that I would make a transaction with you and then the person with whom I made that transaction would then bet that that transaction would blow up is inimical to me. And I guess the question is you weren't purely a broker. You were actually taking subprime product, packaging it up, and selling it under your label. Correct?

BLANKFEIN:

Let me be clear. We were not a broker at all.

CHAIRMAN ANGELIDES:

Correct.

BLANKFEIN:

Not at all.

CHAIRMAN ANGELIDES:

Yes. You were a principal.

BLANKFEIN:

We are a principal.

CHAIRMAN ANGELIDES:

OK.

BLANKFEIN:

The act—it wasn't as if we were creating product, that product existed necessarily, and we were shorting it. The act of selling it reduced our risk.

CHAIRMAN ANGELIDES:

OK.

BLANKFEIN:

Let me be clear about...

CHAIRMAN ANGELIDES:

The act of selling it—I can understand how my point was you had a view of the market as you continued to sell the securities. I guess one of the questions I'd ask you is: How do you go to the rating agencies, with whom I dealt with a lot as treasurer, and how do you persuade them to give many of the tranches the highest ratings—triple A—at the same time that you have credit information that leads you to believe that, in fact, those securities may fail?

BLANKFEIN:

Chairman, I'd have to—and another point. The predicate of your question, we are not necessarily…I know—if you had looked into Goldman Sachs, we were not controlling our risk. When you listen to the testimony that's come by, the biggest problem that institutions had was the accumulation of risk.

We weren't working—a market maker doesn't manage its risk profile because it likes housing or doesn't like housing. Those are separate. We have various pockets of—excuse me. We have various pockets of Goldman Sachs that like a position or don't like it. What we do is risk management. Because we had this risk, because we were accumulating positions, which, by the way, we acquired from clients who want to sell them to us, we have to go out ourselves and provide and source the other side of the transactions so that we can manage our risk. These are all exercises in risk management.

CHAIRMAN ANGELIDES:

Well, I'm just going to be blunt with you. It sounds to me a little bit like selling a car with faulty brakes and then buying an insurance policy on the buyer of those cars. It just—it doesn't seem to me that that's a practice that inspires confidence in the markets. I'm not talking about your own...

BLANKFEIN:

Every purchaser...

CHAIRMAN ANGELIDES:

I'm talking about betting against...

BLANKFEIN:

... is an institution probably professional only investors dedicated, in most cases, to this business.

CHAIRMAN ANGELIDES:

Representing pension funds who have the life savings of police officers, teachers...

BLANKFEIN:

These are the professional investors who want this exposure.

Let me ask you...

CHAIRMAN ANGELIDES:

OK...

BLANKFEIN:

In the current market today, things are...

CHAIRMAN ANGELIDES:

Let's move on. Let's—because it's time...

BLANKFEIN:

I think these are important matters. I think this is one of the most critical questions that are resolving around here.

CHAIRMAN ANGELIDES:
OK. And then I have a question to follow up on this.

BLANKFEIN: No, I understand. We are sitting here today with people commenting in the press, gee, the equity market is being driven by more bubbles because of the liquidity in. Others are saying the equity market is right and we're in the recovery. No one really knows, yet people are coming to us as a market maker—I want exposure to the equity market; I don't want exposure to the equity market. We are dealing—we have to make sure the products do what the products say, that they're honest, that their disclosure and their laws—but we are dealing—we are an institutional firm, and this is the highest part of the institutional market.

Even today, by the way, people are coming to us for exposure to these very instruments, not at a hundred cents on the dollar but $0.08 on the dollar because they think it's going to be worth $0.12 and other people are saying it because they think, at $0.08, it's going to be to $0.04. That's what a market is. And our role as a market maker creates the...

CHAIRMAN ANGELIDES:
I do know what a market is, but I want to ask you this question. Did you always disclose to every investor that, in fact, you were taking the contrary positions? Or are you just—just yes or no? Is that consistently disclosed?

BLANKFEIN:
We were selling as a principal. When we sold, we were selling something that we had owned.

CHAIRMAN ANGELIDES:
Then let me ask you one final question.

BLANKFEIN:

They owned it, and we didn't.

CHAIRMAN ANGELIDES:

Let me ask you one final question on this topic very quickly in terms of—as a principal which is: In September 2004, the FBI's head of the criminal division warned that mortgage fraud was so rampant in this country that it was a potential quote-unquote, "epidemic" and that, if unchecked, it would result in a crisis as big as the S&L crisis. Did you take any specific steps in the wake of that 2004 crisis to evaluate the mortgages that you were selling into the marketplace?

BLANKFEIN:

Well...

CHAIRMAN ANGELIDES:

If you don't...

BLANKFEIN:

We were not an originator of mortgages...

CHAIRMAN ANGELIDES:

No, but…

BLANKFEIN:

We acquired mortgage.

CHAIRMAN ANGELIDES:

Correct.

BLANKFEIN:

We did—we are audited and reviewed and subject, and we have due diligence practices that we think were robust. And so the answer is people can examine what our due diligence processes were, but as I sit here, I have no reason to think they weren't robust.

CHAIRMAN ANGELIDES:
OK. Let me...

BLANKFEIN:
Would I do more now? There's no—listen, there's no –after acquired information I've ever had that wouldn't change my behavior in some respect. Anyone who says I wouldn't change a thing, I think, is crazy. Knowing now what happened, whatever we did, whatever the standards of the time were, it didn't work out well. Of course, I'd go back and wished we had done whatever it took not to be in the position that we find ourselves.

CHAIRMAN ANGELIDES:
All right. Let me ask one very quick set of questions about risk. In your testimony and, in fact, written and today, you spoke about your risk management rooted in accountability. And, today, you talked about, of course, none of us know where things are going, so we have to prudently plan for risk. And I think, you know, you make the point that you had profitability in 2008, but I want to press you a little on this because I think it goes to maybe the overall context of risk as it was perceived and, hopefully, won't be perceived again.

At your firm, you tripled your assets, almost, from about 403 billion to 1.1 trillion from 2003 to 2007. That's an annual compounded growth rate of 29 percent when GDP was growing at 1 to 3 percent. Your leverage ratio, when measured against tangible equity, was 26 to 1. By some analysts' measures, 32 to 1 against common—tangible common equity. You've even made the observation—or a couple of folks here—about the dependence on short-term liquidity, which exacerbates that.

And then, as a balance-sheet matter, there was extensive hedging, I assume, because of the significant leverage and maybe the opacity or the risk profile of the assets you held. In the end of the day—and I'm going to press you on this—it seems to me that you survived with extraordinary government assistance. There was $10 billion in TARP funds, $13.9 billion as a counterparty via the AIG bailout.

By your own Form 10-K, you said that you issued $28 billion in debt guaranteed by the FDIC, which you could not have done in the market but for that. You were given access to the Fed window and the ability to borrow at next to nothing. You became a bank-holding company over the weekend. You had access to TALF. You benefited from a ban on short selling, which you initially opposed, which Mr. Mack had advocated. And you got relief—some relief from mark-to-market rules even though I understand you were assiduous about marking to market.

I guess when you look at the amount of leverage that you had and you do look at your rapid growth, do you really believe that your risk management in the big picture was sufficient to have allowed you to survive but for that government assistance which I laid out?

BLANKFEIN:
Well, there's a lot of predicates to that question. The fact of the matter is we were—much leveraged now, so you could take that as a vote that we wish we were less leveraged then. But when you look at the leverage of companies and people are throwing out 30 to 1 or 40 to 1, our high watermark was actually a fraction of that. It was about 20 -- which was kind of small.

BLANKFEIN:
A lot of that included cash on our balance sheet. I think we did a very good—we had tremendous liquidity through the period. But there were systemic events going on, and we were very nervous. If you are asking me what would have happened but for the

considerable government intervention, I would say we were in—it was a more nervous position that we would have wanted in. We never anticipated the government help. We weren't relying on those mechanisms.

When you think of that extraordinary week after Lehman Brothers, which was the most hard, tense week there was, that weekend when we became a bank holding company, the next day we capitalized ourselves in part privately with Warren Buffett, and the day after that we did a capital raise for $5.75 billion, which you could have made a lot higher. We had access to the capital markets, and we could have made it more, and we weren't relying on that government help. That government TARP legislation came about three weeks later.

That being said, do I—I don't know. I can't say here and tell you what would've happened, and I know for sure no one else knows either. I felt good about it, but we were going to bed every night with more risk than any responsible manager should want to have, either for our business or for the system as a whole—risk, not certainty.

Even after the TARP was done, roles were implemented. Did that exempt us from risk? No. And as you point out, there's still risk today. But the question doesn't have to turn on would you have gone under but for, would you have made? The fact is the world was unsafe. The government, regulators, taxpayers took extraordinary measures to reduce intolerable level of risk to a much more tolerable level of risk, and that we should all be appreciative of.

CHAIRMAN ANGELIDES:
And the reason I—look, the reason I press this is not to make you say "uncle," but, you know, in—in kind of lay terms, what was done at investment banks, different risk profile, the more regulated commercial banks is extraordinary leverage—I mean the akin to a small businessperson who has $50,000 in net worth or a family borrowing $2 billion in some instances, $1.5 billion -- $1.5 million with much of that money due overnight.

And what I'm trying to drive to is whether there is a clear recognition that despite all the risk models, on a fundamental basis excessive risk was being taken, notwithstanding all the models that existed.

BLANKFEIN:
Well, I—as I said, I concede with the—looking now, and again everything is context driven, and I couldn't be more clear. After 10 benign years in the context where we were, look, how would you look at the risk of our hurricane? The season after we had four hurricanes on the East Coast, which was absolutely extraordinary, versus the year before, rates got very low for risk premium on the East Coast of the United States. That year, after four hurricanes, everyone's nerves were such—rates went up spectacularly. They're lower again.

CHAIRMAN ANGELIDES:
But I'll...

BLANKFEIN:
Is the risk of four hurricanes any different any of those times?

CHAIRMAN ANGELIDES:
Mr. Blankfein, I want to say this. Having sat on the board of the California Earthquake Authority, acts of God we'll exempt. These were acts of men and women.

BLANKFEIN:
I'm just saying that you're asking me a question...

CHAIRMAN ANGELIDES:
Now, these were controllable is my only observation.

BLANKFEIN:

I agree. I sit here and read testimony to the effect of reducing our balance sheet, raising capital. Clearly, we are much less leveraged now. Consequently, I wish we were much less leveraged then, even though we were much lower leveraged than others and we had cash on our balance sheet and we did better than under those circumstances. But if you're asking me would I do something differently, knowing what I know now with respect to that capitalization, how could you not? Of course.

CHAIRMAN ANGELIDES:

But I also wanted to put in context the level of risk and the level of assistance, because this is something I think no one would want repeated again. Let's do this, then. Let's now move to questions from other commissioners. I'm going to stop at this moment and move to Vice Chairman Thomas. Thank you very, very much.

BLANKFEIN:

Thank you.

VICE CHAIRMAN THOMAS:

Thank you, Mr. Chairman. I think context is important. You mentioned earthquakes and how familiar we are in California with earthquakes. Mr. Blankfein, you talked about context. I think as we conduct these hearings and talk about the problems that were encountered and how close we came to a catastrophe, that right now in Haiti by one of those acts of God there is an enormous catastrophe. There are thousands of people, and I think the number of deaths will shock a lot of people, if you've never been to Haiti or Port-au-Prince, in terms of the living conditions that were there, subject to the deathtraps available.

I think the general question that everybody wants to ask, and you said it four different ways, and I'll put it in— in the overall overarching way that if you knew then what you know now, what would you have done differently? That may or may not help us as we go forward, but I said at the beginning that what we've been doing is a lot like an iceberg.

You can only see one-eighth of it. Seven-eighths of it is underwater as it comes toward you.

You've been kind to come, and we have a lot of commissioners who want to ask a lot of questions. Mr. Chairman, I want to ask of these witnesses, and it will be applied to all of the witnesses, that we have very limited opportunity at this time to ask questions. We would very much like to submit written questions to you and receive those answers.
The other thing, this commission is also subject to if you knew then what you know now, would you ask different questions? We're only around for most of this year. We have to conclude our work by the end of the year.

Obviously, you start with fact-finding. You begin coming to conclusions. You collect those conclusions. And we will publish our findings after the end of this year.
But the questions that we would ask now perhaps wouldn't be as insightful or appropriate or useful as questions we would ask three months from now, four months from now, based upon our also informing ourselves. So I would like the request in terms of submitting written questions to be applicable during the entire time that we operate.

As the chairman said, you may or may not return to us. But I—I do hope you'll be willing to be available, notwithstanding not—not being available in person, to continue to assist us in our job of trying to explain to the American people what happened. Is that something that's acceptable to you gentlemen?

MACK:
Yes.
BLANKFEIN:
Yes.

VICE CHAIRMAN THOMAS:
Thank you. And in trying to form questions, I know there are a lot of people who want to be in one of these coveted chairs in terms of an opportunity to ask a question, and I'm

sure there are those in the room representing the media—in fact, I think we have an excellent example in this morning's New York Times, and it was also in yesterday's New York Times—of people who if they don't own, they have available ink by the barrel, who decided that they would ask their own set of questions.

So, Mr. Chairman, my questions to begin with will be those that were submitted by the New York Times. And we would ask you to answer those in writing, and then in fact give everyone in America, Mr. Chairman, the opportunity to be in that same position.
And I think it's most appropriate to tell anyone who's listening, watching, or hopefully will read anything about this hearing today, that the opportunity to submit written questions to who it is that you wish that question to be submitted is an opportunity that ought to be available to all Americans.

And so, Mr. Chairman, I take this opportunity to say anyone who wants to write me, Bill Thomas, at fcic.gov, and submit a question, we'll do the best we can to get you the answer. More importantly, the broader, the greater number of people who ask and the broader the questions, no matter how trivial in terms of some pundit's point of view, it's a question the American people want answered, and I think that will be part of our job over this year to answer those questions.

So we may be back to you not with our questions, but was questions that have been supplied to us by people who perhaps thought that some of the answers we're—some of the questions we're going to hear today weren't the ones that they would've asked.

VICE CHAIRMAN THOMAS:
Mr. Chairman, this is relatively unusual, because usually we will close the record after a period of time. Given the job we have and the time in which we need to do it, I would ask unanimous consent, Mr. Chairman, that every hearing's record remain open, that questions submitted either during the hearing or submitted to us—I'd kind of like to channel it to those that are submitted to us because if we open it up, every editorial every day will be a list of questions that just came up. But we can handle that as well. Our job

fundamentally charged by Congress was to get to the bottom of what happened, but most importantly, explain it in a way that the American people can understand.

We have assets with you gentlemen in front of us. We'll have additional assets. We need to utilize all the resources available to produce the document which we hope will assist Americans in understanding what happened primarily for the purpose, as you indicated, Mr. Blankfein, to know what we should have done had we known now what we knew then. And our job by the end of this year will—to be smarter, to ask the best questions we can, but to rely primarily, Mr. Chairman, on every American's opportunity to sit figuratively in this seat and ask the question they would have asked. And that should be agreed to by everyone. And I will then begin channeling those questions that come to us. And obviously, as I said, the first questions are on page A-27 of this morning's New York Times. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES:
I will now call on the commissioners for questioning. I'm going to start with Ms. Murren.

MURREN:
Thank you, Mr. Chairman.
My first question is to Mr. Blankfein. A question for you about AIG. Could you talk a little bit about when the government supported AIG and enabled them to close out your exposures to risk at AIG? Did anyone ask you at any point to take anything less than a hundred cents on the dollar?

BLANKFEIN:
I never got a request myself about taking less. It didn't come up in the—it didn't come up in any conversation that I can recall. Subsequently, somebody in my organization who was going back and forth with some of the—this was after the AIG. This was a couple of months later at the time when they were closing out a portfolio—I think known as Maiden Lane 3 -- told me that he got a question to the effect that—that in case—that at least contained the inference that he—he drew—would you be willing to take less.

And he said he couldn't answer that question now himself at his level. And he then said it never came back up again to him. And as I said, it never came back to me.

MURREN:
Did he further that question up the chain of command at your firm at any point?

BLANKFEIN:
I think he—I can say I didn't get it. I—I—I didn't get it. He might have—he might have told his boss.

MURREN:
Could we talk a little bit about your—your interactions with the regulators? In particular, when you think back on the events of 2007, 2008, there are obviously a lot of people that participate in risk management that are either internal or external at your firm. They're regulators. They're auditors. There's internal audit. There are your external auditors. They're committees of your board. At any point did any of those entities or individuals raise the issue of the quality of the assets on your balance sheet or of the leverage that you had at any point during 2007 or—or later?

BLANKFEIN: We're a mark-to-market firm. So—and we have businesses, important businesses that—we have distressed businesses. We have businesses that specifically go out and buy distressed assets. But they're marked correctly. So our auditors wouldn't say I like this asset, I don't like that asset. Our auditors would say is this—is this asset appropriately marked. And we engage on them. And—and I think I talk to the auditors each time. And they—you know, they tell me we do a very, very good job.
We not only mark them, we go out and the best I can, get external benchmarks and go out and test the marks.

So it's not a matter of—we will today—today we would go out and if a client came to us and wanted to sell us a very distressed portfolio, Lehman Brothers debt or anything like

that, we would have a bid for it. That's our role in the market. We buy it. They could get it off their balance sheet. We'd have it on our balance sheet. But it has to be marked correctly. That's the real issue. Is it marked correctly?

MURREN:
And it sounds like you have quite a bit of discretion in that regard in that it doesn't sound like there was a lot of challenge to the kinds of marks that you were making.

BLANKFEIN:
I'm sorry. There is huge challenge in our organization. We spent a lot of time. Our control system...

MURREN:
I was referencing outside of your organization, specifically your auditors or the regulators.

BLANKFEIN:
Oh no, they go over—they go over our—our—our books and records. It's a very, very long process. They not only audit the marks, they audit the processes by which we get the marks. And they test them.

MURREN:
So then would you—do you think that in light of what's occurred that they were doing a great job?

BLANKFEIN:
I think they did—you know, again, I'm living within the—I'm answering it within the—the scope of my knowledge. I mean, I don't engage with the audit process. I get a summary, and I talk to the audit partner. And I'm a member of the board, and so, I receive it there. So there's limits to what I can tell you in assessing them. But we're quite satisfied—we're satisfied with our auditor. Otherwise we wouldn't have him.

MURREN:

And the regulators as well?

BLANKFEIN:

Well, we went through a—we went through a—an evolution of our regulators, if you know—I mean, obviously, we were regulated—during the period, we were regulated by the SEC as our primary regulator. That was a—that—even that was an institution that came in with the last few years where you had one main regulator. And then that regulator, of course, switched when we became a bank holding company, which would have been in the fall of '08.

MURREN:

But it is their responsibility, am I correct, to help you determine what risks you may or may not be undertaking as a firm? Is that right?

BLANKFEIN:

I would say help to determine what risks. I think of it as that they surveil us and we in the first instance would try to do something. We're always disclosing to them what we think. It's an ongoing process, not that they—we do something, they look at it, we engage them. There's an open—it's—I mean, this is the intention of the process, to be engaged. But then they look, and very critically, if they didn't like it, they wouldn't let us do it or would stop us from—I mean, that's their—that's their role.

MURREN:

And do you think that there should be more...

BLANKFEIN:

But our...

MURREN:

... surveillance in that regard and more supervision of the kinds of activities that are undertaken by investment banks?

BLANKFEIN:
Well, first of all, there—there is—I mean, there has been a clear demarcation between the sociology, for example, of our regulation before and after becoming a bank holding company. So before that with the SEC, which was kind of new as a prudential regulator, I'd say the—the regulation of the Fed is a lot more—you know, a lot more apparent and there. I mean, every day dozens of people from the New York Fed come to work in our building, not as employees of Goldman Sachs, but as employees of the Fed. But this is their place where they do business. And they come in, and they know every part of our business, look at papers, our processes, procedures and are very, very—there's—so it's a different—our regulation is different now.

MURREN:
So is there a yes in there, that there should be more regulation, more supervision?

BLANKFEIN:
Well, there should have been more than there was in September under the old regime. And right now, given that we're still catching up, this is our first year under the Fed, I can't assert that it's not enough. It feels—it feels much different. It feels like a lot of regulation, and appropriately a lot. I can't say now that it's not enough.

MURREN: But things—do you feel as though they've changed and they're better in regulatory—from a regulatory standpoint they're improving?

BLANKFEIN:
I think we have a very, very tough regulator. I can't tell you whether they improved because to us it's a new regulator, not necessarily to everybody on this panel. Because again, we—we acceded to this regulator as— as a result of becoming a bank holding company in September '08.

MURREN:

Thank you. I have one final question, Mr. Chairman.

CHAIRMAN ANGELIDES:

Absolutely. You have—you have time.

MURREN:

I was struck, actually, by—you mentioned several times that your behavior, either individually or as a corporation, was really within the context of what is considered standard for the times. And given that we're now in— in 2010 and we have unemployment at very high rates, foreclosures are high, many people are really suffering right now -- given that these are the standards of the times, could you please comment on your compensation and that of your senior executives?

BLANKFEIN:

First—you know, first as to the standards, I mean, I'm not—what I meant to convey is I'm not sure -- again, I haven't surveyed what the standards of the time were. But let me say—and people will go back and test this, I'm sure, and look. I know the standards of times were different than what we are now. And so, the way I was asked that question, how do you rate yourself in terms of negligence of what you should have done—I'm just saying it would have to be compared to what the standards were.

Those standards, when you look back in hindsight, should have been elevated. And, by the way, that could also be another source of—of incorrectness. Maybe we should have been a part of those who—who elevated those behaviors. But that's what I meant to convey. I wasn't saying that those were fine. I'm saying that when you asked me what the standards were, again, that's how we—that's how we would measure ourselves, in terms of what we were thinking. Now, you asked me a question—you asked me...

MURREN:

Thank you for clarifying that, but the question that I'm asking really relates to where this country is economically. And also just—you know, I noticed that in your 2007 annual report that accountability is listed as one of your firm's core values.

BLANKFEIN:
Sure.

MURREN:
How do you—how can you reconcile these things, given what's going on in the country economically? And do you feel that your compensation adequately reflects your firm's behaviors, what the standards of the times are? And do you think that you have a compensation structure in place that will hopefully reward people for taking a longer-term view as opposed to maximizing their short-term profitability?

BLANKFEIN:
You know, Commissioner, the last compensation we did, which was in '08 -- and we haven't announced any—we haven't announced our compensation yet, our year-ends. We announce our results for our year next week. But I think, in '08, which was a cycle which we already went through in—in—in the heart of this—in this—in this—in this downturn, we took our firm-wide compensation down, and this includes people whose compensation is hard to take down, because they are secretaries and staff, our overall compensation went down 50 percent, about 50 percent, which was in line with—that's—which was in line with our performance.

The senior-most people in the firm were down 80 percent, that group. And the named executive officers— myself, the COO, the vice chairman, the CFO—bonuses were down 100 percent. We took no bonus. So—and I think, given the circumstances, that was quite appropriate. And so that, as far as our structure, we have always had our work—and if you'd look at the history of our compensation, the compensation always correlated with the—with the results of the firm, as it did last year, as it did—as it did last year.

And that's something that emanates—you know, we've been a firm for 141 years, but it's only the last 10 years that we've been a public company. We've been a partnership where clearly everyone in the firm had all their wealth, all their accumulated compensation, stayed in the firm, virtually, until they retired, and everybody got paid in an ownership interest in the firm. And most of our people, all the senior people get the predominant amount of the compensation in shares, and that's been true for years, and we've just even ratcheted that up to the point where our senior committee is only getting shares.

MURREN:
It's an interesting point you raise about the change in your structure, because there are some who would say that now as a public company that there's more of an incentive to take excessive risk because it is no longer a partnership structure, and thereby the risk is shared by your shareholders, not so much necessarily the partners of the firm. And also, just I believe—if I'm not mistaken—that your compensation was not down as a percentage of your revenues last year, so two-part question.

BLANKFEIN:
Well, I think our—the firm's compensation was down in accordance with the revenues.

MURREN:
I see.

BLANKFEIN:
I didn't say in excess of revenues. I said there was a—there was a—there's an exceptionally close correlation.

MURREN:
And the partnership structure?

BLANKFEIN:

And the partnership structure, we still have the people in the firm, the partners, get paid—a lot of their compensation is in shares. Most of the senior people—most of the compensation of senior people is in shares and that they have to hold—I would have—I am obligated to hold 75 percent of those until retirement, actually, post-my transaction with Warren Buffett, 90 percent. So I would say the senior—the people of Goldman Sachs are—have their results, have correlated with the success of the firm.

MURREN:
Thank you. Thank you for answering my questions.

CHAIRMAN ANGELIDES:
Mr. Thomas has a follow-up on his time very quickly.

VICE CHAIRMAN THOMAS:
Did I understand, in terms of your answer, that you're now providing compensation in part in shares?

BLANKFEIN:
Well, we always...

VICE CHAIRMAN THOMAS:
You always did?

BLANKFEIN:
... provide—as a public company, when we had shares. Prior to having shares, partners only got paid in interest that they had to keep in the firm, except for a—a stipend, in effect.

VICE CHAIRMAN THOMAS:
Mr. Dimon, in terms of the question that was asked of Mr. Blankfein, could you give us a before-and-after, if there's been a change in the compensation structure? Have—have

you changed your compensation after the, quote, unquote, “downturn” to require some equity time prior to receiving that...

DIMON:

So, recently, you saw the G-20 and the Federal Reserve and a lot of people brought up compensation principles, which we generally agree with, but we have always had the following principles, that senior people get paid a lot of their compensation in stock. It’s generally been 50 percent to 75 percent, higher for me. You have to maintain ownership of that stock, 75 percent of it as long as you’re part of the senior management committee. We’ve had certain claw backs.

It’s always been risk-adjusted, so we look at the amount of risk you’re taking before we actually unnecessarily pay their compensation. And—and we don’t have things like special change of control parachutes, special severance packages, things like that.

VICE CHAIRMAN THOMAS:

Mr. Mack?

MACK:

We’ve always paid a large portion of our compensation in equity. We have increased it for the most senior people up to 75 percent, which they have to hold. The only thing new we’ve done, sir, is we’ve put a claw back provision in now, so some of the bonus we’ll have access to, up to three years. If a trade turns bad into the new year, we’ll be able to go in and take that back. That’s been the big change.

VICE CHAIRMAN THOMAS:

Mr. Moynihan, you’ve got a new position, but you’re not new, so you can tell me about BofA.

MOYNIHAN:

We've had a tradition of paying in stock, likewise—like Mr. Mack said, in our firm, also, for this year, we've instituted claw backs to better match the duration of the risk, so something somebody does today we can look at in two years and actually claw back against their compensation.

VICE CHAIRMAN THOMAS:
And both of you said instituted this year. That means that's an ongoing change in your compensation, not just for this year?

MOYNIHAN:
It's part of our compensation scheme, but paying in stock has been part of our compensation scheme for a long, long time.

VICE CHAIRMAN THOMAS:
Thank you.
Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES:
Thank you, Mr. Vice Chairman.
Now, Senator Graham?

GRAHAM:
Thank you, Mr. Chairman. My questions go to the issue of incentives. Incentives are the things that are intended to shape or direct behavior and performance. We've talked some about the form in which those incentives are taking. I'm interested in what are the underlying goals of those incentives. Mr. Mack, you said that you closely linked compensation to performance. What are the primary elements of performance to which the compensation is linked?

MACK:

Well, number one, I think the first criteria we look at is clearly profitability. And then as you go from profitability, you look—if you go into the sales and trading area, which most of these questions are focused on, is how much risk they take to have that profitable performance, how much interface they have with other senior members of a sales and trading operation to make sure communication is what it should be.
We also look at the interface that ourselves and traders have with our clients and what kind of interface is that. And, most important, one of the things that we look at is, how do our risk managers—and these are risk-takers --how do they interface with our risk management team? These—these are people who report directly to me, do not report to sales and trading, but oversee the soundness and safety of the kind of risk we do take. And under that, we have put a lot more resources, Commissioner, into that process and put a number of people to work in creating models to make sure we can monitor that risk.

So if you go to risk management, as an example, you say to yourself, clearly, given what we've been through in the last few years, that individual needs to be paid, who runs risk management, not on profitability, but needs to be paid on safety and soundness. Is he or she doing their job to make sure that we're not taking excessive risk, that we have liquidity in our risk positions?

MACK:
So when you say, "How do you pay?" you need to go department by department. So, many departments, if they're support areas—let's take the I.T. function—where we're doing a lot of work, especially now that we report to the Federal Reserve, in building our models and building the ability to measure the kind of risk we take on our balance sheet. So they're—they're paid differently, but they're paid on what do they produce, and how quickly they get it online, and does it work? But broadly speaking, each group within the firm has certain goals, depending whether they're support services, marketing services, risk management services, or trading services. And then, again, we could go into investment banking, how we look at each one of our bankers.

GRAHAM:

From your answer, I got the impression that, in the risk area, for instance, that most of the measures of performance are a process. Do you then go back and assess whether that process actually resulted in greater or lesser risk and that that—those outcome measures become part of performance?

MACK:
We definitely go back. And one of the things we've done recently, sir, is create a separate risk committee of the board where risk management will report to them. Risk management, we do look at those process, we do evaluate them, but more importantly, those are—those are decisions that are almost instantaneous. So as soon as a new risk comes on the books, it's the responsibility of risk management to analyze the impact it would have on our value at risk. How much risk are we taking? Are they liquid?
So the answer to you is yes.

GRAHAM:
I guess my question is, your testimony and the testimony of your—of your other colleagues this morning, some of those decisions by virtue of time have been shown to—to have been excessively risky and put the financial system—contributed to putting the financial system in the shape that it is. Have those actual outcomes of risk analysis, particularly where they were turned to have untoward outcomes, did they become part of the performance evaluation?

MACK:
They did. But, again, as the chairman said, we want to be brutally honest. There's no question that we had not put enough resources into our risk management system.

GRAHAM:
Do any of—do any of you and your performance standards include aspects that are external to your own firm? One of the justifications for your role as an intermediary is that, for instance, you are wise people in determining how to allocate resources to the benefit of the overall economy of the country. Do those kinds of considerations—how—

how much have your decision-makers contributed to economic growth, job creation, those things that affect the general economy? Are they part of the performance measure?

MACK:
Well, clearly, given what we've been through and the pain that homeowners are going through, and the people losing their homes, we have been very direct in our mortgage area to make sure—and I think I gave you a statistic that we're about 44 percent, with all of our mortgages that we hold—have renegotiated the payments. So in that aspect, the answer is yes. But when you look at some of the automobile companies who we have loans to, you know, those loans are—are made based on how much risk we're taking. We know those automobile companies or other industrial companies need loans, but we also have a fiduciary responsibility to make sure that we have done our due diligence and it's not the same social push as we do in home loans and our mortgage facilities.

GRAHAM:
In terms of evaluating—and maybe I'll turn this question to Mr. Moynihan—as among potential sources of—of investment for growth, how do you then relate those judgments as to the compensation of the executives and other personnel responsible for making those decisions?

For instance, there's—there's concern that maybe an excessive amount of—of capital was placed in the housing market to the detriment of other areas of the economy. Is that a factor that is considered in your performance evaluation?

MOYNIHAN:
I think the—a specific factor I'd say no. No, sir. But in terms of generally how we build our financial plans and how we think about how we grow our business, we make allocations of capital, and then one of the goals of a executive or a person working is to make that financial plan, and that—so it indirectly factors in. But specifically we don't relate someone's individual performance into a broader social question of how to allocate capital in the financial system.

GRAHAM:

How—in retrospect, looking back over the last decade, how effective do you think your performance standards have been and the compensation that they have generated to achieving goals of the—of your institution and the broader economy?

MOYNIHAN:

I'd say that, like my colleagues, we could do a better job of aligning, really, in some areas the timeframe of which a risk can be taken on by a decision today that could come true or not down the road. We've also do that through the holdbacks of equity and claw backs that we'd have in other areas, like credit card, where you make underwriting decisions today and they turn out to be true later. But that is one of the changes that we've made in the incentive plans, as we—for '09 and '10, and it will continue to hold, because I think we learned a lesson in—over the last several years that the—the nature of the underwriting—it takes time to figure out whether a decision made today comes true, and that's the claw backs and stuff we put in, so we're trying to address that, sir.

CHAIRMAN ANGELIDES:

Senator Graham, one—one minute.

GRAHAM:

Yes. Well, one last question to Mr. Blankfein. Your firm about 10 years ago changed from being a partnership to a publicly held corporation and now you changed again to a bank-holding company. How have your approaches to performance evaluation changed, or have they, as you have changed the structure of Goldman Sachs?

BLANKFEIN:

I think we've—owing to becoming a public company; I—I think we stayed and tried very hard to stay—keep the partnership ethic. So, for example, there are elements of our

compensation scheme that might be a little different. It suits our culture, and it suits our history, might not suit everyone's. So, for example, no one at Goldman Sachs gets paid solely out of his or her own performance, not traders, not salespeople. Everyone gets paid partly on the base of the firm as a whole, their business unit, and, of course, we take account of their own performance, but the object for us is to keep going with that spirit of partnership and cooperation and teamwork, and also, by the way, an incentive for everyone to surveil everyone else around him or her, because we make everybody co-responsible for each other.

So that's—that would be a distinctive element of our structure that wouldn't be—but in terms of metrics and looking at it and scrutiny, it's—you know, it's pretty—it's—it's—we try to keep it. The big change for us is not becoming a partnership. It's becoming a much bigger global company, where there are—we still call them partners, partners of Goldman Sachs and staff in Beijing and far-flung places, where as 20 years ago clustered around some American cities and maybe London, maybe Tokyo.

GRAHAM:

Just one last question. Has the percentage of your total revenue, which is distributed in compensation to your partners, changed as the legal status of Goldman Sachs has changed?

BLANKFEIN:

In the status situation, in the old regime, everything that was left over belonged to the partners. They were effectively the shareholders. Since—but I will say, in the 10 years or so as a public company, we have been—we started out and said to the world that we will start looking at the beginning of every year like it would be about 50 percent, and it's just gone—it's largely gone lower, largely gone lower for the good reason that our revenues had often gone higher, and so you didn't need to pay—pay as much. And in the overall effort of what to do—you know, one of the—one of the problems that I think, you know, we have is what we do a lot for the economy isn't that visible as an investment bank. We help allocate capital. We raise. We do—we put companies together.

BLANKFEIN:

We launch new businesses by raising capital in the process, but it really doesn't interface a lot. It doesn't interface enough with the people who we would want to understand what our role is in the system. And so recently, we've embarked on a program, which we call 10,000 small businesses to try to get Goldman Sachs to apply itself to that issue to deal with something that's on a dimension that's close to what's needed for the current moment.

CHAIRMAN ANGELIDES:

All right. I'd like to move this along. Thank you very much, Senator Graham. And on my time— and I'm going to ask one follow-up question to Mr. Mack with respect to the senator's questions. And that is: Just very succinctly, what's the pay structure and amounts for risk managers versus traders? And what's the kind of ratio?

MACK:

Well, I would say that we've been very clear, especially in '08, when we changed our head risk manager that happened to be a gentleman, who many years ago was a trader, that he can make the same kind of money that our best trader can make.

CHAIRMAN ANGELIDES:

But that has not been historic?

MACK:

Historic, that's correct.

CHAIRMAN ANGELIDES:

So going forward...

MACK:

That’s the change.

CHAIRMAN ANGELIDES:

All right. Thank you very much.

All right. Let’s go—thank you.

Mr. Holtz-Eakin?

HOLTZ-EAKIN:

I want to pick up on that and ask a question a little more broadly of the whole panel. Each of you, in your testimony, talked about problems of managing risk and excessive risk. Mr. Blankfein talked about under pricing of risk that led to massive leverage across wide swaths of the economy. A discussion from Mr. Dimon about compensation practices and misjudgments about aggressive underwriting standards. Mr. Mack talks about not having sufficient resources to manage those risks.

And so each of the institutions you represent are publicly traded. They have audit committees. They have boards. They have internal auditors. And so my question is what is it about this traditional structure that failed us? Why is it that the risks that you have identified weren’t uncovered in the moment? And what specifically has each of you done, in addition to what you’ve discussed, to change your risk management practices since the crisis?

We’ll just start with Mr. Blankfein.

BLANKFEIN:

I think if I had to say one thing in specific—and a lot of—we focus a lot, a lot of efforts and always have on risk management and our senior risk managers rise to the highest levels, including our named executive -- one of our named executive officers is our risk manager. So it’s the highest level of the firm. I’d say the one thing that we constantly learn from every crisis—‘98, tech, this one, of course, which is a different level—is the need for more stress tests. Very often in our business, we go through the analytical

process of what could go wrong versus what is the probability of that going wrong. And, therefore, tend to discount the consequences too much.

What a stress test does, it just says don't tell me that this is unlikely; what if it did happen? But it's not going—what if it did? What I've learned after so many years in the markets is, given enough time, not everything can happen, but everything will happen. And, therefore, implementation of more stress tests.

HOLTZ-EAKIN:

So you've done that as a firm?

BLANKFEIN:

Yes, constantly.

HOLTZ-EAKIN:

And are these essentially of the type that we saw the Treasury conduct?

BLANKFEIN:

No. It's a little bit different. So you read in the paper, some anxiety over whether the emerging markets are having a bubble. So we look at that—we may read it in the paper, we may feel this swelling up, we may see it in the pricing of some assets. And it's far on the horizon because, actually, we're quite positive in our research about emerging.

But we said, OK, what if—what are the knock-on effects? What are our exposures to those places? What are our exposure to those places that have exposures to those places? And we go through a process of going around and assembling—OK, assume this happens. And we constantly, through our risk committee are doing those kinds of things which both help us to avoid problems but also tells us what to do if something happened. It won't be the first time we've considered it.

HOLTZ-EAKIN:

And the stress test process would be audited in the usual fashion? Disclosed?

BLANKFEIN:

Well, a lot of this has to do with our own internal risk committee functions. We, obviously, describe our risk committee, but this is an ongoing organic process.

HOLTZ-EAKIN:

OK. Mr. Dimon?

DIMON:

I say, if you do everything right in business, you are going to make mistakes. And you really have to look at the continuum of how many, how big. Even if you were right, you'll make some. Hopefully, they'll be smaller and won't be threatening to our your institution or anybody else. And the process is very rigorous. You know, if you look at—we have risk. We have a separate pricing group.

It's internal audit, external audit, and it's reviewed by the OCC and the Fed. I think when you have a chance to look at those things; you'll be pretty impressed with the diligence behind some of that process. And as a company, we always did some stress testing because history tells you that things go bad in the markets and you have to be prepared. That should never be a surprise, and you don't know exactly what's going to go bad or exactly what direction it's going to come from. When you look at a business—this partially answers the question that the senator was asking, too—we look at a whole balanced scorecard. So it's not—you know, if you are not financially successful, you fail. So it is, obviously, a sine qua non of doing business, but it is not the most important thing.

So if you were running a business for us, we'd say, are you building a great company for the future? Will you be proud of it? Is it sustainable? Are you building better systems, better processes, better people, better training? So we look at the whole thing. It is never driven by one metric, and I think you can get—make mistakes doing that.

And looking back, I also think, as a business, you have to look at what you did right, what you did wrong. And if you're not continually analyzing and improving it, you will not get better.

So I've already mentioned the biggest mistakes we made. In mortgage underwriting, somehow we just missed, you know, that home prices don't go up forever and that it's not sufficient to have stated income in home prices.

HOLTZ-EAKIN:
If you've been doing—you have been doing stress tests prior to the crisis?

DIMON:
Yes.

HOLTZ-EAKIN:
Did you do a stress test that showed housing prices falling?

DIMON:
No. I would say that was probably one of the big misses. We stressed almost everything else, but we didn't see home prices going down 40 percent. And that's now part of the stress test.

HOLTZ-EAKIN:
OK. Thank you.

Mr. Mack, you've answered about beefing up the...

MACK:
Sure.

HOLTZ-EAKIN:

But there are other things you'd like to...

MACK:

Well, let me just...

HOLTZ-EAKIN:

And how the traditional system failed.

MACK:

Well, I'll just add a couple of things. Our head risk manager sits right by the CEO—our new CEO, James Gorman, on the floor. So there's a real link with risk management and the most senior person in the firm. The other thing I just want to comment on—and this goes to Commissioner Murren's question earlier to Mr. Blankfein—I think with the Federal Reserve now as our lead regulator, the amount of focus and scrutiny that we get on risk, not just outright risk but the systems around risk models, how we test the models, even to the point, if we want to make an acquisition or make a major move, they're involved and ask certain questions that is very new, in my 40 years, with this new regulator. So I would say that I'd give high marks to our regulator in how—I don't want to use the word "intrusive"—how diligent they are in our risk and how we manage risk.

HOLTZ-EAKIN:

Thank you.

Mr. Moynihan?

MOYNIHAN:

I think, much like my colleagues, we have an independent risk management function—have had. And if you ask what we thought we missed, I think it would be similar to where Mr. Dimon said, which is if you think about it in a—as we support the broad economy in what we do, so we have—yes, we have the investment banking in a larger one now, but we've—the mistakes we made and the most losses we've taken have actually been in credit cards and mortgages. And that was just where we kept originating prime—prime

assets—too deep into the economy, and we didn't do the kind of testing you actually do in a trading book saying what if housing goes down 40 percent and test
what your thought would be irrespective of the probability of just how you protect your firm. And I think that's probably the best lesson we've learned out of this crisis and will apply. When you actually look on some of the commercial lending side, well felt that in the '89, '91 -- and so, therefore, we had a practice of that. On the consumer kind, we didn't have those kinds of practices. And I'd say, above
all, that's what we've actually implemented and we'll continue to make sure we are diligent about.

HOLTZ-EAKIN:
So you have, at this moment, stress tests that look at commercial real estate and the concerns that are out there now in picking up your exposures?

MOYNIHAN:
Yes, we have. As you said earlier, the work that was done last year about this time to put in a stress test and things like that brought firm-wide stress tests, but we've always had a view of commercial real estate really through with the hard knocks taken and the late '80's and stuff to be very diligent about what could happen, too.
I don't think the consumer side had ever seen this kind of recession, and that led us down a path that we've learned from.

HOLTZ-EAKIN:
A lot of this revolves around housing, and I want to pick up on something in your testimony, Mr. Blankfein, where you said—if I have this right—that almost all of the losses that financial institutions sustained over the course of the crisis thus far have revolved around bad lending practices, particularly, in real estate. Can you tell us exactly what those bad lending practices are off the top of your head? What are the list of things that were bad?

BLANKFEIN:

In the consumer area—and there are other people here who have consumer businesses—clearly, all that's been written about origination and Jamie referred to stated income without tests, and I'm sure he can pick up that cudgel and talk about on the consumer side.

On the more corporate side, I would say it had to do with leverage and it had to do with terms, covenants, conditions. The markets got more competitive. There was a sense that the world had a lot of liquidity. And so the commodity of money got less scarce and people paid less attention to it.

BLANKFEIN:
And as a consequence, people were lending to support transactions, which is a business that we're very familiar with, that had more multiples of debt for the equity and the conditions that applied—the covenants, the maintenance, the things that allowed a lender to intervene in the company became more and more lax, and so you could intervene less. So that lack of rigor on the—on the transactional side I think had its counterpart in the consumer side and in the commercial lending side, which others here are more familiar with.

HOLTZ-EAKIN:
Were you aware of this at the time? Did you see the standards going down? And if so, how did you highlight this in your risk management?

BLANKFEIN:
In all honesty, we did—we did know. You cannot miss the fact that the covenants are getting a little lighter and that the leverage is getting bigger. With the benefit of hindsight, I wish I weren't in the position of having to explain it. But at the time, I know we all rationalized the way a lot of people—other people—have rationalized. "Gosh, the world is getting wealthier. Technology has done things. Things are more efficient. Interest—there's no inflation. Things belong low. These businesses are going to do well." And I think we talked—much of the world did—talked yourself into a—into a place of

complacency, which we should not have gotten ourselves into and which, of course, after these events, will not happen again in my lifetime,
as far as I'm concerned.

VICE CHAIRMAN THOMAS:
Mr. Chairman, I'd like to extend an additional three minutes to the commissioner for his questioning, if he's interested.

HOLTZ-EAKIN:
Thank you.
If I could, I wanted to follow up with another piece of your testimony, where you said something to the effect that, you know, essentially too many institutions outsourced their risk management to the credit rating agencies, and ask you specifically did Goldman Sachs do that? Did it test the rating agencies' ratings? Did you look at products that were rated highly and do internal scrubs? And what was your experience in that area you've highlighted in your testimony? I'd like to know how Goldman looked at that.

BLANKFEIN:
I think we did some—I could think—I'd like to talk of the places where we were scrupulous and scrubbed ourselves, but you know...

HOLTZ-EAKIN:
I'm asking about the others...

BLANKFEIN:
I think there were instances where we also deferred. Not necessarily you're the only judgment—it was our judgment. You can't—just the same way you'd say you can't blame the regulator, and we wouldn't, we can't really blame a regulator for—for a credit agency for a decision that's our decision to bear the consequences of.

But I would say I would be more complacent when I saw something had AAA than if it had a AA or a AA then had a single A. So to that extent, I also must have been deferring to a rating agency.

HOLTZ-EAKIN:

And to close my time, I'd like to just ask Mr. Dimon to go back to the mortgage underwriting and your observations on how many—how so many bad mortgages could be written in the United States and the decline in lending standards.

DIMON:

Right. So it's really not a mystery, and it's kind of surprising. High LTV—a long time ago you did 80 percent loan to value loans. With proper appraisals it went to 85 percent, 90, 95, 100, even higher than that. Second is in the old days you had to verify your income, show a tax return or a pay stub and make sure the
income was there. And there was more and more reliance on FICO scores and people saying, "I earned this."

The third is that it went lower and lower on credit. So call it subprime, Alt-A, but basically as these things were taking place, they were more—more on credit. And you never saw losses in these new products, because home prices
were going up, people were making money. And—and in addition to this, I think it's also true there were some bad products and some bad actors and excess speculation.

HOLTZ-EAKIN:

Can you talk specifically about the bad products and bad actors?

DIMON:

Well, I think as it turned out, you know, option ARMs were not a great product. I think certain subprime, Alt-A products weren't great products. I think there were some—there were some unscrupulous mortgage salesmen and mortgage brokers. And, you know, some people missold. And there was a lot of speculation, far too

many people buying second and third homes using these things, as opposed to the place you're going to live.

HOLTZ-EAKIN:
Thank you.
Mr. Chairman, I yield back my time.

CHAIRMAN ANGELIDES:
Just a quick follow-up on my time, and that is that I mentioned earlier in—in September of 2004, the FBI made a clear warning about the level of fraud in the marketplace. And, Mr. Dimon, you indicated in your written testimony, and I think again today, that you excised most—I thought it was all, but I heard today most—mortgage brokers from—broker originated lending from your practice. And—and you were seeing default rates of two to three times. Just very quickly—and it's a yes or no, really, for the balance—did any of you excise broker originated mortgages from what you were securitizing, packaging and selling to the market?

BLANKFEIN:
No, we were securitizing broker-originated mortgages.

MACK: No.

MOYNIHAN:
No, not that I'm aware of.

CHAIRMAN ANGELIDES:
Did you not have that data?

MACK:
We were late in that process of securitizing product, and the only way we—we did sampling and testing, but we did not excise anyone who—that after the fact has come out

that were giving us faulty data. We did have the right, Mr. Chairman, when we found faulty data or faulty mortgages, to put them back to their originator, and we did that.

CHAIRMAN ANGELIDES:

All right. But—but it—OK, I'll leave it there. Thank you.
Let's now move on. Thank you very much, gentlemen.
Let's move on to Mr. Georgiou.

GEORGIOU:

Gentlemen, I'm a strong believer in the strength of the market system. And although regulation of the financial services industry is proper and necessary, despite their best efforts government regulators often lack the
resources and expertise to monitor adequately activities that create undue systemic risk.
So it is important for us to focus on creating market mechanisms that reduce the likelihood that risk-taking practices will get out of hand and
threaten the stability of the entire financial system.

Expert commentators have suggested that the crippling financial crisis was at least partially caused by inadequate accountability of those responsible for the creation of financial instruments for the consequences of their action, because they lacked, quote, "skin in the game." The investment bankers who undertake the fiduciary duty to conduct due diligence on the integrity of the security, the lawyers who draft the prospectuses, the accountants who audit the financials of the issuer, and the rating agencies, which rate the safety of the security, are paid their fees all in cash from the proceeds of the sale and thereafter suffer no financial consequence, whether the security succeeds or fails.

This system places the burden of loss exclusively on the purchasers, often pension and retirement funds investing on behalf of citizens who worked a lifetime, legitimately expecting that there will be sufficient resources available to fund their monthly benefits during retirement.

It has been suggested that this lack of accountability could be remedied, if all the firms and individuals involved in the creation of financial instruments had to, quote, "eat their own cooking," requiring, for example, that their fees be
taken not in cash, but in significant part in the securities they created, which they would be required to hold until maturity unhedged. So if a bond were issued that was to pay 7 percent interest per year for five years, then repay the capital
investment, the originators would receive their compensation on the same basis. If the investment banker who led the underwriting was entitled to a million- dollar bonus, he or she would receive the million dollars worth of securities, yielding $70,000 per year in income for the five years, receiving the million in cash at the end of the fifth year.
If the security failed to perform as represented, just like the investors, the originators would lose their expected annual income and the expected principal amount of their bonus.

Alternatively, some have suggested that investors should have a put for 18 to 30 months, during which time if the security failed to perform, investors would be entitled to a refund, requiring the issuer and the underwriting investment bank to buy back the financial instrument. These suggestions are in no way intended to punish the responsible individuals, but rather to improve the quality of the diligence they exercise in the origination of the security, knowing that their financial future, just like that of the purchasing investors, is tied to the success or failure of the security to perform as they represent it will perform.

And I would ask each of you whether you think that the volume created of illiquid toxic securities that contributed significantly to the global financial crisis could have been materially reduced by some such mechanism of placing financial responsibility where it belongs on those who originate financial instruments.

And I would respectfully request that you attempt to answer not as leaders of four of the world's most prominent financial institutions focused on maximizing your firm's profits,

but just like the commissioners on this panel, as Americans struggling to identify the root causes of this devastating financial crisis, and potential remedies to avoid its repetition. Mr. Mack?

MACK:
I have an answer first of all just on some of the product and the mortgages. We did eat our own cooking, and we choked on it, so—we—we kept positions, and it did not work out—not necessarily the positions specifically, but that part of the industry, the housing market. Number two, the idea to be paid in stocks or bonds for payment, I would do that. But I think it would be an issue with investors. Today, if we get that kind of payment, or in the past when we've gotten payment, especially with start-up companies, we've been criticized for holding back stock. It should be all distributed, especially if it's a successful transaction.

But as an industry point of view, you know, if I'm paid in stock or I'm paid in bonds that would not be an issue. I—I like that idea. But I think it would create some issues with investors. As far as your idea...

GEORGIOU:
I'm not sure I understand that point. Maybe you could elaborate.

MACK:
Well, let's say we have the next Apple computer company, wherever it may be. We do the underwriting. Instead of getting paid in cash, we get a certain amount of stock. The stock was hugely successful. It went up dramatically. I think people would want to make sure they have access to invest in stocks like that, or bonds that also do well.
The SEC in the past has been pretty clear that when we distribute securities, especially when they go up, we do not hold any securities back. They're all distributed to investors. So I think there could be a debate about should we be paid in equity or should we be paid in fixed-income instruments.

GEORGIOU:

Right. But you're customarily paid as a percentage of the issue when you—when you engage in underwriting. And so why couldn't that percentage of the issue simply be in significant part in the securities themselves, which would permit you to benefit substantially were it to rise, but would also permit you to lose substantially if it went down, just like the investors do?

MACK:

Again, I would welcome that. I think you would have to give us some leeway because markets are volatile—if markets are to go down, some way of hedging that. Other than that, I wouldn't mind being paid in equity or in fixed instruments.

GEORGIOU:

Well, but the problem is that the hedge itself undermines the whole notion of the concept, which is to place responsibility on you, the underwriting, the originator, the party that has the greatest access to the information, for the success or failure ultimately of the security, just like the investor.

MACK:

But if you are a very large underwriter of either new issues or fixed income, and we've just gone through a week of record issuance in the corporate bond market, you very quickly would fill up our balance sheets and you would have us in a situation that we'd have to curtail our business. So there has to be some way to adjust it. It could be a shorter period of holding the securities. That may work.

GEORGIOU:

Yes.

MACK:

But again, I'm not opposed to it.

GEORGIOU:

Or it might require more capital raising on your part to expand your business.

MACK:

Possibly, but we've raised a lot of capital and have very high tier-one ratios. It could.

GEORGIOU:

Right.

MACK:

The other part about a put back to us—you mentioned if the security has not performed. Again, there is a short period of time, oftentimes. If there is information that comes out right after a new issue has been priced, there are times that new information comes back and there is a put back. But to extend that over a long period of time is putting all of the risk on the underwriters. And some of you—some of you broadly, not the panel here—may think that's the right way to do it, but that would curtail our business dramatically and I think hurt the capital markets in the United States and also on a global basis.

GEORGIOU:

Mr. Blankfein could you comment on any of—any mechanism to—to put on the originators some responsibility for the...

BLANKFEIN:

I think it would be hard—hard to organize. I mean, we don't—directionally, trying to put some of the—more onus on the issuers, on the originators is probably a good idea. Some of these elements, you know, you can go back and forth on. I think the way the origination process and syndication process is designed; we're not supposed to be in conflict. We're not supposed to have a stake in it.

In other words, if we were going to originate a security and we were going to end up with some of it, we would have incentive to have the security sold at a lower price than the

higher price. And a lot of securities laws are designed to make us not have a conflict with the—with the client that's originating. But that's neither here nor there. If the overall theme is should there be some skin in the game. That could be a theme worth pursuing. The issues that John Mack brought up are all considerations that we'd have to take account of— clogging up balance sheets, having a conflict with your clients, because now, all of a sudden, you're not just someone trying to find the right price between a seller of a security—the person who needs the capital—and the investing public. You're now a member of the investing public.

And so that's—you know, those things would have to be sorted through.
The other point that he made earlier—how effective is that in terms of influencing behavior. In this—in this process, most of the problem wasn't, in my opinion, the cynicism of companies, which held these positions, even though they knew they were toxic, and motivation. They didn't know they were toxic. Why else would some of these balance sheets of some of these companies have many tens of billions of dollars of these securities? They were—it was a failure of risk management, I think, more than a failure of incentive. That's just my feelings...

GEORGIOU:
But wouldn't—but wouldn't...

CHAIRMAN ANGELIDES:
Mr. Georgiou, you have 20 seconds.

GEORGIOU:
But wouldn't the underwriter—wouldn't the entities, the originating entities be in a better position to know whether these securities had the possibility of becoming toxic? For example, if you—I mean, as you evaluated some of the CDOs that you created, wouldn't you be in a better position to know whether they were likely to fail?

BLANKFEIN:

Again, if your—you should be, in terms of your knowledge, you should be in a good place in both cases. In terms of incentive, I can't think of a bigger incentive than having $50 billion of the stuff accumulating on your balance sheet.

GEORIGOU:

Right.

BLANKFEIN:

And they had that incentive and it didn't work.

GEORGIOU:

OK.

BLANKFEIN:

I think it was a failure of competence more than...

GEORGIOU:

Let me ask one—let me just ask one question. Some of you talked about claw-back provisions. Have any of you actually utilized your claw-back provisions? And I wondered whether each of you, since I don't have time to hear your answers, I wonder whether each of you would undertake to advise us in writing of whether you've actually applied the claw-backs to people within your firms, without naming the particular person, but how much money you clawed back from them; what percentage of their compensation it was. And if you could provide that in writing, we'd appreciate it very much.

CHAIRMAN ANGELIDES:

Terrific. We're going to now take a—literally a five- minute break, if that would be desirable. But let's make it five minutes and get on back and get on with our business.

(RECESS)

CHAIRMAN ANGELIDES:

If everyone in the audience can please take your seats. Mr. Vice Chairman, we're going to roll forward now. OK.

Mr. Thompson?

THOMPSON:

Thank you, Mr. Chairman.

I'd like to take the discussion, if I might, back to the causes of the financial crisis. And as I reviewed the written testimony of several of you, particularly, Mr. Blankfein, in your testimony, you said that there were products that were created that served no purpose. What were those products? Why did they get created? Why weren't they regulated better? To what extent did those products that had no purpose contribute to this problem?

BLANKFEIN:

I'm not sure I—I think—at that point, I think I was talking—maybe I was talking about SIVs or those off-balance sheet. I think that there was regarded as a kind of an arbitrage, if you will, to have a company or a trust that invested in longer-term assets and financed itself short in the commercial paper markets. And that is a—that is a mistake that is as old as financial markets to make that that liquidity would be there and, ultimately, those risks contained in the assets that were acquired weren't—the vehicle was structured in a way to keep the risks off the balance sheet, but when they blew up, they suddenly came onto the balance sheet of institutions and created a lot of uncertainty as to the solvency of the institutions that sponsored them.

THOMPSON:

So we saw a collapse a few years ago of an organization that took down an awful lot of people and collapsed two companies, Enron and Anderson, where underneath that were a set of instruments that were off-balance-sheet financed items.

BLANKFEIN:

Yes.

THOMPSON:

And many, many statutory changes were made to govern organizations to make sure that they didn't do things like that again. How could that have occurred in such a massive scale this time?

BLANKFEIN:

I think in my written testimony when I cited that issue about off-balance-sheet risks, I said, post-Enron, that is amazing was the line I used because—not because these things haven't happened before where people had risks that they weren't showing—which, by the way, creates two problems. One, whether you have profits and losses in our own business and, two, an uncertainty of the people who deal with you about whether you're solvent or whether anybody in the world is solvent, which froze the system.
I think it's quite a—it's quite a big lapse that that happened. We, as a mark-to-market firm, because of our regimen, we are required to put everything through our P&L whether or not it's on our balance sheet. If there is a risk, if we make a commitment before it's even a security, we have to mark that commitment to market.

And so our regimen that we were always under wouldn't have allowed us to do that, but it created a lot of problems for some of the big banks and sponsoring institutions and for everybody else because not only, again, did it affect them, but it created this wave over the financial markets where there was insecurity about whether anybody could be trusted.

THOMPSON:

While it certainly would suggest that risk management might have lapsed, it also might suggest that corporate governance lapsed just a bit in terms of the interactions between the audit committee and the board and the voracity, if you will, of the work that was being done to determine exactly what the quality of the book was. So to what extent does financial innovation and the regulator or even organizations ability to keep up really put

this economy at risk?

BLANKFEIN:

Well, I think there's always—the answer is: It does. And the question is what is the—how do you moderate the risk or how do you cover the risk or how do you—you know—let's apply the word "excessive" to prudence instead of excessive risk. How do you take such prudence that you can allow for risk, but you've built safeguards and conditions and liquidity and a lot of capital around it because you don't want to—it's the age-old problem.

You don't want to fail to innovate on the one hand. And on the other hand, you don't want to bear the consequences of innovation that goes poorly.
And so that is a balance that has to be reached, and you'd like to reach the best balance, again, before the hundred-year storm, not the day after the hundred-year storm. But that, I think, is going to be one of the most important uses of the information that's gleaned from this—from the work of this commission is how do we reset the balance but, also, making sure we don't go so far that we so delever the system, if you will, or so take no risk that we lose a lot of the engines that drive growth in the economy.
It's a challenge.

THOMPSON:

So, Mr. Mack, you indicated that you've had a 40-year career in this industry. How would you suggest, going forward, we think about innovation and managing the risks associated with innovation because you've seen a great deal in your time?

MACK:

Commissioner, I think it's—in many ways, it's very simple. I think our regulators and the industry have to focus on complexity. Instruments today can be so complex that even though—let's assume I am a salesperson at Morgan Stanley and you run a pension fund

or insurance company. You and I understand what you are buying. And then a year later, you move up. I move over to a different role. Someone else takes your job. How difficult is it to get into the structure of that instrument? Now, clearly, people are qualified and smart enough to do that, the question is does it happen.

And I've said this to Chairman Bernanke, and I've also said it to Barney Frank when I visited with him. I think we do need to look at complexity. It continues to jump higher and higher and, of course, with innovation and computers and very smart people, you can continue to make it complex. So I think one of the things that the regulatory framework needs to focus on is complexity.

THOMPSON:
So can the regulatory framework adapt or adjust fast enough given the pace of innovation in the industry?

MACK:
Well, I think, again, I've said it, and my colleagues on this panel have said it. We do need a regulator who has more resources and more—bigger budget to focus on that and to attract people into that arena to focus on it. But, yes, they can do that. But it needs—again, we have many different regulators. I would like to see some consolidation. I would like to see a kind of a head regulator, not just here in the U.S. but tied to other regulators across the world in a global economy. And I think if you had the super-regulator—and, again, it's a new experience for Morgan Stanley to be reporting to the Fed, but I've got to tell you, the amount of questions that we're asked—and Mr. Blankfein said earlier—that every day people from the Fed are in his building; the same at Morgan Stanley.

MACK:
I find that very helpful. It's a great check-and-balance. And certain things that we think we can do, they say, "Well, if you do, let us tell you how we're going to look at it." Now re-think it.

THOMPSON:

Well, there's the old adage that if it sounds like too good of idea, maybe it is. And perhaps some of this oversight is management's responsibility, not necessarily that of the regulator. So, Mr. Dimon, to what extent would you put the onus on you and your management team, not defer that necessarily to the regulator?

DIMON:

Well, I think I started my opening statements by saying that I blame the management teams 100 percent, and no—no one else. So it does not mean we shouldn't look at what—what gaps are in the regulatory system. So if I was—if I was the regulator, I would say there should be no gaps in the system. There should be more authority to deal with certain types of more complex situations. New products should always be reviewed and aged.

But I don't think it's unique to financial services. New products have problems. And, you know, give it a little bit of time before people leverage up on it. And so I think that the—it's really the responsibility of committees. And I think most of these things can actually be fixed pretty quickly in a thoughtful way, you know, as you go through your work and receive where, you know, all the flaws were. One of the surprising things about all these things—a lot of the things we all talked about—mortgages, SIVs, derivatives—they were all known. They were not a secret out there. No one put it all together. There was no systemic regulator trying to look around the corner and say, "Well, if a money market fund has a problem, that's going to cause a problem for X." It's not a mystery. It's not a surprise. And we know we have crises every five or 10 years.

My daughter called me from school one day and said, "Dad, what's a financial crisis?" And without trying to be funny, I said, "It's something that happens every five to seven years." And she said, "Why is everyone so surprised?" So we weren't—we shouldn't be surprised, but we—we have to do a better job looking forward, no regulatory gaps, better disciplines in some of the companies, eliminate some of the off balance sheet stuff that helped facilitate some of the problems.

THOMPSON:

One more.

On a longer-term basis, some say that our country has had more of its human capital diverted to financial engineering as opposed to mechanical engineering or electrical engineering or engineering of real products that over time really make the economy competitive. To what extent has the compensation structure of the industry attracted away the true raw human capital and made this economy weaker from its perspective of delivering real products and services into the marketplace?

DIMON:

You're asking me?

THOMPSON:

Yes.

DIMON:

You know, I think probably a lot of talent has gone to financial services. I think you've really got to ask almost macroeconomics how the talent moves and why it moves. I don't know. I know a very lot of talented people who—my brother has a Ph.D. in physics, and he would never even pretend to want to get involved in something so mundane as trading. So, you know, it's different—different strokes for different folks.

But I think you probably will see a change over time. The talent will go into a whole bunch of other fields. And you have seen it. You've seen it was that Googles and technology and—and so I think that will continue. The— the trend will probably reverse at one point.

THOMPSON:

Thank you.

CHAIRMAN ANGELIDES:

Great. Thank you.

Mr. Thomas?

VICE CHAIRMAN THOMAS:

Could I ask a quick...

CHAIRMAN ANGELIDES:

Yes.

VICE CHAIRMAN THOMAS:

... follow-up question?

In terms of the complexity, there's more and more drive with documents that the public deals with in terms of trying to put them in plain English to a certain extent so that you can understand them. I know sometimes it's—it's difficult to put it in simple terms, but don't all of them focus on who gets what when and how?

And you can permeate that in any way you want to, but there are some fundamentals that don't have to be there, that sometimes complexity is impressive. I mean if I said, "I hate you," you get it. If I said, "I have extremely strong feelings of animosity," some folks may not. Now, maybe the blow has been softened by that, but the fundamentals are the same. To what extent can you folks, even from a PR point of view, talk about simplification so that people can understand? Or is it kind of an agreement that you're going to have a fraternity which gets paid highly and has the jargon—we run into that a lot in government; I used to run into it a lot in government—in which jargon was used to reduce the number of people they had to interact with? Is that the case in terms of some of the complexity that you find now? You get paid more for 100 pages than you do for one.

MACK:

No, that is not. It's more of the engineering and structuring in derivatives and synthetic products. It's not about 100 pages instead of one page. Certain products answer certain

questions or problems that someone's trying to solve for, so all of us are lucky to have very smart people. And if there is a problem that an asset manager has are pension fund, and you try to work with them to solve that problem, as a result...

VICE CHAIRMAN THOMAS:
Is each one unique? Or can you run to a standardized structure on those, quote-unquote, "problems?" It's something about who gets what when and how?

MACK:
Well, it's a combination. One of my colleagues used the—the word earlier "bespoke." Some of these products are—are tailored just for a specific problem, but others are generic and can be used across many different fields of investing.

VICE CHAIRMAN THOMAS:
And bespoke always costs more than the general.
Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES:
Thank you.
Mr. Hennessey?

HENNESSEY:
Thank you, Mr. Chairman.
I want to focus on the too big to fail question and just a—a comment on—on the selection of the panelists. I just—I think it's interesting that we're talking about risk management with the four firms that survived, whether that was because of your risk management practices. But I'm much more interested in hearing about risk management practices at Lehman and Bear Stearns and Fannie Mae and Freddie Mac, the firms that actually failed to manage their risks and—and went under.

But I think the American people probably really don't care about risk management practices at Home Depot or Caterpillar or even the biggest firms like Wal-Mart and Chevron, because if those firms fail, they go under, and they're—they go away, and their competitors swoop in. But I think that a lot of the policy problems and a lot of the political blow-back comes because there was, at a minimum, a perception within the government that we could not allow the largest financial firms to fail because of the broader consequences for the economy.

So what I want to do is, first, I want to focus on the perception of the too-big-to-fail question—and it's a question for each of you—on both investors and on managers and your board members. And that is, in the fall of 2008, do you believe that investors that were investing in your firms were pricing in the possibility that the government might come in and provide assistance; that the government might decide that your firm was too big and too interconnected to fail?

And then the related question is, as you talked with other firm managers and with your board members, did the possibility of the government coming in and rescuing your firm or preventing your firm from failing enter into those discussions? I'm much less interested in whether your firm was likely to fail than whether you think investors thought your firm was likely to fail and whether you were discussing with others, well, if things get really bad, we can always count on the government to step in. And it's a question for each of the four of you.
Since we've been starting from my left the whole time, why don't we start from my right and work our way leftward.

MOYNIHAN:
Well, I think in terms of discussions, again, I wasn't party to those discussions. But I think, as Mr. Blankfein said earlier, on the darkest days, all of us had to go to bed thinking if this thing doesn't stop, what could happen. And we all have very concerned at that time. In terms of your view of what investors thought of our companies, I think if you look at spreads in our debt and from, say, August of '08 and into the first quarter of

2009, you'll see that they've widened out dramatically and, therefore, the investors would take a position that they were requiring a substantially different yield, multiples of the yield that they required prior to the time the crisis really hit in earnest.

Many people got preferred stocks, and other things you'd see the same. The yields reached, in some cases, I know, at least as high as 30 percent. So I think the investors, actually, are pricing in a deep discount. What they individually did, you'd have to ask—you could get panels of investors to say, but during those tough times, I don't think any of us in the industry didn't think about the ramifications of what could happen if we could—if the liquidity and stuff was not at least restored in the system in some regard.

MACK:
I think after Lehman was allowed to fail, that no investor—at least in Morgan Stanley—was thinking we were too big to fail or the government would come in and help us. As a result, the stock traded at one point down to $6.71. If they had a view that that was not the case, the stock would have never gotten that low.

So I think Lehman sent a wake-up call to any investor out there that the government was here to help you and would get you through this crisis. At the board level, it was never discussed. It was never discussed if we get into where the Japanese are not
going to put the money that they invested in with us, would we be bailed out by the United States government. It was never discussed, never thought about.

DIMON:
You raise a very interesting question, and because at no point before the crisis did the market price these firms like they're too big to fail. And all you have to do is look at what they paid...

HENNESSEY:

Mr. Dimon, would you move the microphone closer to you? I'm getting signals. It's very difficult to hear in the back.

DIMON:

I can't move it any closer, but I'll sit up here. I am saying, at no point in the market before the problem started were these firms priced like they were too big to fail. So if you look at what people lent money to at the firms, no, they were priced like there's a potential for failure like any other company.

Even after things started failing and the government—remember, they did allow firms to fail like Lehman. But there was Indy Mac, WaMu, virtual failures in Wachovia, Bear Stearns. Even after they let things fail, that was true, and even after the government did the stress tests and said they don't want these things to fail, the market still priced them—their stock price and their debt—like they could fail. At our board level, we never had a conversation, ever, that we should rely on the government to do anything.

BLANKFEIN:

We never had—I don't recall any internal conversation among the employees or with the board that—about what we would do if we would—if we would fail. I'd say on the too-big-to-fail issue, I agree about the sequence. Nobody in our company entertained government intervention and, certainly—and, certainly, we didn't behave that way. We're shareholders. We work for the shareholders. The equity—even in the context of a too-big-to-fail, if you take Bear Stearns, that was, quote, "rescued," the equity failed. And we work for the shareholders, and all of the people in the firm are shareholders. And that's how we think internally of what constitutes a failure. So for our purposes, they rescue the debt and the equity goes. That's as much of a failure as anything could possibly be.

External, I think everybody contemplated that the equity could go to zero because that was the pattern. And, in fact, it's an interesting—and I would say on the debt, after the government—after you saw the too-big-to-fail noise came out—which only came out

after Lehman, not before—you could see debt spreads contract a bit. But it's interesting because every—there's always unintended consequences. Our shares didn't go down to the lows until, for us, after Buffet, after the—we did our capital raise the week after we became a bank-holding company at 123. We went down to a low under 50. That was after we got capitalized privately and after the TARP got passed because, at that point, people external to the firm started thinking they'll be quick on the trigger, the debt will get saved perhaps, and maybe the equity will get crushed. Maybe we'll get into the scenario of a kind of a Bear Stearns.

And so we were running—in other words, that put some pressure on the equity of our shares which, again, didn't—went through—went to those lows after the—after the government inserted money into the firms.

HENNESSEY:
OK. Thank you.
A related question—and why don't we go this direction now. The Capital Purchase Program and the stress tests drew a line between the 19 or 20 largest firms and everybody else. Do you think that drawing that line has changed that perception in the market? Do you think that investors now believe, well, because my firm was a part of the Capital Purchase Program, because they were a part of the stress tests, because the federal government clearly stepped in and saved, at a minimum, the financial system and, in fact, certain specific firms, that there is an implicit put option in those -- in the value of your firm and those other 15, 16 firms?

CHAIRMAN ANGELIDES:
And by the way, I'm just going to say there's two minutes. So if answers can be brief for Mr. Hennessey.

BLANKFEIN:

Yes, that's—I would say we don't behave that way, but that sentiment is in the eye of the person who you ask, and maybe some people think like that. I think, by the way, post-Lehman—which, by the way, was allowed to fail—obviously, allowed to fail—and these conversations and the debates in Congress and the toxic reaction to rescuing these firms, I think that's gone a long way to unravel the idea that the government won't let a big institution fail and away from the context of a big systemic risk like we had where it was critical—I think any one of these—a firm can fail now in the context that we are in now a lot more easily than it could have at that moment.

HENNESSEY:
OK. Then let me ask a different but related question, which is: Do you believe that, if one of your three counterparts here—if one of your three counterparts messed up and that firm failed tomorrow, do you believe that policy-makers would step in and prevent that firm from failing?

BLANKFEIN:
I think tomorrow, in the context of this environment, at some level, the government would intervene. I don't think the equity holders, the shareholders, or the employees who own shares would find any relief from that, but there would be something done because of the fragility of the system today, I believe.

HENNESSEY:

OK.

BLANKFEIN:
A year ago, a year and a half ago, maybe not. A year from now, maybe not.

HENNESSEY:
OK. Quickly, I believe Mr. Dimon mentioned support of resolution authority, some sort of wind-down authority. The rest of you, views on resolution authority? Is that important in legislation?

VICE CHAIRMAN THOMAS:

Mr. Chairman, I'd yield the gentleman three additional minutes to be able to pursue the line of questioning.

MOYNIHAN:

I'll start.

Yes, I think that, similar to Mr. Dimon's comments, I believe the resolution authority is key to—so that we don't have it left to people's speculation of what might happen; there's a clear path forward, as has been in the FDIC process for years and years and years.

MACK:

We agree with that, also.

BLANKFEIN:

We don't want to—we would like not to have the too-big-to-fail context prevail.

HENNESSEY:

OK, but on the specific question of should legislation incorporate some form of resolution authority...

BLANKFEIN:

Yes. I'm sorry, yes.

HENNESSEY:

OK. Then can you explain to me the difference in views? I was in the administration, and clearly there was a view that there were systemically important financial institutions.

HENNESSEY:

We now hear the Secretary of the Treasury, we hear the chairman of the Fed, we hear other people talk about systemically important financial institutions, a higher level of

regulation, a higher standard for preventing them from failure. Presumably, that is because—I know past policy-makers, and I believe current policy-makers believe that we cannot allow your firms to fail. What is the gap, then, between your perceptions that you describe from 2008 and the perceptions of the policy-makers?
Mr. Mack?

MACK:
Again, and I think Mr. Blankfein said it correctly, somewhere in the future, if it's one year or two years, clearly any of these institutions could fail. I think given how fragile the markets are, not just here, on a global basis, I think that's an issue.
So as you go forward, and when I say, "go forward," I'm not just talking about the U.S. economy. I'm talking about the global economy. Everything's interlinked. And some of the problems, you know, if it could be just isolated to the U.S., you could probably get there faster in pulling away this idea of a safety net.

But unfortunately, it's more complicated than that. And I think that regulators or leaders, either in the Fed or the Treasury, have more insight to what the global problems are and the risks on a global basis. And as they work through it, and there are a number of meetings going on now, as you know, trying to figure out what is the right template to have, I think down the road that this safety net that many believe, and I believe at least in this particular timeframe, is in place, I think that will evaporate and will not be needed.
But—but there's a tremendous amount of work that needs to be done. What we all have learned, and not just through the crisis, these markets are connected around the world, and some event in one part of the world can have huge impact on here in America or what we do here impact somewhere else.
But it's going to take a lot of work and due diligence to come up with the right framework where we can remove the safety net, but I'm convinced that will happen.

HENNESSEY:
And just an observation, I think...

CHAIRMAN ANGELIDES:

Time—time, Mr. Hennessey.

HENNESSEY:

Just—just 15 seconds.

There is a significant difference between an increase in the perception that your firm will fail and whether or not a put option exists. They may both be the case. It may be the case that your spreads increased significantly after Lehman failed, but there might still be—investors still might be pricing in the risk the possibility that the government would step in and rescue your firm.

Thank you.

CHAIRMAN ANGELIDES:

Thank you, Mr. Hennessey.

Mr. Wallison?

WALLISON:

Thank you, Mr. Chairman.

I'd like to focus on a couple of things—a few things for all of you that relate specifically to what caused the financial crisis. The newspapers have covered this somewhat, but I'd like to get it in the record.

VICE CHAIRMAN THOMAS:

Excuse me, Mr. Wallison. Would you pull that mike down and make it more toward you, and then pull it up. I know it's hard, but it allows...

WALLISON:

Got it. I got it.

Mr. Blankfein, I'd like to start with you. And incidentally, I'd like to say that we "W's" always envied you "B's" because you always went first.

(LAUGHTER)

But in this case, I don't think it's something to envy, and I now recognize the downsides of being a "B." But in any event, let me start with you. The newspapers have covered this quite a lot, but I'd like to get it in the record, as I said. If AIG had been allowed to fail, what would have been the consequences for Goldman and why?

BLANKFEIN:
You know, this is an issue that's subject—that we hear—obviously, we hear a lot about. So much about it, by the way, that we put an explanation on our Web site where it sat for a couple of months as to what happened. But we had transactions outstanding with AIG. Because of the protocols of our risk management, we had margin arrangements with them.

WALLISON:
These are credit default swaps you're talking about?

BLANKFEIN:
Credit default swaps. The positions over time eroded, with the result that they owed us a lot of money. They owed us and paid—literally gave us the cash in our possession with respect to the mark-to-market law... I'm sorry.

WALLISON:
Well—go ahead and finish.

BLANKFEIN:
... with respect to the—with respect to the difference, we held the cash. During the pendency of this period and through '08, we were very—and we were marking to market, as is our regimen, and we were probably one of the most aggressive markers to market because that's our regimen. And we called them for more margin, and they became very slow in—in giving margin, such that there was a gap.

As a result of our protocol, which doesn't allow us to take more than a certain amount of risk, we went out and bought our own protection against their credit such that the combination of literally the cash we had and the credit derivatives we had from other big financial institutions, with whom we also had margin arrangements, so we had the cash for them, effectively covered what would have been the loss.

WALLISON:
What was the total coverage that you had?

BLANKFEIN:
We had on the exposure of about—and again, these numbers are more specific and available, and so I'll do the best I can—are about $10 billion of exposure against which we had, I believe, about $7.5 billion worth of cash, literally cash, and—and $2.5 billion of credit protection. Now maybe that cash in marketable securities, but they'd have been agency or government securities—cash-like.

WALLISON:
Now, what—what were these credit default swaps covering or insuring you against? What was the nature of the...

BLANKFEIN:
Against default by—in the event of a default by AIG to my best...

WALLISON:
No, the—not the ones you bought, but the ones that AIG was originally covering. What kinds of assets were they? Were they—were they what people call "toxic" assets? Were they CDOs? Were they…securities?

BLANKFEIN:
They were—they were—again, I think they were a lot of assets, and some of the elements of our business with AIG wasn't just—was with other parts of AIG, including

other things. But to the point, I think the main part of it were CDO-like pools of—pools of securities.

WALLISON:
OK. So you were holding such as investments. These were not in your trust portfolio.

BLANKFEIN:
Actually, we had—and again, I don't want to get too far over my skis on a technicality of a bunch of these things...

WALLISON:
But you'll answer these in writing afterwards?

BLANKFEIN:
Yes, yes. But what they were—I believe we had given protection to another counterparty and acquired that protection from AIG. So in effect, we had no real kind of equity risk, but we did have a credit risk to AIG because we were required to perform on one side, and we needed them to perform...

WALLISON:
So you hedged yourself with AIG, in effect.

BLANKFEIN:
Correct.

WALLISON:
That's what you're saying.

BLANKFEIN:
Correct.

WALLISON:

OK. The—since Goldman was regulated by the SEC, which I think, again, in about 2004, your leverage increased substantially from 2004 until about 2008. Why would leverage increase after you became regulated by the SEC?

BLANKFEIN:

You know, I don't have—the way we did leverage, the way we looked at leverage under our regulatory regime, it was the notion of adjusted leverage, which was—which didn't rate every asset the same way. So for example, right now we sit here with a balance sheet of about $880 billion. But about $170 billion of that is cash, but it's on our balance sheet. So we assign a very low risk to that. And the regulation assigned a low risk.

So we had notions of our metric was an adjusted test. The Federal Reserve for bank holding companies has a growth leverage test, which I—which, again, I don't want to misspeak, but I don't—I'm not—we never really focused on, and even at this moment, I don't think is as important as the risk-adjusted leverage test. It is how—what is the—how much capital do you have to have against cash?

WALLISON:

I fully agree, but—but the leverage tests have been published in the newspapers—not tests, but leverage numbers have been published in the newspapers. People are under the impression that the investment banks became very highly leveraged after the SEC began to regulate them. And I'm trying to get at...

BLANKFEIN:

I'll have to get you what our leverage was at each time. But the investment banks, as a gross term, there was comments—and I read some of the materials -- 40-, 60-times leverage. I think the high water mark of our leverage, which we never sat at, I think was in the mid-20s—ever—as a high water mark, for example.

WALLISON:

All right. In consistent terms, though, what you were leveraged before the SEC began to regulate you in post-Basel II...

BLANKFEIN:

Yes. We are now, and today we sit here literally on a gross basis with about half of our high water mark.

WALLISON:

OK. Thank you.

And Mr. Mack, would you answer the same question? And that is, at least there have been reports that the investment banks became much more highly leveraged after the SEC took over regulation in about 2004, and imposed Basel II regulations. Could you respond to that—why that happened? Or if it didn't happen, see if you can explain why these allegations are out there?

MACK:

I think it happened, but I don't think it was tied to the oversight of the SEC. I just think that you had a robust period of low interest rates and a consistency of movement in markets on the upside so people took more and more risk. But I don't see the connection. We'll be more than happy to go back and look through our files and talk to my general counsel and try to give you a more specific answer, but I'm not aware that that was a trigger point for more leverage.

WALLISON:

Back to you, Mr. Blankfein.

When was Goldman, in your knowledge, first alerted to the fact that there was serious problems with subprime mortgages?

BLANKFEIN:

I would have to look—as Goldman Sachs, I just wasn't—I wasn't at all focused on it until it started getting into the press.

WALLISON:
Well, again, I'm going back to newspaper reports that Goldman was early in recognizing the dangers here and began, at that point, to sell short against certain indexes...

BLANKFEIN:
No.

WALLISON:
... in order to protect itself. Was that not...

BLANKFEIN:
No, let me be clear. First of all, we had research which we make available that showed Goldman Sachs—I mean published research to the world—that showed that we were very negative on the housing markets, I believe, going back way before '07 and '06. Our movement in the, you know, mortgage market was, for us, a matter of hedging and managing our risk because, as a syndicator of product, we were usually in a position of finding ourselves long much like the banks that have had big, big problems and accumulated tens of billions. Our risk management protocols required us to try to sell down those positions or else stop being of service to the clients who wanted us to syndicate their pools of loans.

And so we were always—we were driving ourselves from a point of view of let's moderate our risk. People are using the word "going short." What we were trying to do is get closer to home because we were, for the most part, had long—almost like every other financial institution would have had a lot of this stuff. We were always trying to get back into a risk limit.

WALLISON:
OK. Thanks very much.

Mr. Dimon, you said that residential mortgages were, quote, "poorly underwritten." And I think you implied that one of the reasons was that there was so much money around that—and losses were not being suffered, but—and that is probably true. But were there any other reasons that traditional mortgage standards, such as an 80 percent loan-to-value ratio and so forth, were eliminated, eroded over time in this period of the 2000's up until the mortgage meltdown?

VICE CHAIRMAN THOMAS:
Mr. Chairman, I'd yield the commissioner three additional minutes?

WALLISON:
Oh, my goodness. OK. Time does go fast. Go ahead.

DIMON:
So I think the standards eroded over a long period of time, and the losses were masked by the fact that home prices were going up.

WALLISON:
Right.

DIMON:
And I think the whole industry, you know, all of us just erode those losses. And I think economists will look at—and so I think you've seen the same things I see—the low rates helped fuel it a little bit and maybe helped fuel a lot of housing speculation. And, you know, I've always looked at Fannie Mae and Freddie Mac as being part of the issue in how they grew over time. I don't blame them for the bad behavior of our underwriter banks, but I do think they were part of the problem for the industry as a whole.

WALLISON:
Let me ask a question of Mr. Moynihan in my very limited time now available.

The—what is, in your view, proprietary trading? And was Bank of America—that is the bank and not the holding company—engaged in that activity?

MOYNIHAN:
The rules of a federal bank—a national bank are such that—flip it around. We conduct our securities activities and securities company much like our colleagues do.

WALLISON:
And that's an affiliate; that's not the bank?

MOYNIHAN:
It's owned by the holding company.

WALLISON:
Right.

MOYNIHAN:
Proprietary trading is going to be one of those things that you hear a lot of talk about and you can— and you can try to define, but I think when you offset a position, you're doing it for the firm, as Mr. Blankfein has been describing, and you can say it's proprietary, but it's actually managing a risk.
And so I think one of the challenges with some of the thought processes that are out there about the ideas of regulating proprietary trading inside a bank-holding company are going to be what is proprietary and what's customer driven and what's between the two.
So if we do an interest-rate derivative to help a middle-market customer cap their interest rate obligation so that they know that they have a fixed rate of interest in the future, we have to then offset that because, for the same reasons we can't carry one side of the trade, we have to offset that.

So then we go out and put on the other side of the trade that is proprietary in that it is offsetting the trade and it is us engaging with the counterparty. But at the end of the day,

it's to manage the risk so that we can provide that middle-market customer with fixed rates though they can have the certainty to run their business. And I think that's going to be the challenge. And I think, with good engagement by our firm and other colleagues and the industry, we can try to be more specific. But it is a very difficult task.

WALLISON:
Well, I'm just trying to get at one question. And that is: Is this—is there a trading business—a proprietary trading business—in the bank rather than in the holding company?

MOYNIHAN:
The assets are in the securities firm, generally. We can answer that in written submission.

WALLISON:
Please.

MOYNIHAN:
But basically, our securities activities are in our securities company, which is the affiliate.

WALLISON:
Thank you.

CHAIRMAN ANGELIDES:
Terrific. Thank you, Mr. Wallison.

Ms. Born?

BORN:
Thank you.

I'm going to address first issues regarding the enormous and unregulated over-the-counter derivatives market. Your institutions are four of the largest OTC derivatives dealers in the world. The Office of the Comptroller of the Currency has reported that, in September 2009, you collectively held over-the-counter derivatives positions of more

than $230 trillion in notional amount. Your positions consist of more than a third of the world market in over-the-counter derivatives. Mr. Blankfein, in your written testimony, you've stated that standardized derivatives should be exchanged, traded, and cleared through a central clearinghouse. And you further state, quote, "This will do more to enhance price discovery and reduce systemic risk than, perhaps, any specific rule or regulation."

I would like to ask your opinion of the role that over-the- counter derivatives played in causing or contributing to the financial crisis.

BLANKFEIN:

Now, I think people will have—may have different opinions about this, but I would say that the aspects of the over-the- counter derivative market was a very, very big concern and a big worry, so much so that a lot of institutions—all of the institutions here, I believe—were working very, very hard to make sure that the plumbing—that things would settle, that things would clear, and that we started the process of creating these clearinghouses well in advance of this particular crisis and really glad that we do. I mean, this was highly publicized. The Federal Reserve of New York created a program to get people to just make sure that confirms were done well. And that was a very big concern.

As it turns out, my belief is that the derivatives market functioned—over-the-counter derivatives market functioned, actually, pretty well under the circumstances. Now, the risks that may have been embedded to the extent that they had credit in them, people made bad credit decisions because of—and so—and some of those credit decisions were taken in derivatives. Some were taken in terms of securities.

But the derivatives market itself actually worked better, I think, than we had a right to expect. And if you could call anything lucky in the crisis, I think it was that it worked so well.

So for example, Fannie, Freddie, Lehman, WaMu all had big events of default with huge numbers of offsetting but, clearly, people were taking credit risks with each other,

offsetting derivatives on those credits. They settled and they cleared. And in the benefit of hindsight, that means people were able to hedge their risk, lay off risks, protect themselves. And it was—it worked very well; better than I would have thought.

BLANKFEIN:
I don't think we should rely on—I think that was lucky. And I think the amount of attention and time that people—regulators, the industry, legislators—are focused on making sure that the instrumentality and the pipes of clearing derivatives are in place is highly justified, notwithstanding, we didn't specifically have a derivatives crisis.

BORN:
Do you think that the failure or near failure of AIG was related to credit swaps? That is, credit-default swaps? And do you think that having clearing would have, in any way, reduced the risks inherent in AIG's position?

BLANKFEIN:
I believe that it wouldn't—it may have helped a bit. I don't think that was a key thing. AIG was bent on taking a lot of credit risk. They took that credit risk in the derivatives market. They took that business by writing insurance against credit events. They took it by holding securities. It was a failure of risk management of colossal proportion, and there were derivatives in there, but it was really -- those were merely mechanisms of taking credit exposure to get paid for that exposure that they took through multiple kinds of vehicles and could have substituted other vehicles for them.

BORN:
Do you think—how would having a clearinghouse and having exchange trading of standardized derivatives reduce systemic risk as you say in your testimony?

BLANKFEIN:
I think that, to the extent that you have a—starting with a clearing house—to the extent that you have a clearing house, the issue we had with an AIG, vis-à-vis margin or fighting

over settlements of what mark-to-market should be for the smooth transfer of margin, we would have avoided. We got margin for them, but it was hard to get out of them and it was slow. It lagged what we thought the mark-to-market—in a clearinghouse context, that would be easier to do. So anything that's liquid enough and could be priced easily to go through a clearinghouse should.

If further it's standardized so it could trade liquidly on an exchange, then it should. I wouldn't banish bespoke and tailored solutions that couldn't trade on an exchange because they serve a useful purpose. If somebody wants to hedge their grade of oil, let them hedge their grade of oil. Don't force them to hedge a different kind of oil.
But what could be on an exchange should be on an exchange. Those that can't could be through a clearinghouse. And those that still can't can be bespoke bilateral contracts between companies, but they should be surveilled and subject to extra capital.

BORN:
Thank you.
Mr. Mack, I think, in your testimony, you indicated that you thought that clearing would be a valuable reform effort at this point. Would you comment on that?

MACK:
Happy to. But, as Mr. Blankfein said, it really would alleviate some of the issues of settling up with your counter parties. So not to be redundant, but it would be very helpful—you'd have better discovery, you would shrink, I think, some of the notional amounts by being able to do that. So I think it would go a long way in helping us, especially in times of crisis. But away that, it makes sense to do, and if you go back not too many years ago when we were able to put swaps business into that clearinghouse, that's helped us on swaps.

BORN:

Could you tell me how much—I understand the only standardized contracts could be exchange traded and cleared easily and that bespoke customized contracts because they wouldn't be part of a fungible group are not as amenable to clearing. Could you tell me what percentage of the over-the-counter derivatives that your business is involved in are standardized as opposed to bespoke or customized?

MACK:
I can't give you an exact percentage. I will get you that information.
But predominantly, they are standardized, but we will give you the exact numbers, but I don't have that at the top of my head.

BORN:
Mr. Blankfein, could you tell me what percentage of yours—that your business in over-the-counter derivatives dealing are standardized?

BLANKFEIN:
No, I can't. I would have to look into it. And I would guess that our business mixes would be different from each other. We have different places in the market.

BORN:
I would appreciate it if each of the witnesses could provide the commission with information on the percentage of standardized contracts that your over-the-counter derivatives dealing business has dealt in, say, for the last four years, please.

VICE CHAIRMAN THOMAS:
Would the commissioner yield on my time on that point?

BORN:
I would—a little of it.

VICE CHAIRMAN THOMAS:

If, in fact, we created—no, it's my time. Yours is being saved. If we created the standardized versus bespoke versus what the ratio was over the last four years, don't you think it would change over the next four years in terms of a whole lot more bespoke and fewer standardized?

MACK:

I don't know.

VICE CHAIRMAN THOMAS:

It always works that way, doesn't it?

MACK:

Yeah, I don't know.

VICE CHAIRMAN THOMAS:

We'll see.

DIMON:

We've estimated about 70 -- first of all, a lot of derivatives are already on exchange to clearing houses. So I'm talking about just credit derivatives. We estimate 70 or 80 percent will go into clearing house. And I think one of the big fears of regulators or the public has been that, if you leave this opening for over-the-counter, well, that's just a way that you could put a lot of stuff in there. The requirements should be that, if it could be cleared, it should be cleared. And I think the regulators can limit and charge capital against the over-the-counter things that remain in a way that everyone's comfortable.

VICE CHAIRMAN THOMAS:

Thank you. Thank you for your...

BLANKFEIN:

Let me make it clear. I would like—just so you know what our motivations are. I would like more things to go through a clearinghouse. The biggest problems that we had during this period was counterparty risk. And so it would really suit us to have everything not just that are standardized, that could be standardized and make sense to go on those—to go on those clearing house arrangements. In fact, the industry has, you know, been driving this.

CHAIRMAN ANGELIDES:

Ms. Born, back on your time.

BORN:

Thank you. Have you—have any of your institutions changed your operations in terms of over-the-counter derivatives dealing in light of what was learned through the financial crisis?

Mr. Moynihan?

MOYNIHAN:

I think the point about the credit risk and understanding the counterparty risk, I think, everybody in our firm did a lot of work on in '07-'08, and the regulators have looked at it very carefully because that was the risk that built up in a way that I don't think people anticipated. So that's where we've spent a lot of our time, not only the core economics, but also the underlying credit risk that comes with these transactions.

BORN:

Mr. Dimon?

DIMON:

I mean, other than being more vigilant, I think not a lot. But I will make one exception because we probably spend a little more time now looking at our exposures to another large financial company, so we are more prepared in case they have problems since we have a lot of contracts with other companies.

BORN:

Thank you.

CHAIRMAN ANGELIDES:

Do you do need another minute or so? Are you OK?

BORN:

I would like another minute just to ask one follow-up question to questioning that Commissioner Wallison made. I would very much appreciate it if each of you could submit to the commission information on your proprietary trading over the last four years; that is, the kinds of trading that you were engaged in, whether it was speculative, the degree to which it was hedging your risk, and the revenues and profits for each of the last four years.

Thank you.

CHAIRMAN ANGELIDES:

OK. Thank you, Commissioner Born.

Mr. Vice Chairman?

VICE CHAIRMAN THOMAS:

Thank you, Mr. Chairman.

First of all, I want to thank all you. We have a very difficult job, and when you rely on secondary and tertiary sources, it makes it very, very difficult. And your willingness, one, to come in front of us and begin to answer the questions that we're asking. I might just tell you, Mr. Chairman, based upon my request, we've already—over the Web—and I

have some directed specifically to some of you. I won't ask them now, but we'll get it back in writing and we'll communicate. We've got California, Tennessee, Connecticut, Missouri, and more coming in.

This is going to be very useful to us. We want to assure you, as we have the administration, that any information provided to us will be handled in the appropriate legal and protective ways, especially sensitive with the private sector on Trade Secrets Act and other information. It's just that, without your help in follow-up questions that we will ask to get some detailed understanding, that we can provide not just the rough picture of what happened, but a more nuanced, understood, in- depth picture of what happened because, frankly, an argument that I made a lot and then quit making when I was in Congress is that it's basically you just don't understand what we're doing and the context we're doing it. And I'm sure you've heard a lot of that.

Our job, hopefully, is to provide as mild and easy a form of education as possible. Just how complicated this world is today and what makes it go round? Your help in that regard, as I said, is invaluable. We'll ask you questions. We would hope we get a timely response. As we get nearer our time to exist it will be a bit pushier in terms of getting your response.

But once again, Mr. Chairman, I want to thank the panel, one for their willingness to come. Two, their openness
in response, and three, the answers you'll be giving us over the course of the next eight months. Thank you very much.

CHAIRMAN ANGELIDES:
Thank you, Mr. Vice Chairman, members. There is, I know you'll be glad to know, a little remaining time. So I'd like to just ask a few follow-up questions before we move out of here. And, Mr. Blankfein, maybe you're going to suffer from me having been A all my life and you having been B, but I do want to revisit some of the issues we talked

about. And let me preface this by saying if I die 51 percent right and 49 percent wrong I will be a happy man.

But I do believe that one of the issues we must explore is, was this purely a perfect storm? Or was it a manmade perfect storm in which the clouds receded? And that's why I'm driving towards questions and answers about responsibility. I'm going to put aside for a minute my view that I'm troubled by your inability to accept the probability or certainty that your firm would not have made it through the storm but for the vast array of federal assistance. But I really want to turn to this issue of mortgages, which you securitized, as did other firms. BofA stopped making subprime loans in 2001, but you still did securitize mortgage packages, Alt-A, jumbo, that had significant problems, 16 to 25 percent default. So maybe those are like the Murder on the OrientExpress, everyone did it.

Having said that, Mr. Blankfein, I read your testimony you said there was cheap money. Albeit there was, there was public policy driving this mortgage business, but you weren't subject to the Community Reinvestment Act. They were the standards at the time, but I would hope that we always would try to elevate standards. I think what I'm bothered by is this. You weren't just a market maker. You were securitizing and underwriting packages of mortgages, and when it was clear the market was going bad, even though there was information about bad lending practices that other people moved on, you kept moving this product in the market.

And I guess what I'd ask you is what is your responsibility when you put your name on a security to investor to underwrite that thoroughly? There were FBI warnings. There were loan tapes available. Did you fail in that respect in that you did not underwrite the loans that you then securitized and moved into the market?

BLANKFEIN:
Mr. Chairman, all these loans—what we did in that business was underwrite to again the most sophisticated investors who sought that exposure. I know it's become part of the

narrative to some extent that people knew what was going to happen at every minute. We did not know at any minute what would happen next, even though there was a lot of writing. The FBI may have wrote a report in '04, but I will tell you that there were people in the market who thought that -- was going down and there were others who thought, gee, these prices have gone down so much they're going to bounce up again.

I remember being teased because at my shareholders' meeting early in '07 somebody asked me what inning were we in and I said the seventh inning of the crisis. And of course it turned out not to be the seventh inning. It turned out to be the second inning. What was drought—and so what we were doing was we were creating processes. If you ask me do I wish we had done it? No—yes...

CHAIRMAN ANGELIDES:
I think I'm asking a more direct question. Was your due diligence adequate?

BLANKFEIN:
Well, that could be...

CHAIRMAN ANGELIDES:
I mean did you scour loan tapes? Did you dig deep into looking at what you were moving, the actual product? And I guess the question is, isn't that—you know in the 1920s everything's different. But Wall Street banks were selling bad Latin American debt. I guess at what point do you have a responsibility? What is the sense of responsibility...

BLANKFEIN:
Well, we have a responsibility to be open and to tell people what they're having. But in our part of the market...

CHAIRMAN ANGELIDES:
Not to insure good product unto itself?

BLANKFEIN:
Good product that does—that creates the exposure that these professional investors are seeking. Right now you could buy—we would underwrite distressed product as long as we disclose it, help somebody move that distressed product off their balance sheet, and give it to somebody, a sophisticated investor, knowing what the product did would give them that exposure.

CHAIRMAN ANGELIDES:
But you were doing more than that. You were facilitating the market in which products were being offered in the consumer marketplace that were clearly...

BLANKFEIN:
Yes.

CHAIRMAN ANGELIDES:
... deficient and unsustainable...

BLANKFEIN:
Yes. It had—yes. For sure it had that effect. By allowing that to turn over and by us giving the dollars back to the originators in exchange for the loans it allowed them to go out and originate more loans. So to that extent we were—played a part in making that market—all of us as syndicators doing what the capital markets do, which is give people access to capital. And so that was a role that...

CHAIRMAN ANGELIDES:
Well after Mr. Mack's rather compelling statements about regulations recently, we cannot control ourselves, you have to step in and control the Street. Is this an argument for very tough regulation of products offered at the ground level because of the inability of the chain of securitization and the chain of private players to control the quality?

BLANKFEIN:

I think nobody—looking what happened and the most horrible thing of this crisis, what has happened to consumers, to individuals, in the mortgage market, in other things have taken on debt as a consequence of behavior. And the confluence of behavior and the recession I would say no one would argue that there shouldn't be more protection and safeguards and regulation of that interaction between finance and the consumer.

CHAIRMAN ANGELIDES:

All right. There's one minute left. And the only final question I have is for you, Mr. Dimon. How do you control—correct the asymmetry in compensation? Let me just say it simply. I was in the private sector half my life. I was in a business where you put real equity at risk and if you lost you lost. You bet big, you could also lose big.

There's an asymmetry here where in the financial services industry it seems that it's almost like you're at a Black Jack table in which you never really get wiped out. At the end of the day the worst you can do is walk out with what you had. On the other hand, if you hit big you can hit big. It seems to always tilt towards making the biggest bet possible because there's no consequence for the biggest bets. How do you correct that?

DIMON:

Well, there's a consequence that you could lose your job. You could lose your reputation. But I do think that you raise an issue. The first way to correct it is that you actually risk adjust it, actually look at the capital being deployed and you make an evaluation. Did they do the right things for the right reason, for the client, et cetera? So you are constantly trying to evaluate are you doing the right things on trading debts. But it is a little one-sided that way. And the more senior the people become, the more stock they own in the company. So they are responsible for the well being of the whole company and they will pay a price if our company pays a price. I think that's generally—you've seen that a lot of the companies that went belly-up their people did pay a price.

CHAIRMAN ANGELIDES:

Even though the Harvard study by Professor Bebchuk said that even in those instances people took out you know hundreds of millions of current compensation. So downside compared to what most Americans feel is not nearly the same.

DIMON:

Right, but they should redo some of those numbers for that study because they weren't all right.

CHAIRMAN ANGELIDES:

We'll debate that after this session.

Members of the Commission, members of the public, the gentlemen who came before us today, thank you very, very much for coming here. Thank you for adding to our work, and appreciate it. We will be posing written questions to each and every one of you.

Thank you.

Panel, ladies and photographers, hold on a minute. Folks, hey, clear out of there, guys. Hang on. We're still
trying to do a meeting.

VICE CHAIRMAN THOMAS:

Can you please leave the well?

CHAIRMAN ANGELIDES:

Yes. Move aside.

VICE CHAIRMAN THOMAS:

The hearing is not recessed.

CHAIRMAN ANGELIDES:

Yes. We appreciate your fervor to inform the public, but we will take a 25-minute break and commencing at 12:45 we'll be moving to the second session of this hearing. Thank you all very much.
(RECESS)

CHAIRMAN ANGELIDES:
We're going to recommence this meeting. Thank you all very much for rejoining us. I want to thank the panels who are with us. As I said when I began today it will be usual and customary practice to swear all witnesses so I'd like to ask each of you to stand right now so that I can swear you in. Do you solemnly swear or affirm under penalty of perjury that the testimony you are about to provide the commission will be the truth, the whole truth, and nothing but the truth to the best of your knowledge?

ALL:
(OFF MIKE): I do.

CHAIRMAN ANGELIDES:
Thank you very, very much. Members of the commission, we are now going to move to panel number two. I'm looking for my agenda to make sure I do this in the right order.

And we will be hearing from Mr. Mayo, Mr. Bass, and Mr. Solomon. And even though you are not seated in that order, I think what I'm going to do is take you alphabetically and ask you—actually, let me do this. I apologize.
They gave me the order.
Mr. Mayo, we're going to start with you today, and so I'd ask you to take up to 10 minutes for your testimony. Mr. Mayo? Thank you.

MAYO:
Chairman Angelides, Vice Chairman Thomas, members of the commission, thank you for inviting me to testify today. I work at Calyon Securities and in affiliation with COSA, but

I'm here to represent my own views. I've submitted almost 200 pages of supporting material. I hope you received that.

Two decades ago, I worked down the street at the Federal Reserve. At the time, we were helping banks recover from crisis. We took great meaning from our work. I hope the commission's efforts lead to a banking system that we don't have to revisit every two decades to save. This is important. I've been covering an industry on steroids. Performance was artificially enhanced, and we're now paying the price with the biggest bailout of U.S. banks in history. And it's also resulting in the biggest wealth transfer from future generations to the current generation. My children, 9, 7, and 4, and their generation will have to pay the price.

I'm shocked and amazed more changes have not taken place. There seems an unwritten premise that Wall Street, exactly how it exists today, is necessary for the economy to work. That's not true. The economy worked fine before Wall Street got this large and this complex. Wall Street has done an incredible job at pulling the wool over the eyes of the American people. This may relate to the clout of the banks. The four banks that testified this morning have annual revenues of $300 billion. That's equal to the GDP of Argentina. My perspective? I've analyzed banks since the late 1980's. I value the independent reputation of COSA. And I've been negative on banks since 1999, and I've published over 10,000 pages of research to back up my view.

I've identified 10 causes of the crisis. If you can turn to Slide 3 -- and I'll go through each cause. Cause One: excessive loan growth. We could not accept the reality that we're in a slower-growing economy, a more mature market. Loans grew twice as fast as they should have grown, twice as fast as GDP.

Cause Two: higher yielding assets. The U.S. banking industry acted like a leverage bond fund. More borrowings with the proceeds invested in more risky assets. Look at Treasury securities. As a percentage of securities, they went

down from 32 percent down to 2 percent. That's the least risky asset. Instead, banks took more risky securities and more risky loans whether it's home equity or construction loans. Look at construction loans. The percentage of construction loans to total is double the level where it was even in the early '90's.

Cause Three: too many eggs in one basket. Look at data for loan growth last decade and look at the fastest area of loan growth. First, mortgages; second, mortgages; construction loans, commercial real estate, multi-family real estate. One element in common: real estate.

Cause Four: high balance sheet leverage. Shortly before the crisis, the U.S. banking industry had the highest leverage in 25 years. And then take a look at the securities industry. In the '80's, 20 time levered, in the '90's, 30 times levered. And right before the crisis, almost 40 times levered.

Cause Five: more exotic products. Some of these were so exotic that I don't think the directors, the CEOs, and in some cases, even the auditors fully understood the risks. And I think of this like cheap sangria. A lot of cheap ingredients are bad—or bad sangria, I should say. A lot of cheap ingredients repackaged to sell at a premium. It might taste good for a while, but then you get headaches later and you have no idea what's really inside.

Cause Six: consumers went along. There's some personal responsibility here. Consumer debt-to-GDP is at the highest level in history. Japan didn't have that. We didn't have that during the Great Depression. There is a false illusion of prosperity through this additional borrowing. It's no secret that everybody from kids to pets to dead people got loan solicitations, but a lot of people took these loans voluntarily.

Cause Seven: accountants. The SEC, in 1998 made some rules or some decisions that encouraged banks to take less reserves for their problem assets. And look what happened next. Reserves to loans at U.S. banks declined from 1.8 percent down to 1.2 percent right

before the crisis. That was a wrong move. It should change now. And the bank regulators should be back in control in helping us set reserves for problem loans. That was not a close call for many of us in the industry.

Cause Eight: I know Jamie Dimon said regulators were not at fault. No, that's not true. Regulators share some blame here, too.
Banks—U.S. banks always paid insurance premiums for their deposit insurance. Ever since the FDIC was created after the Great Depression they always paid deposit insurance until 1996. For a decade banks paid no premiums for their deposit insurance. OK. Well, maybe—somebody else might be upset about this, too. OK?

It's a sign that banks for a decade not paying any deposit insurance premiums is ridiculous. And tomorrow when Sheila Bair testifies, that would be a great question to ask her. Why did they not pay deposit insurance for a decade? That's analogous to getting car insurance and not—not paying premiums until you have an accident or getting life insurance and not paying premiums until you die. It just doesn't work for an insurance scheme.

Cause Nine: Government—government facilitated allocation of capital to the housing market, so government's involved here, too.

And Cause 10: Incentives. I think if there's one word—after you spent all these months going through this, one word's going to come up as being a key cause. And that one word is incentives. People do what they're incented to do. And if you look at the banking industry compensation, what the industry pays out is pretty constant as a percentage of revenues.

But guess what? That doesn't reflect for the risk of those revenues. So if you hold a lot of treasury securities or if you make construction loans of if you own CDOs, it makes a big difference in terms of the degree of risk you're taking.

So in summary, I consider this an industry on steroids. Performance was enhanced by excessive loan growth, excessive securities risk, securities yields, bank leverage. Excesses were condoned. Yes, they were conducted by bankers, but they were also conducted by accountants, regulators, government and consumers. The side effects were ignored, and there was little financial incentive to do anything about it. So we ignored the long-term risks. And I say we collectively.

The solution, I say, is partly a function of A, B, C. A is for accounting. Let's have greater transparency and more consistency. The B is for bankruptcy. We should allow firms to fail. The prudent should not have to subsidize the imprudent. And a terrible precedent for the decade was saving long-term capital in 1998. And the C is for both capital and capitalism. During the crisis we all realized that banks are as vital as our most precious utility. Imagine walking into the kitchen in the morning, turning on the faucet and not getting water. We were close to that in the banking industry. That can never happen again. So we need to have enough capital for the banks.

The other part of the C is capitalism. And capitalism is about having good information to make decisions. It's about allowing firms to fail. It's about having markets over government allocate capital with prudent oversight and regulation. To me the crisis was not caused by capitalism. It was caused by a lack of capitalism. And one more point on capitalism—capitalism is about money, but it's also about meaning. And for this I look no further than my cousin Andy, who is a captain in the Army. Andy is going from the Army in Iraq to business school in the fall. And here's what he wrote to me.
He said that he hopes that we as the world leader in capital markets can make sound investments that help less fortunate people provide for their family. To him he'll continue his pursuit of peace and prosperity as he goes into business. And to cousin Andy, Captain Andy, as I would like to call him—he gave a reminder the larger purpose of financial services. And that is to improve people's lives by helping to allocate scarce resources to where they can best be used.

I would like to hear the CEOs remind people of this ultimate purpose more often. And I appreciate the commission's efforts to find out the root cause of this crisis, to bring greater awareness to this mission and to facilitate its execution. I look forward to your questions when they're done.

CHAIRMAN ANGELIDES:
Thank you very much for that very good and timely presentation. Thank you very much, Mr. Mayo. Mr. Bass, you are next. And you know what I realize is that even though the commissioners have seen all your bios, you might just identify yourself with your firm and your responsibilities currently.

BASS:
OK. Thank you.
Chairman Angelides, Vice Chairman Thomas and members of the commission, my name is Kyle Bass. I'm the managing partner of Hayman Advisors in Dallas. And I would like to thank you and the members of the committee for the opportunity to share my views with you today as you consider the causes of the recent crisis as well as certain changes that must take place to avoid or minimize future crises.

I believe that I have somewhat of a unique perspective with regard to this crisis, as my firm and I were fortunate enough to have seen parts of it coming. Hayman is a global asset management firm that managed several billion dollars of subprime and Alt-A mortgage positions during the crisis. And we remain an active participant in the marketplace today. While I realize the primary objective of the hearing today is to provide baseline information on the current state of the financial crisis and to discuss the roles that four specific banks or investment banks—Goldman, Morgan Stanley, Bank of America and JPMorgan—have played in the crisis, in my opinion, no single bank or group of large institutions single-handedly caused the crisis. While I will address each participant's structure and problems independently later in my testimony, the problems with the participants and regulatory structure needs to be considered more holistically in order to prevent future systemic breakdowns and taxpayer harm.

While there are many factors that led to the crisis, I will address what I believe to be the key factors that contributed to the enormity of the crisis. The first of which is the OTC derivatives marketplace. It was brought up in the prior hearing. But with nearly infinite leverage that it—that it afforded and continues to afford the dealer community, it must be changed. AIG, Bear Stearns and Lehman would not have been able to take on as much leverage as they did had they been required to post initial collateral on day one for the risk positions they were assuming. Asset management firms, including Hayman, have always been required to post initial collateral and maintenance collateral for virtually every derivatives trade we engage in. However, in AIG's case, not only did they have to post initial collateral—or didn't have to post initial collateral for these positions, when the positions moved against them, the dealer community forgave the so-called variance margin. The dealer community as well as other supposed AAA rated counterparties were, and some still are, able to transact with one another without sending collateral for the risk they are taking.

This so-called initial margin was and still is only charged to counterparties that are deemed to be of lesser credit quality. Imagine if you were a 28-year-old mathematics superstar at AIG Financial Products Group, and you were compensated at the end of each year based upon the profitability of your trading book, which was ultimately based upon the risks you were able to take without posting any money initially. How much risk would you take?

Well, the unfortunate answer turned out to be many multiples of the underlying equity of many of the firms in question. In AIG's case, the risks taken in the company's derivatives book were more than 20 times the firm's shareholder equity. For a comprehensive look at those leverage ratios we can move to tables in my presentation later. The U.S. taxpayer is still paying huge bonuses to the members of AIG's Financial Products Group because they've convinced the overseers that they possess some unique skill necessary to unwind these complex positions. In reality there are hundreds of out-of-work derivatives traders that would happily take that job for $100,000 a year instead of the many millions being paid to these supposed experts.

To solve this OTC derivatives problem—I heard a few of the—of the potential solutions this morning. But I'll go over the three that I think are absolutely mandatory to fix this problem. One is—is the key issue—is homogeneous minimum collateral requirements. All participants in the derivatives marketplace—do not bar the dealers from this—should be required to post initial capital based upon some formulaic determination of the risk by the appropriate regulatory body.

Two, centralized clearing and mandatory price reporting of all standardized CDS, FX and interest rate derivatives—we believe close to 90 percent of these derivatives are standardized. Centralized data repository for all cleared and non-cleared derivatives trades—essentially there must be some place where every single transaction is recorded and monitored. As of today, that still doesn't exist. It's hard for me to believe that where we are today that that doesn't exist. The second thing I'd like to talk about is bank leverage. And this is just the fundamental tenants of the U.S. banking system.

Under current regulatory guidelines, banks are deemed to be well- capitalized with 6 percent tier one capital and adequately capitalized with 4 percent tier one capital based upon risk weighted assets. As an aside, the concept of risk weighting in assets should also be reviewed. This in turn means that a well-capitalized bank is leveraged 16 times to its capital, much more to its tangible common equity. And an adequately capitalized bank is—or a minimum capitalized bank—sorry—is 25 times levered to its tier one capital. I don't know how many prudent individuals or institutions can possibly manage a portfolio of assets that is 25 times levered when we hit a crisis. But—but I surely can't.

Unfortunately, the answer so far has been not many of the other banks have been able to manage these risks either. Of the 170 banks that have failed during the crisis to date, the average loss to the FDIC and the taxpayer is well over 25 percent of their assets. When you think about that, that means they've lost more than six times their equity, of the banks that have gone down so far.

Depository institutions like Citibank were able to parlay their deposits into large levered bets in the derivatives marketplace. In fact, at fiscal year-end 2007, Citigroup was 68-times levered to its tangible common equity, including off balance sheet exposures. Clearly, the composition of these assets is important as well, but I am simply trying to illustrate how levered these companies were at the start of the financial crisis. While AIG's derivatives book was only 20-times levered to their book equity, $64 billion of these derivatives were related to subprime and subprime credit securities, the majority of which were ultimately worth zero. In some cases, excessive leverage cost the underlying company many years of lost earnings, and in other cases it cost them everything. I've put a table labeled "exhibit two" in my presentation. What we've done is looked back at the cumulative net income that was lost in financial institutions since the third quarter of 2007.

Fannie Mae lost 20 ½ years of its profits in the last 18 months. AIG lost 17 ½ years of its profits in the last 18 months. Freddie Mac lost 11 ½ years of profits in a little bit more than a year. The point I'm trying to make is the ridiculousness of what's gone on in the leverage that was in the system. The key problem with the system is the leverage and we must regulate that leverage. I'm going to—my third point that I'll talk about briefly here is Fannie and Freddie.

With $5.5 trillion of outstanding debt in mortgaged-backed securities, the quasi-public are now in conservatorship, Fannie and Freddie, have obligations that approach the total amount of government-issued bonds the U.S. currently has outstanding. There are so many things that went wrong or are wrong at these so-called "GSEs" that I don't even know where to start. First, why are there two for-profit companies with boards, shareholders, charitable foundations, and lobbying arms ever given the implicit backing of the U.S. government? The Chinese won't buy them anymore because our government won't give them the explicit backing. The U.S. government cannot give them the explicit backing because the resulting federal debt burden will crash through the congressionally

mandated debt ceiling, which was already recently raised to accommodate more deficit spending.

These organizations have been the single largest political contributors in the world over the past decade, with over $200 million being given to 354 lawmakers in the last 10 years or so. Yes, the United States needs low-cost mortgages, but why should organizations created by Congress have to lobby Congress? Fannie and Freddie used the most leverage of any institution that issued mortgages or held mortgage-backed bonds in the crisis. At one point in 2007, Fannie was over 95-times levered to its statutory minimum capital, with just 18 basis points set aside for loss.

That's right -- 18/100ths of 1 percent set aside for potential loss, with 95 times leverage. They must not be able to put Humpty Dumpty back together again. If they are going to exist going forward, Fannie and Freddie should be 100 percent government-owned and the government should simply issue mortgages to the population of the United States directly since this is essentially what is already happening today, with the added burden of supporting a privately funded, arguably insolvent capital structure. I will conclude my testimony there, and—and leave it to questions.

CHAIRMAN ANGELIDES:
Thank you very much, Mr. Bass.
Mr. Solomon?

SOLOMON:
Thank you, Chairman—Vice Chairman Angelides and Vice Chairman Thomas and members of the commission. Thank you for asking me to appear before the commission. Before I begin, I want to commend the leadership of the House and the Senate for creating this bipartisan commission to examine the causes of the current financial and economic crisis in the United States. When I entered Wall Street in the early 1960s, security firms and commercial banks had not changed much since the 1930s. Stock ownership was not widespread. Pension funds and endowments did not invest broadly.

The average volume on the New York Stock Exchange was about the same as 40 years earlier. There wasn't a large public bond market. The business of commercial banks was lending. The securities firms were usually private partnerships. Investment funds were separate from banks and security firms.

I've been afforded the opportunity over 50 years to observe the dramatic changes in the financial world from a number of perspectives. My career at Lehman Brothers spanned 29 years. I rose to vice chairman of the firm in the 1980s and was co-chairman of the Investment Banking Division and chairman of the Merchant Banking Division. I have held financial positions in the public sector, as deputy mayor of the city of New York during the financial crisis of the 1970s, and as counselor to the secretary of the treasury in the Carter administration. I have been active on corporate boards, not-for- profit foundation boards, where I've been involved in investment decisions.

For the past 21 years, I have been chairman of the Peter J. Solomon Company, a private independent investment bank and member of FINRA. Our firm is a throwback to the era of the early 1960s when investment banks functioned as agents and fiduciaries, advising their corporate clients on strategic and financial matters such as mergers and raising of debt and equity capital. Unlike today's diversified banks, we do not act as principals, nor do we take proprietary positions. We do not trade and we do not lend. For a moment, let me set the scene of the 1960s investment bank. The important partners of Lehman Brothers sat in one large room on the third floor of Number One William Street, the firm's headquarters. Their partners congregated there not because they were eager to socialize, an open room afforded and enabled the partners to overhear, interact and monitor the activities and particularly the commitments of their partners. Each partner could commit the entire assets of the partnership.

You may be interested to know that Lehman's capital at the time of incorporation in 1970 was $10 million. The wealth and thus the liability of the partners like Robert Lehman exceeded the firm's stated capital by multiples. Since they were personally liable as partners, they took risk very seriously.

The financial community changed dramatically in the 1980s. Incorporation and public ownership by security firms enabled them to compete with commercial banks. Innovations like junk bonds, for example, allowed securities firms to lend to non-investment-grade companies. All the firms accelerated the push into global markets, far-flung operations, mathematical modeling, proprietary dealings in debt and equity, and the growing use of leverage and derivatives to hedge risk.

As the commission investigates the causes of the 2007-2009 crisis, it is important to remember that market crises occur periodically. To name a few in the last 20 years, the markets have been roiled by Asian, Russian and Mexican crises, the crash of ‘87, the collapse of long-term capital, the 2000 dot-com bubble collapse, and of course, Enron’s bankruptcy. The question before the commission is: What events or actions occurred within the capital markets or the environment which allowed this crisis to become a debacle? First, every legislative and regulatory move in the last 20 years has been towards obliterating the distinctions between providers of financial services and freeing the capital markets. The shining example, of course, is the Gramm-Leach- Bliley Act of 1999, which removed the last vestiges of Glass-Steagall.

Second, financial institutions used the more lenient regulatory environment to build scale and extend scope. Citigroup, Bank of America, J.P. Morgan, and Lehman Brothers, for instance, acquired competitors and expanded their operations into new fields. Concentration created institutions too big to fail. Government regulation in terms of oversight and coherence did not keep pace with innovation, leverage and the expanded scope of the banks. Three, access to new capital permitted the banks and security firms to shift the nature of their business away from agency transactions and towards more proprietary trading that took positions in marketable and less liquid securities and assets such as commercial real estate. Combined with greater leverage, earnings volatility increased.

Fourth, scale, scope and innovation created an interdependency, most noticeable in credit default swaps, disproportionate to the equity capital of all banks. Management misjudged their capabilities and the capabilities of their elaborate risk-management systems, like VaR, to keep their institutions solvent. Even for insiders in those institutions, transparency diminished so much that firms were not prepared for the extraordinary, the so- called black swan event. Paul Volcker has suggested that financial firms might be categorized between activities with ongoing relationships, such as lending, and transactional interactions, such as trading. He has proposed that these functions be separated.

A corollary question is whether it would be preferable from a public policy perspective, and adequate from a capital markets point of view, to require proprietary investing to be in private partnerships. Until it went public, for example, Goldman Sachs remained a private partnership and was able to attract sufficient capital and weather a series of large losses.

In closing, my hope is that the commission will determine that the 21st century model is consistent with the need for stable banks and capital markets sufficient to finance the world economy. The commission has an opportunity to approach this challenge in a bipartisan manner and produce unanimous recommendations. These conclusions can have a profound effect on legislation, as did the recommendations of the 9/11 Commission. In doing so, the commission will make a major contribution to the stability of financial markets and we will have a chance to mitigate future crises.
Thank you very much.

CHAIRMAN ANGELIDES:
Thank you very much, Mr. Solomon.
We'll now begin our questioning. In this round, members, I'm going to actually not start off. I'm going to—
Mr. Vice Chairman, do you want to ask some questions to start?

VICE CHAIRMAN THOMAS:

Thank you, Mr. Chairman. Just a couple of questions.

Mr. Solomon, I appreciate and admire your belief that we're going to be able to do what you just described. We certainly hope we can. As I requested during the first panel, I really do want people to submit questions that we need to ask to particular institutions, agencies, or private sector structures, but you folks are an example to me of the kind of people who probably, in your areas of expertise, know more of the questions that should be asked than we can think about putting together in the time frame we have to produce a product.

So one of the things I hope you will get to us, and I always prefer them in a hierarchical order, are some questions that you want answered, from which particular agency or structure. And then what I would especially want from you is a parenthetical, or a separate sheet explaining what you believe the answer should be. Because sometimes in comparing what someone says versus someone who has looked at it for some time thinks it should be helps us in our education as well.

For example, Mr. Solomon, I was here in this institution when the Gramm-Leach-Bliley Act was passed. We certainly did not have, most of us, the experience with the early reaction to and the becoming comfortable with the Glass-Steagall Act. And so what in terms of Gramm-Leach-Bliley really contributed to this financial crisis? As you said, it was the vestige of Glass- Steagall, but was it the last joint on the tail that got cut off or did you have the animal and it took the heart out?

SOLOMON:

It's a very good question.

There's a great debate about the effect of the Gramm-Leach-Bliley bill, but 1999 was a very interesting year, '98, '99, as I look back on it. And I would not have said that at the same time, contemporaneously. In '98 -- at the end of '98, you had the collapse of Long-Term Capital. In '99 you had the merger of Citigroup and Travelers. That, actually, merger was delayed until Gramm-Leach was passed, as I believe. '99 Gramm-Leach is

passed, '99 Goldman Sachs goes public. There was a confluence of events which we only see in retrospect, and I actually only realized as I was doing the preparation for this hearing actually. And you could see that '99 was a critical moment.

I think what really has happened, and my fellow panelists have said it, is that the combination of legislative enabling, regulatory daddling, sort of dawdling—and administrations—successive administrations encouraging coalesced into really fundamentally irresponsible behavior. You know, everybody knew that the end was coming. They didn't know how it was going to come. But you could see all these things beginning to occur and building up to a storm. You asked the question earlier, Chairman, of whether it was a, you know, perfect storm from outside or perfect storm from inside. It was a perfect storm from inside. Everybody could see this coming. We didn't know how it would end.

So Gramm-Leach, the point I'm making is there's no single—there's no bullet—there's no silver bullet here. As I've said about this, there's sufficient number of villains that if you list—if you listed all the villains in this tale, you wouldn't get to the plot. And that's...

VICE CHAIRMAN THOMAS:
Maybe that was the plot.

SOLOMON:
... and that's—that's my answer. It wasn't—it wasn't a single thing, Gramm-Leach-Bliley.

VICE CHAIRMAN THOMAS:
Thank you.
Mr. Bass, we have a lot of people interested in risk management, and apparently on the first panel they're now more interested in risk management than they were a few years ago in terms of just how important it really is.

Can you provide for me briefly, and if necessary additionally in writing, how banks' risk models and monitoring activities take off- balance-sheet activities into account? I think they probably are far broader and more sensitive than they used to be, but what is it and what needs to happen?

BASS:

Sure. So—sure. I can give you a few examples of how they do it, just to help you understand it a little bit better. When the commercial paper crisis happened shortly after Lehman failed, what you have is on-balance-sheet are loans already made. A few things that are off-balance-sheet are, of course, derivatives to a certain extent, but more importantly credit lines. Right? If they extend a credit line to someone or extend a backup credit line to a corporation, the amount of assets they pledge against that credit line is literally razor thin, because they believe that in a noncorrelated marketplace, if one corporation has to tap its backup lines, all of them won't. So what they realized, that when everybody had to tap their backup credit lines, no one had the money. So the day that TARP was announced, that was the day that G.E. went to tap its backup credit lines and they ran to Congress— B of A and the banks ran to Congress and said, "We're getting tapped, we don't have the money." So Congress had to come with TARP.

So the off-balance-sheet exposures had no capital assigned to them. As a matter of fact, if you read Fannie and Freddie's statutory capital guidelines, their on-balance-sheet capital requires 2.5 percent capital set aside for the loans on balance sheet. Their more MBS guarantees in their off-balance-sheet exposures require 45 basis points. So on-balance-sheet they can lever call at 40-1, and off-balance- sheet they can level 200-1. So what do you think they did? Right? They went 200-1 wherever they could. So they got to about 95-1 on a blend. So when you talk about off-balance-sheet, that's where you go. But risk weighting of assets is another thing that maybe Michael is better at than I am. But when there are statutory minimal capital levels, that doesn't apply to all assets.

For instance, a Fannie or Freddie bond, as I spoke with Keith earlier on, has a zero risk weighting. So you can buy as many of those as you want. A U.S. treasury has a zero risk

weighting. A AAA security has a very, very low risk weighting. So you can buy a lot more of those and stay within leverage and capital guidelines. So that's where the ratings agencies come into play here. The risk weighting should be reviewed because the ratings agencies argue that they're just a—a—I guess they're asserting their right of free speech and they're just a data point, is what I keep hearing from them.

BASS: However, they set the gold standard for which what pension funds and endowments can invest and what's investment grade. The fact that they set the investment grade guidelines makes them a de facto regulator, and it's what everybody bases their capital decisions on. So there's so many things we can talk about here—things that go wrong— but off-balance sheet and risk weighting are very important. I don't know, Michael, if you want to add to that.

VICE CHAIRMAN THOMAS:

Thank you.

And I'm going it ask Mr. Mayo a question as well. But that's why I do want to, once again, extend to you a willingness, if you are willing, to have the record run until we're done in terms of our work so that we could get back to you as we, again, get more sophisticated and understand the questions we should have asked and work with them. And appreciate your willingness to do that. Mr. Mayo, I like your sheets on the ten points. My question to you: Given the complexity of a bank's financial statements, the derivative off-balance-sheet position that we talked about, how are you able to—I mean, they all claim that they have adequate capital. How difficult is it for you to get a clear picture of what is actually there? Are current SEC disclosures sufficient if you're good enough and have a bright enough light? Or is that an area that we could talk about looking at as well as, perhaps, was one of the problems; no one could get a clear picture of what the situation actually was until, of course, after the fact?

MAYO:

I think about your question a lot. And, you know, accountants try to recreate reality in numbers, and we,

as financial analysts, take those numbers and try to recreate reality. So if the numbers that accountants give us aren't good, then the conclusions of the analysts won't be good either. So, definitely, more disclosure is good and would be helpful.

I'd say innovation always outpaces regulation, but in this case, it was just much further ahead. And, you know, you certainly need more capital for newer activities or more risky activities or other activities without a long enough track record. And you saw that.
And, as Mr. Solomon said, we've had a lot of once-in-a-lifetime events. And you—you know, whether it's Enron and WorldCom or Russia and Asia and Mexico or, you know, the tech bubble and then the real estate bubble. It seems as though these once-in-a-lifetime events happen every couple of years. So the idea of more capital overall makes a lot of sense for these once-in-a-lifetime events for these new activities.
And as far as additional disclosure, no question. It would have been very helpful during the crisis and would still be helpful now especially with regard to problem loans at U.S. banks.

I would make one point, though. We can't be too pro-cyclical. If you try to correct all at once, then you're going to kill the economy. So you have to do this in a balanced way.

VICE CHAIRMAN THOMAS:
A question to all of you, and it's just from my previous job on Ways and Means and the tax code. Would it make a big difference, not much difference, if we had in the time of all of these once-in-a-lifetime events, a better understanding between equity and debt and the way in which major American corporations and even international corporations can utilize debt versus equity? And had we recognized it in the tax code, that, to a certain extent, the old cash-on-the-barrel head is, perhaps, a good way to see what's going on, notwithstanding the complexity of the world today?

SOLOMON:

Well, I'll take a crack at that. I don't know quite how to answer that saying, "I'll take a crack at it." I think that the taxing of debt and equities is fairly appropriate. And I think credit is what is makes the world go round, and credit is what makes the economy go round. And what we're trying to do here and what I hope you will reach conclusions on is what is the balance between the capitalist markets and liquidity of the capitalist markets and the need to regulate them. And if there are changes that should be made in the tax code over a long period of time to cause that to be in balance and to not favor one greatly over another, then you—then I would hope you would reach those type of conclusions. But I don't see that as the number one issue. I see the extension of risky, as both my colleagues here have noted. It's the extension of bad loans. It's simply bad loans.

There was a testimony today about the role of leveraged loans. I think Mr. Blankfein said it, but Mr. Dimon and all people here who testified this morning were extending loans—covenant-light loans and leverage buyouts. Well, who would think that was a good idea? Was that equity or was that debt? That's the question. If you don't have to repay it, if you violate a covenant, is it actually debt even if you have to repay it at the end? Maybe it isn't.

BASS:

I'd like to make two observations...

VICE CHAIRMAN THOMAS:

Just briefly, yes.

BASS:

Two quick observations on that. The first one is I agree with Mr. Solomon about the tax structure. I think it's fairly appropriate the way it stands today. I think that when you look at the banking business, there were securities that were considered to be hybrid securities. They weren't equity. They weren't debt. Banks could raise hybrid securities in forms designated as trust preferreds.

They got to raise that money, and yet it didn't impact their total indebtedness. So it was this—it wasn't equity, it wasn't debt security. I think what you're asking is should we draw lines. And I think we should absolutely draw lines between equity, preferred stock, subordinated debt, and senior debt. There should be bright lines in the cap structure of U.S. companies and not all these crazy hybrid securities where no one knows where to put into the cap structure.

And I guess since I'm being brief, I wanted to add one more point that I didn't get to make in my testimony with regard to the cap structure and the debt and the equity of these companies. When the taxpayer money comes in—and this is a separate debate. But when taxpayer money comes in to a company—I realize that Treasury was dealing with pitches as they were thrown and that this was very much ala carte model of dealing with the financial crisis because we didn't prepare for it.

But going forward, I think what has to be done from the commission's perspective is to determine a methodology for which taxpayer money is to possibly be infused in companies. It needs to be last in and first out. It needs to be senior to the bank debt.
The fact that we're buying equity with taxpayer money is an abomination to the taxpayer. So that's a little bit different spin on debt and equity, but that's where those loans need to go.

VICE CHAIRMAN THOMAS:
Thank you very much. Thank you, Mr. Chairman. Reserve the balance of the time.

CHAIRMAN ANGELIDES:
Thank you, Mr. Vice Chairman.
I was going to hold all my questions until the end, but I want to ask one now so I don't forget. And that is, one thing you seem to be saying is, in a world of rapid innovation, rapid change, expansion of new industries, there's an argument, at least for the core financial sector, to have perhaps even greater stability as opposed to, for example, all the entities out there who can take greater risk without consequence to the taxpayers.

But you seem to be saying that the price of greater innovation, greater volatility in the larger economic world may be having a stronger core. Am I hearing you correctly?

SOLOMON:

Yes.

CHAIRMAN ANGELIDES:

OK. Well, if it's all yes, then unless you want to...

MAYO:

Well, I would say not completely.

CHAIRMAN ANGELIDES:

OK.

MAYO:

So and it's partly—the source of a lot of the losses were detailed by Mr. Bass and Mr. Solomon. And a lot of the companies they named were outside of the core banking industry.

SOLOMON:

The activities were.

MAYO:

And the companies were, too, to a certain degree. I mean, the story is not over yet for the U.S. banks, but big losses you've seen were outside the core part of the U.S. banking industry. So I'd make that point to start off. The second point I would make is, to some degree, it's management over model. So you can go down the whole laundry list of the types of financial firms. You have big conglomerates; some did well, some did poorly. You have brokerage firms; some did well, some did poorly. So I don't want to overstate the point that you're making here.

SOOMON:

It would please every business school to know that management matters. And so one of the things we realize is—and you saw it today—is that people who are better managers did better in times. But what we have to also acknowledge is many of these firms have very large hedge fund proprietary trading operations. And they have shifted from becoming agents to dealers—to proprietary traders.

And this has changed the nature of their view. This is certainly affecting compensation as you get to that issue. It's affecting risk. It has to be affecting risk. And it's probably affecting judgment. And you heard the folks this morning talk about that and say that, "Yeah, we didn't use all the good judgment we could have." But acknowledge today that what is the difference between some of these folks who talked today and what we call hedge funds? You have a totally different view of those, but if you look at the income statements and proprietary trading, you will find that they've increased materially and they have two different forms of regulation and of recognition.

I would argue that hedge funds should be privately—should be private and should be not in the same structure as, for example, the lending business.

BASS:

I think I would respectfully disagree with Mr. Mayo on this. I think we need to determine—if an institution is systemically important to the United States and to our system, we need to determine what appropriate level of leverage are, and we need to force those companies to live within those leverage bounds. You know, today, as I mentioned, it's somewhere between 16 and 25. And I will just assert to you that that is—that's too high. So what we need to determine is—to Mr. Solomon's point—if you're going to be a proprietary trading firm and you want to engage in risk and it is the U.S. way and it's capitalism, go do it. But there will be no safety net for you if you fail. All right. Don't become systemically important.

So you can make that happen. You can separate those two. And it goes back to the Glass-Steagall argument. But I think, of the institutions—we have four banks in the United States that owns 45 percent of the assets. We have 8,300 others that own the balance. Our whole system is very top-heavy here, and the reason that they're systemically important is they're that big. So I think, more holistically, we need to figure out what the structure of the system needs to look like, and we need to set what the leverage ratios are of those systemically important institutions.
That's my opinion.

CHAIRMAN ANGELIDES:
We're going to go to questioning. And, actually, I'm going to keep the same order we did last time. We'll reverse it, tomorrow, members.
So Ms. Murren, why don't you start off, and then we'll do the same order for this panel and the next.
Thank you.

MURREN:
Thank you, Mr. Chairman.
And thank you, gentlemen, for appearing today.
I wanted to follow up on this last topic since we didn't have a chance to cover it too much in the first panel. But could you talk a little bit about financial institutions that lie outside of what be considered the core banking system and
talk, perhaps, a little bit about whether you think any changes in regulation or standards should be made there? And then, a second question relates, actually, to short selling. And I wanted to talk a little bit about your position on whether or not short selling should be a disclosable item in the same manner that a long position would be.

BASS:
OK. With regard to institutions outside of the system, to reiterate the point I just made, first of all, we have to determine who's systemically important and who isn't. And if they systemically important, they need to have a higher risk premium charged to them, and we

need to regulate them heavily. And if they're not, they should be able to engage in these non- bank activities or even lending activities and lever however many times they'd like to be levered. But, again, if they fail, they need to be able to fail. In my testimony, I say, you know, capitalism without bankruptcy is like Christianity without hell. Right. There have to be consequences of excessive risk taking.

As far as short selling is concerned, I believe that short selling is a vital part of our marketplace. And it's interesting what, when Mr. Mack was advocating the ban on short selling during the crisis, once the short selling ban was put into place, the financial equities actually dropped more with the ban on than they did prior to the ban being put on. So I think the proof was in the pudding back during the crisis that supposed short sellers didn't—did not create this crisis; it was simply a lack of confidence in the people that owned these equities. I think it's actually a very good thing.

SOLOMON:
Well, I'm not an expert in this, but I will note that the SEC change in short selling, eliminating the uptick rule, was viewed by an awful lot of my friends who are in the trading business as a bizarre event. They couldn't understand why the SEC in sort of the middle of the summer or wherever it was eliminated the uptick rule. And I'm not talking about the period you're talking about, which is it was the ban on short selling of financial institutions. That was really very, very late. But it was one of the more curious things that occurred in the regulatory environment was this change in the uptick rule. And you really should look into how that happened and who influenced it.

And one of the things that the folks have covered, one really has to look on the influence of the financial institutions in terms of campaign contributions on the regulatory and legislative process in this country.

MAYO:
I think we're talking about systemically important. I think there's four different factors we can think about as we talk about this topic.

Number one would be if you're outside the banking industry, there's a clear lack of oversight. And so we need to get, you know, the shadow banking industry back under the umbrella of oversight. So I think we're probably in agreement on that point.
A second point would be the actual activities that are allowed to be conducted by the banks. And we may agree to disagree on that point, but I would say I was shocked and amazed because, of all the activities conducted, a lot of them are still being conducted. And the ones that aren't being conducted, it's just because the business isn't there right now. When the business comes back, it will be conducted some more.

And so I think that's certainly a point for debate and discussion which activities should be allowed. I think the third point here would be there are other risk factors, so let's not make this a one—you know, one-item issue. So I brought up management as another risk factor. And the fourth point would be size. And on the size point, I do agree with Mr. Bass here that, you know, certain firms are so large that they might be systemically important. I mean, where you draw that line is a big question, but I disagree with Jamie Dimon. There's, in so uncertain terms, J.P. Morgan is too big to fail.

$2 trillion balance sheet? They're not failing. And I heard Mr. Blankfein, I heard Mr. Dimon present earlier. And they said—and you asked the question could you fail today. Well, they said, well, the system is a little too fragile right now, but once it's not fragile. So let me ask you—or if you want to ask them again, under what circumstances would J.P. Morgan be at risk of failure when the system isn't fragile? It's not a close call in my world, and you can poll everyone else you talk to. Maybe the other people on the panel—could J.P. Morgan fail?

SOLOMON:
No. The corollary is this. When you—when there is a government-induced oligopoly, what's the government's role vis-à-vis the oligopoly? And can you afford to have one member of that fail? So, no, of course, I agree with Mr. Mayo.

CHAIRMAN ANGELIDES:

I'll—this discussion is going well. I'll yield three, four minutes. You tell me what you need. I've got flexibility this time.

MURREN:

That should be perfect.

CHAIRMAN ANGELIDES:

Fine. Let's do three minutes and see how it goes. And we'll go from there.

MURREN:

You mentioned that you disagreed with Mr. Dimon on that particular point. I'm curious maybe if you could each just briefly mention what you most agree with that they said—the previous panelists. And I'm assuming that you had an opportunity to hear their testimony. And then, perhaps, maybe one or two things that you disagreed with.

MAYO:

You know, as I listened to Mr. Blankfein, he brought up one word that hit me that I think, if I'm still doing this job 20 years from now, is going to stick with me. And that's when he said, "rationalized." We rationalized what we were doing based on the circumstances at the time. And I think one of the conclusions of your hearings throughout this year, that's a warning to the future. Look how much we rationalized the activities that were taking place in the industry. So I very much agreed with that.

And with regard to Morgan Stanley, Mr. Mack mentioned there was just too much leverage at the firms. That's an easy call, and you can certainly track that.
Well, let me yield to...

SOLOMON:

I certainly agree on leverage. They all said there was too much leverage. And I also agree that all their managements failed. So I can agree on both those.

What I really disagree on is that standards change. And that's why I gave you a little history of the 1960's. Standards do not change. What changes is the competitive environment. And what has changed is limited liability, incentive compensation, and public ownership. And that's what's changed. One of the reasons those folks made those decisions is they have analysts judging how well they're doing. And when one of them provides a leveraged loan with seven times (inaudible) to some company, the other one competes and says I can do it at eight times. And one tries to buy real estate and sees that

Goldman Sachs or somebody buys, you know, (inaudible), then Dick Fuld goes out and decides he has to buy the West Coast if somebody else has bought the East Coast.
And it's the competitive nature of public ownership and limited liability that is at the essence of the problem, in my view. But I don't agree that standards change.

MURREN:
Thank you.

BASS:
I think I might surprise you with this. With regard to something I disagreed with or, let's say, I agreed with Lloyd Blankfein on and something that the press is jumping all over and I heard this morning. With regard to securities they were creating and them taking the other sides of those, I think if you think that all the way through and you understand what was happening, these firms—I agree with Mr. Blankfein that these firms are—they take reverse inquiry.

BASS:
Their clients come to them and say I want to buy X, Y, Z. And if it's a synthetic instrument, they have to create it out of thin air and either source that risk somewhere else or make it themselves. It's the same as if they wanted to buy an equity option that's off—that's off the listed marketplace and Goldman creates it. They don't—I don't think they'd have to disclose to the other party that, hey, we're creating this for you.

It might go to zero, right? I think the point he made about institutional investors taking risks was—was actually a good one. And I actually think that the press is barking up the wrong tree with that argument. I don't think you'll get anywhere with that argument, you know, from my perspective. The thing that I disagree with—when I heard this morning that Morgan Stanley had changed their compensation plans to allow their risk managers to make as much as their traders. I think that's a horrible idea. OK?

If you have a risk manager out there that is—that is supposed to be reining in risk, the only way you make money at these firms is to take risks. OK? If he has—if he's incentivized to get paid as much as the trader, he is going to be more incentivized to let things go. I think that—that income inequality between a risk manager and a trader creates some avarice within the firm that needs to exist. They just missed it the first time. I think if you force it the other way, it's going to be a big, big mistake. You'll have bigger problems, not smaller problems. So those are two key points that I heard this morning that I—that I wanted to reiterate.

SOLOMON:

May I raise one more? It involves the clearinghouse. They all seem to be in favor of the clearinghouse. This is really revelation to me, as it must be to you. Yes, there should have been a clearinghouse three years ago. It was clear. It was evident. Many of us wrote about it. The reason you don't have a clearinghouse is that the price will go down. It'll be like May Day 1975 where the commissions went from 25 cents. We all thought they would go to 16 cents. They went to 8 cents. It took about three days.
So the spreads will go down. They can be—you said they were 90 percent customized. The folks...

BASS:

No, standardized.

SOLOMON:

Standardized. They could be on a clearinghouse and—and the response, I think, to your question. So I would...

BASS:

I'd like to add one more point with regard to that, Mr. Solomon. I think...

CHAIRMAN ANGELIDES:

You know what we're going to do?

BASS:

OK.

CHAIRMAN ANGELIDES:

We're going to move on just to get more questions, more issues on the table. But I'm going to actually take a minute of my time, having said that. But I'm going to charge my minute. I just want to make one comment. Here—here's what I think is a significant issue with the betting two sides for—particularly for significantly large institutions.

I think responsibility of what you move into the marketplace is relevant to the stability of the economy. You can make the argument that there was a demand for Florida swampland. There is responsibility of the sellers of Florida swampland. And the fact is that what was coming through that pipeline—there are big questions about what was coming through that pipeline and what was the actual quality of what was being sold. Just an observation.

All right, Senator Graham?

GRAHAM:

But, Mr. Mayo, I was interested in at the conclusion of your comments you were talking about what is the fundamental purpose of financial institutions. And my definition of their fundamental purpose is to be an intermediary between the—the general public and economic opportunities and to make judgments as to where allocation—how

resources should be allocated. Is that consistent with your definition?

MAYO:

Yes, it is.

GRAHAM:

Now, the questions that I was asking to the first panel were were any factors that are relevant to that definition included in their performance evaluation of their employees. Do they utilize any metrics that relate to how well that financial institution has, in fact, allocated resources and then reward or sanction persons within the organization as the result of application of those metrics? Is that a naive expectation of an institution to look outside its own financial interest to the broader interest of the economy in evaluating the performance of its employees?

MAYO:

Well, we don’t want our CEOs practicing morality with other people’s money. So I don’t think we want to be in that situation. Having said that, making money is not mutually exclusive from creating value to society. So the reason I put my point in about, you know, my cousin Andy who’s a captain the Army going from Iraq to business school is because maybe it’s about time to have the ethics committees at these firms take a little bit tougher look inside the firms. If you asked, you know, are these firms producing for society, well, to some degree they must be because they’re making money. And unless they’re cheating, they’re making money, you know, in plain sight.

But maybe it means leaving the last 10 percent on the table. Maybe some of these transactions that really take place in the gray area—you say, maybe we shouldn’t do that. Maybe the ethics part of these firms should have a little bit of a stronger hand saying we might make a little bit less money now, but the ability to make money will be more sustainable. And the reason I feel this is so important is I believe, you know, financial services is one of our greatest exports in our country. It has been. The number of people living under free market capitalism has gone from 1 billion in 1990 to 5 billion today.

And our ability to export our financial services system wouldn't have worked if we had all these abuses we've had the last several years. So, yes, I do think ethics is important. It shouldn't be the overriding principle. But it should be more of a factor
than it's been.

GRAHAM:
Well, not to denigrate ethics, I don't quite see this as an ethical issue. As an example, I'm associated with a couple of health care organizations. One of the things that we're talking about is in establishing the performance standards that would be used for the officers of those firms to include in the measurement of their performance how well they function as a health care organization.

Are the people who are their charges, their—those who look to them for services—being better treated? Are they healthier? Are they—are they detecting diseases early enough to take effective intervention—those kind of metrics. If those are appropriate standards for a health care institution, why aren't general effects on the economy an appropriate standard for the evaluation performance of people within a financial institution?

MAYO:
At a minimum, it would be nice to hear the CEOs of these major firms remind the employees about the ultimate purpose of what they're doing. And when they come across that gray area, that transaction that maybe shouldn't be done, that maybe doesn't produce economic value, maybe they step back. So I think some step in that direction—maybe not too far, though. There's—there's some point to go, I think, where you're headed.

GRAHAM:
Mr. Bass, I understand that at one point you were sufficiently concerned about the impact of the subprime mortgages that you talked to—maybe it was Bear Stearns and also to the Federal Reserve. Could you summarize what message you delivered to those two audiences and what response you got?

CHAIRMAN ANGELIDES:

Yield a couple of minutes more?

BASS:

Sure. First of all, I'll—in the interest of full disclosure, I was a senior managing director at Bear Stearns for five and-a-half years from 1996 to 2001. So a lot of the people at that firm are very good friends of mine. And a lot of the people that ran the firm are very good friends of mine. In—in September of 2006, I went to Bear Stearns to meet with a guy named Bobby Steinberg, who at the time was their chief risk manager at the firm. He congregated a meeting in a conference room at their headquarters for me with the head of mortgage trading, the head of fixed income trading, the head of mortgage risk, fixed income risk and himself. And I went through my entire presentation as to what I saw building in the housing market where I— where I thought mortgage credit was going to go.

And—and—and, you know, a couple points that I'll make. Someone—someone in this morning's hearing said did you ever contemplate housing prices ever dropping. They didn't even have to drop for losses to show up. OK? If housing prices just went flat, they would have lost 9 or 10 percent on these securitizations, which would have wiped out everything up to close to the AAs. So to put it into perspective, I—I went through my presentation with their risk committee and said do you realize that if I'm right—and—and by the way, I'm one data point from Dallas, so I realize that they can discount what I had to say. But the presentation's fairly compelling. If I'm right, do you realize what's going to happen to this firm, knowing how—the firm's position? And he said-- he said, Kyle, you worry about your risk management, and we'll worry about ours. And that was the last time I spoke with them. Again, it's—it's one data point.

And with regard to the Federal Reserve, I met one of President Bush's staffers and—and went through it with him. And he suggested I go talk with the Federal Reserve here in D.C. And I met with one of the Federal Reserve board members and went through my—my presentation again, just a data point from Dallas—meeting at the Federal

Reserve here in D.C. It's—it's not a large data point.

However, their answer at the time was—and—and this was—this was also the thought that was—that was homogeneous throughout Wall Street's analysts—was home prices always track income growth and jobs growth. And they showed me income growth on one chart and jobs growth on another, and said, "We don't see what you're talking about because incomes are still growing and jobs are still growing." And I said, well, you obviously don't realize where the dog is and where the tail is, and what's moving what. But again, it was my opinion which, you know, they intended—or they—disregarded.

GRAHAM:
Thank you.

CHAIRMAN ANGELIDES:
Mr. Holtz-Eakin?

HOLTZ-EAKIN:
Thank you, Mr. Chairman.
Thank you, everyone, for coming today.
Mr. Bass, you got my attention with leverage at 68 to one at Citi. Can you walk through those numbers for me again?

BASS:
Sure.

HOLTZ-EAKIN:
I just want to make sure I understand sort of the full range of your argument, which sounds to me as if, first, there's the officially measured leverage, then a leverage measure which recognizes the off balance sheet, uncapitalized derivative positions—things like that. I'm trying to figure out where—where do the numbers...
BASS:

Right. So what I've done for you, and in my presentation, is I've given the salient facts of—of the time period in question. What I'm happy to supply you with is the full spreadsheet of—of these numbers. And these numbers were aggregated from 10-Ks, -Qs and their off balance sheet reporting, so it was all publicly available data.

HOLTZ-EAKIN:

OK.

BASS:

So I'm happy to just supply that with you—for you.

HOLTZ-EAKIN:

That would be great. Thank you.

BASS:

I don't have it here in front of me, but I have a full data set for you.

HOLTZ-EAKIN:

OK. That would be great. And so this is 2007, we have leverage at 68 to one. And what we heard from the panel this morning again and again in their written testimonies, oral remarks, were everyone became too levered. We're, you know, going the other way now. But what I did not hear, even in the discussion of their risk management practices, is how the leverage got determined, how internal calculations were done about appropriate levels of leverage, and how they affected their risk management regimes and their expected outcomes. So I was wondering if you could give us your perspective on how that was done in the industry if there have been significant changes in it, and the extent to which this can only be imposed externally.

BASS:

Sure. I think that it—the way that this leverage was built, when you think back to the timeframe in question, pre-crisis, you look at the securities they were levering. And again, it moves back to the ratings agencies' kind of de facto gold standard on investment-grade, and more important AAA, which has statistically the lowest probability of impairment of any security. If you were leveraging an enormous amount of treasuries, you can hedge your interest rate risk and you can put on a fairly sizable position and not have an inordinate amount of risk on your balance sheet.
And—and the same thought can iterate itself through the next layers of AAA, right? So the next layers were

Fannie-Freddie, and the next layers were AAA mortgage securities that have never defaulted. So they took on enormous leverage, and the only thing they were hedging in these levered books was interest rate risk. They weren't hedging capital risk. And you heard some of the—some of the participants this morning say, "Yes, we kind of relied on the ratings agencies to provide us their ratings and that's how we ran our leverage books."

So when you look at the institutions that failed—if you look at my exhibit one, when you look at gross leverage to tangible common equity at Lehman, it was 52 times. At Bear, it was 38 times. At Citi, it was 68 times. You know, when you look through these leverage numbers, and if you're 60 times levered and you lose 3 percent, you've lost two times your money. Right? And—and the losses are going to come in much higher than 3 percent. So I think it just boiled down to people getting lazy and people just levering the wrong securities and not being able to hedge those risks.

HOLTZ-EAKIN:

Mr. Mayo, you said in your list of 10 causes that one was government-provided steroids through the GSEs. What exactly were the mechanics of that? What should we have seen at the time?

MAYO:

I think the misallocation of capital in the housing market was partly facilitated by the GSEs. I personally have never covered Fannie and Freddie and those enterprises. There's usually a separate set of analysts that covered those companies. But I think what we should have seen is the massive amount of capital that was allocated to the housing sector, government-incurred with a government guarantee, and that encouraged a whole industry off these government- sponsored entities. And that was a mistake, easy to say in hindsight. Many of us in the industry saw it for a while, and that goes back to the loan growth, some of the fastest growing areas, as I showed on my loan chart. I mean, every slice of real estate, you know, first mortgages, second mortgages, and then Wall Street certainly facilitated some of these activities.

But you know what? Wall Street also met the demand. So it was kind of together—the government with Wall Street with the banks that facilitated this market.
I made the general comment, I would prefer to see markets over government allocate capital, but with very strong oversight and regulation.

VICE CHAIRMAN THOMAS:

Mr. Chairman, I would yield the gentleman two additional minutes.

HOLTZ-EAKIN:

Thank you.
I wanted to get Mr. Solomon's reaction to the observation; I think it was Mr. Moynihan whose testimony walked through the mono-line institutions that failed during the crisis, and made the argument that it was in fact the large and diversified institutions that survived better, which seems to stand in contrast to a lot of the thrust of your argument about post-Gramm-Leach-Bliley activities.

SOLOMON:

Yes, I think that's—yes, I think that's not a bad point. It is clear that the more diversified firms did survive, and that's why I don't pin the blame on Gramm-Leach-Bliley. That's why I said it was just one—that was my response. So I don't—I think it is—I'm not sure anything is clear, incidentally, and that's why you have the commission.

HOLTZ-EAKIN:

That's not encouraging. We need to figure this out.

(LAUGHTER)

SOLOMON:

That's why you're there. All right? To figure out what the clarity is, but—because all these things happened and they all happened simultaneously. The point that the chairman made, I believe it was—or the vice chairman—is they weren't caused from outside. They were caused inside the institutions, and that's the point you've got to continue to probe on. And I think we all agree on that. So I think—I think Brian is right on that point. It's just management. It's how you set the standards, how you set the risk and how you manage the risk, and your own hubris at managing the risk. You see, a lot of this is just pure management failure even in the best of institutions. You heard Mr. Dimon, Mr. Blankfein—all of them—Mr. Mack— say that we failed. They're right.

HOLTZ-EAKIN:

Thank you.

CHAIRMAN ANGELIDES:

Thank you, Mr. Holtz-Eakin.

Mr. Georgiou?

GEORGIOU:

Thank you, gentlemen.

You know, Mr. Mayo, you said that innovation always outpaces regulation.

And, Mr. Solomon, you had almost 30 years at Lehman Brothers and sort of hearkened back to the days when all the partners sat in a room and listened to each other make commitments on behalf of the firm and on behalf of each other's capital, effectively, and that you thought those days the market, in that the partners were unconditionally liable for the commitments that the firm made, was essentially the, you know, the safety valve that prevented people from over committing themselves and putting the whole financial system at risk.

Given that today we don't really have many of those firms that are in the upper levels of the financial marketplace, what can we do and what ought we to be thinking about doing to create market mechanisms that would replicate, if that's possible, the discipline of the capital that was unconditionally an unlimited liability in the private marketplace?

SOLOMON:
Well, unless you get to the place I would like to get to, which I agree it's unlikely, which is to hive off some of these activities and make them be private and make them be partnerships. And I understand how difficult that will be. But a lot of things we thought were difficult at one point later became true, for whatever reason. I think you just have to have a regulatory environment that is coherent, not patchwork, and enforceable. The regulatory environment failed here. And the proposals, if I may say, for a council of regulators getting together seems to me a nightmare.

Just look at what happened in homeland security with the bomber. We—those regulators couldn't all—those folks all couldn't get together to look at information they all had. And now we're going to have regulators get together in a council. I think that's foolhardy. I think you'll get nowhere with that, and it'll just fall through the cracks again. I'm for one very strong regulator. And the best regulator that we have is the Federal Reserve. And the reason it's the best regulator is it has—seems to have the biggest cadre in most places. And you heard the folks this morning again say that they were very impressed by the regulators in their offices.

John Mack certainly made that point; others did. But you're not going to catch up with innovation, and unless you change the structure—and I'm not sure it's advisable; I would like it, but I'm not sure it's going to happen—I think you've just got to have very strong and constant and non-patchwork regulation.

GEORGIOU:
But does that mean—are you suggesting that really that regulation means enforcing significantly higher capital requirements?

SOLOMON:
Well, that's certainly one thing. I don't think anybody doubts that. Nobody—again, the folks today testified that they thought their capital was too low.
So definitely higher capital requirements. That's a sine qua non. That's a starting point. But that's just a starting point.

GEORGIOU:
Right. But the criticism when I—when we suggested that in the course of the questioning I did, the banker suggested, well, that, you know, that limits the amount of business that they can do, which of course is...

SOLOMON:
Well, you asked that—if I may—in terms of underwritings, I think, and whether they should hold back—be required to hold a piece of their underwriting. And I don't know, they didn't give you—that wasn't a bad answer they gave, meaning that there is a legitimacy to that, but whether the firm should have more capital is the issue
I'm saying, not whether they are required to take a part of their underwriting and hold it back instead of underwriting fees or suffer the loss.

Now, one of the things that does happen today is they're much smarter. They're, you know, when you talk to these folks, you read about Goldman Sachs, and if none of you

have read the Charley Ellis book on Goldman Sachs you should all read it, particularly the updated version. I'll give Charley a plug. You should read it, because it's very revelatory about the thinking of Goldman Sachs about their business and how they look at markets. And, you know, let the—let their words tell you where they're going.

GEORGIOU:
Just one real quick.

CHAIRMAN ANGELIDES:
Couple of minutes?

GEORGIOU:
Just a real quick question. I guess I'd direct it maybe to Mr. Bass, as well as to Mr. Solomon. Are you suggesting that we ought to reclassify essentially these financial services firm, there ought to be certain functions which are only permissible in privately capitalized institutions and the other functions that, you know, that the government backstops, effectively, ought only to be conducted in—only those—those functions ought to be permitted in the public...

SOLOMON:
I don't want Mr. Bass to have to take my position. He'll speak for himself.
Would I do that? Yes, I would do that.

GEORGIOU:
Mr. Bass?

BASS:
I would do the same. I think that—I think that you must take depository institutions that are systemically important or just depository institutions in general. The reason we made Morgan Stanley and Goldman bank holding companies wasn't because that was exactly

what they wanted. That was because what they had to have at that point in time to stop the run on the bank.

The fact that we have depository institutions today betting in the derivatives markets is—I think it's a problem. I think you need to separate the bank from the—from the proprietary trading. Now, proprietary trading, no one's brought this up, you need—you need to bifurcate your thoughts on proprietary trading. There's two kinds.

One is the facilitation business that Mr. Blankfein spoke about. They have a client call them and say, "I want to buy X, Y, Z," and he goes out and finds X, Y, Z and he makes a spread in the middle. That's—that's proprietary trading, but that's riskless proprietary trading. And then there's the risk business, where they go out and just bet.

You have to separate those two. And you can allow banks to facilitate. I don't think you can allow them to take risk positions outright.
So that's my opinion. But you have to separate those things and regulate them.

SOLOMON:
I agree with that.

GEORGIOU:
Mr. Mayo?

MAYO:
I think this is where we respectfully disagree a little bit. I mean, this proposal's been out there. You put the real safe activities into the utility, with the deposits, and you take the risky ones and you put them in the casino and you separate them. I agree to some degree, but it comes down to the definition. When is it riskless? When are you making a bet?
It's just not that clear cut.

And so there should be some separation, and I am shocked and amazed because banks are still allowed to do all the activities they were doing before the crisis. But I'm not sure it has to go that far where you automatically separate everything off. There's other risk factors to think about, such as management continuity, consistency of strategy, success over the last, you know, decade or two. There's other factors than just the one factor of what the activity is.

GEORGIOU:
Thank you.

CHAIRMAN ANGELIDES:
Thank you very much. Thank you, Mr. Georgiou.
Mr. Thompson?

THOMPSON:
Thank you, Mr. Chairman.
Gentlemen, no calamity of this size could ever occur with it emanating signals of its building well ahead of it being visible the public at large. And so, I noticed in your testimony, both Mr. Bass and Mr. Mayo, that you indicated that, gee, I saw this coming. So what I'd like to know is how early did you see it? Not 2006 or 2007, but how much earlier than that? And what signals did you see that others should have seen as well and taken action?
Mr. Bass?

BASS:
When you look back—Mr. Mayo talked about loan growth doubling that of GDP growth. When you look back at the housing market—and you can go back through OFHEO's raw data, all the way back to about I think it's 1971, you look, you can go back and plot the housing price appreciation x inflation and chart that against median income.

It only makes sense that as income moves up, housing prices should be able to move up in a perfectly parallel fashion—you make a little bit more money, you can afford a little bit more house. Those lines were parallel for the good part of 40 years.
And what happened in 2001, when Dr. Greenspan traded the dot.com bust for the housing boom, he lowered rates down to 1 percent. He made money free, and encouraged all of the lending possible to try to restart the economy after the dot.com bust.

I simply think he did a bad job. Other people think he did a great job.
But I think that he enabled this housing market. So when you started seeing rates—rates started—they started raising rates in 2004? When rates started to be—started an increasing path, you saw prime mortgage origination in 2004 drop 50 percent. That just makes sense. Everybody refinanced their homes that could. Everyone got reset and settled, but subprime origination in 2004 doubled. And then it doubled again in '05, as prime originations fell off a cliff because rates were moving up.

So what happened is Wall Street had these machines built to manufacture mortgages. We wanted affordable housing, so they could lower rates with exotic mortgages. And what you saw from 2001 on is you saw those two parallel lines, home price—median home price and median income—diverge. And not only did they diverge by—for those of you that are statisticians, it was an eight standard deviation divergence. OK? That doesn't happen very often. I know we talk about once-in-a- lifetime calamities every 10 years, that one just hasn't happened.

THOMPSON:
The Fed would have certainly seen that. Why, in your opinion was there no action taken there?

BASS:
You know, I mean, why—why do politicians not want to take the punch bowl away when things are going well is kind of what you're asking me. It's just a difficult decision. And, politically—even appointments at the Fed, right? Everyone's on somewhat of a re-

election cycle. If you make that difficult decision when things are good, you're the bad guy. You'd rather be the guy that helps clean it up once it breaks. So you get into more of a—an ideological question when you ask.

THOMPSON:
So a bubble mentality.

BASS:
Well, do we prick the bubble or not? All right?

THOMPSON:
Mr. Mayo?

MAYO:
Yes, three things. Number one, I went back. I did a thousand-page report in 1999, and, right upfront, I talked about what—the real estate situation and how that could fall out and cause a lot of difficulties. So I had to think about why did I put that in there.
And I remembered, because every—not every—many management presentations I went to—we as analysts sit in an audience, hear what the company wants to do over the next three, five years. Many management presentations I went to, they said, "We want to expand home equity." "We want to expand home equity." "We want to expand home equity."

And so, they all had the same goal. So the goal by itself may have made sense. They just weren't paying enough attention to what their competition was doing.
By the way, the same thing happened with branches. Right? They said, "Oh, I think there's a good spot for a branch," they just weren't anticipating the other two or three banks also opening up a branch on that corner. Right?

So that's what happened in home equity, and that was certainly a tipoff to me. And that is a tipoff that might not have been gotten by the regulators that early, but analysts who

were going to all these meetings would get that. The second thing would be deposit insurance. I've written about this nonstop since 1994. And in the early part of this decade, I thought it would be increased. It wasn't. I was wrong. And some of my clients, you know, reminded me of that.

But that was a tipoff to me about the clout of the industry. And that's why I used the word "clout" earlier. And if it's—at the time, it wasn't Sheila Bair head of the FDIC, but if it's—I said the revenues of the four banks that presented this morning equaled the GDP of Argentina. If it's Argentina against Sheila Bair, who's going to win? And so when you talk to her tomorrow, I know part of her answer. I've heard her give the presentation before.

She was lobbied, and she was lobbied heavily. And she said she's saved a lot of the letters from some of the banks that
were lobbying her. So how much was that clout of the banks and how much that influenced the regulation, I think that's an important topic to be highlighted by—perhaps as early as tomorrow. The third point is simply the leverage. It was as clear as day in the middle part of the last decade. I have all my charts there. I'm just using regulatory data. In my mind, people just weren't incented to care enough.

CHAIRMAN ANGELIDES:
I'll yield a couple minutes to finish up.

THOMPSON:
Thank you.
Mr. Solomon, you have suggested that there are structural changes that, if they were made, it might prevent or preclude a disaster of this magnitude. But you've also said that you would acknowledge there were significant management failures that helped to create or facilitate this process.

In your opinion, if the management systems of these companies had stronger accountability, would that not be an appropriate step before structural change in the industry?

SOLOMON:

Yes. I mean, great management will take bad situations and make them better, but they'll be bad situations. I think we are dealing with a structural problem, and we'd better hope that management's fabulous, and it isn't always fabulous. It's a—it's a reality. Even the best business schools can't turn out fabulous people for enough places.

THOMPSON:

Thank you very much.

CHAIRMAN ANGELIDES:

All right, Mr. Hennessey, if I'm—no?

Mr. Georgiou already did it.

Aren't his comments seared into your brain?

(CROSSTALK)

HENNESSEY:

My apologies. Can you compare the—can you compare Fannie and Freddie, what happened with them to the failures at other large financial institutions?

I'm interested in both the competence of management, the risks that they took, and the impacts on the financial system of their failure.

As—as we look at what are the causes of the financial crisis and we have to figure out how to allocate our time and other resources, looking into the failure at WaMu or the failure at, you know, Lehman or Bear Stearns and Fannie and Freddie, can you give us a sense how important were those firms relative to other failures, and can you also give us

a sense of how should we—we've heard a lot; we've been talking a lot about ability to manage risks and about the risks that they were taking. Can you give us some sense of comparison?
Maybe—Mr. Bass, I know you've talked about it a lot.

BASS:
Sure. Gosh, I don't even know where to start with that question. Number one, you should never be 95 times levered, right? When you talk about what they did and management and competence or gross incompetence, they were pushed, as you know, by the fair housing authorities. They were pushed by Congress. They were—again, you can't—you can't allay blame to any one person in that situation. I just think you need to look at all the participants.

But when you look at Fannie and Freddie particularly, that's $5.5 trillion of liabilities, OK? To put that into perspective, the mortgage market, at the end of '07, was about $10 trillion prime, $1.2 trillion subprime, $1.5 trillion Alt-A. Five and a half trillion dollars is almost as many bonds as exist from the U.S. government—well, not any more, you know, but it's close to $7 trillion or $8 trillion, right now, growing about $1.5 trillion a year.

But I think, when you—when you're talking about prioritizing what to look at, clearly, they're the biggest by a mile, right—or 50 miles. So when you look at Fannie and Freddie and what happened, you know, they still sit in this gray area today. And taxpayer money's at risk. And to put it into perspective, you know, the S&L crisis that was so enormous—the FDIC concluded that that cost taxpayers $124 billion. We've already given Fannie and Freddie $183 billion alone, and we've opened the spigots, as of Christmas Eve, for as much capital as they need.
We at Hayman think they'll lose $375 billion or more in the crisis. So the interesting thing is, why is the taxpayer on the hook with Fannie and Freddie when Fannie's cap structure today has $890 billion in it. It has $55 billion of equity and it has the rest in preferreds and debt. Why don't we force the losses on some of these debt holders?

Why is the taxpayer taking a penny of a loss if in fact the losses are going to be a couple hundred billion a piece? I don't understand.

HENNESSY:
A follow up…

VICE CHAIRMAN THOMAS:
Will the gentleman yield briefly to...

HOLTZ-EAKIN:
I want to follow up on exactly that point, with your permission.

VICE CHAIRMAN THOMAS:
Go ahead.

HOLTZ-EAKIN:
I'll go fast. Is it fair to say that one of the reasons—and one of the reasons Fannie and Freddie are more interconnected than the others is the preferential regulations that allow banks to hold unlimited amounts of their debt in there?

And so if we were to in fact force those losses out, their vast interconnectedness would have large implications for the system?

BASS:
Right, but the commission's task is to clean up the system and prevent—from what I read—prevent future crises, right?
So if you're going to end up pumping those—those losses through the public shareholders, it's equally divisible between banks in the United States, banks outside of the United States and foreign creditors. So they took those risks; they should assume them. And if, in fact, it forces U.S. banks into problems, well, the government's paying

for it anyway. Let's go ahead and just pay a fraction of what we're paying and let someone else shoulder some of the blame.

So your answer's yes.

HENNESSEY:

OK. And, Mr. Solomon, you talked about how some of these large banks have, in essence—are running hedge funds within them, where they're benefiting from their trading. The argument is frequently made that Fannie and Freddie have a public purpose aspect to facilitate home ownership. Can you explain what benefit the hedge funds being run within Fannie and Freddie, those portfolios of retained assets—how do they relate to the public purpose of Fannie Mae and Freddie Mac?

SOLOMON:

It's something I don't know enough about to give you a good comment. I can't imagine that any proprietary trading with any—within any institution of the type Mr. Bass was talking about, meaning really proprietary as opposed to facilitating—I can't imagine that that proprietary trading has any value except to the people who are running it and the shareholders of those folks.

I can't imagine what public purpose it could possibly have.

HENNESSY:

OK. Thank you. I asked the CEOs this morning the question about perceptions about their institutions being too big to fail. I think we've heard from at least one person. Could—could the other two of you talk about, do you believe that investors believe there is a government backstop to the largest 19 or 20 firms?

SOLOMON:

Well, I don't think they do today, as much. I'm not sure investors do today. I think Lehman Brothers must have believed they were too big to fail or that they would be rescued. Because they knew they had inadequate capital and they knew it for some period

of time, and they didn't take sufficient action to take care of it. And whether they were led to believe that or whether they simply believed it, I don't know.

But up until the moment when you rescue Bear Stearns and don't let Bear Stearns fail and, you know, you develop a pattern. The pattern of this government was they were too big to fail. And I agree with Mr. Mayo that, if JPMorgan came in tomorrow and said they were going to fail, there are very few people in and around this building who would say, "too bad."

HENNESSY:
Related to that...

VICE CHAIRMAN THOMAS:
Mr. Chairman, I yield the gentleman two minutes.

CHAIRMAN ANGELIDES:
Sure.

HENNESSY:
Thank you.
Related to that, we've been talking a lot about risk management. And everyone wants to believe that they're going to do a better job managing risks than last time. And all of the regulators are going to do their best to do a better job at oversight than last time.
But I am confident that someone, in the future, is not going to manage their risk perfectly and some regulator is going to miss it.

So, again, I want to come back to the question of, sort of, hardening our infrastructure and preparing the system so that it is sufficiently robust that it can withstand those shocks.

What is the solution within that realm for “too big too fail”? One of the answers implicitly got at it when they said it’s a global issue. I frequently heard the argument limiting the size of large financial institutions in the U.S. would place them at a competitive disadvantage with firms overseas.

How do you deal with—how do you manage a system or how do you create a system of rules so that we don’t have to be put into a situation where taxpayer funds are put at risk if one of these—these funds—one of these firms fails?

MAYO:

Yes, I just—I want to go one direction and go another direction. If you overdo the regulation, overdo the safeguards, money will leave and go elsewhere.
And I see this at my—you know, I’m affiliated with COSA, which is number one in research in Asia. I went to our conference in Hong Kong, and there are many U.S. portfolio managers with U.S. dollars taking the money and investing it in Asia.

So if you come down too hard on, you know, any of these topics that we have been talking about, including the ethical side—which I agree with to a certain degree—require too much capital, money will go elsewhere more than ever before.
Having said that, having a lot of capital it’s no longer uneven with investment banks—which it had been for a while. In the ‘50’s and ‘60’s, U.S. banks actually traded higher valuations back then, probably due to some of the stability and strength element. And if we are going to have these once-in-a-lifetime events every few years, there is a very strong flight to quality benefit. And that’s one area where Mr. Dimon could have been more forceful saying, yes; there was a big quality benefit.

There’s also a big quality benefit with too-big-to-fail, though. It’s not just the perception of investors. I think there’s also a benefit in terms of getting market sharing customers. I think we have to look at it from a few aspects there.

CHAIRMAN ANGELIDES:

All right. Thank you. I'm going move on now.

Mr. Wallison?

WALLISON:

Thanks very much, Mr. Chairman.

Mr. Mayo, as an analyst at banks, how many subprime mortgages did you think were outstanding in our economy, and many of them held by banks, in 2008? What percentage of the total number of mortgages were subprime or Alt A? In other words, non-prime in some way?

MAYO:

I thought that was like a trillion out of 11 trillion. Is that...

WALLISON:

So you thought it was about 10 percent?

MAYO:

Yes.

WALLISON:

If I told you it was half, would it have differed—would that have caused your view of what the problems might be to change the order of the various causes of the financial crisis that you describe?

MAYO:

That would be a little bit of a different conclusion, yes.

WALLISON:

OK. I thought it might.

The other question I was puzzling about is your description of capitalism. And you said that capitalism has to involve bankruptcy. No one should be too big to fail. Everyone

should be allowed to fail. But then you said but under prudent oversight. What is the purpose of oversight if it isn't supposed to be keeping people from failing?

MAYO:

If you mean oversight during the...

WALLISON:

Regulation. Oversight. That's what I meant.

MAYO:

OK.

WALLISON:

What is the purpose of it other than to keep people from failing? And why do we want to keep people from failing if capitalism involves bankruptcy?

MAYO:

Well, I think the way I view regulation—and I will defer to others—and this is not my day job completely. But I'll say, to the extent that there's externalities caused by the banking system or any industry—in this case there's very clear externalities in the banking industry due to the contingent liability to the government if a...

WALLISON:

Let me modify that then. Let's leave the banks out, which are already subject to a system of resolution because of exactly what you're saying; the government is backing them. But for institutions that are not backed by the government, what is the reason for having oversight and keeping
them from going bankrupt?

MAYO:

Well, if they're a significant systemic risk, then that would be a justification for some sort of oversight.

WALLISON:

And if there is no systemic risk, then there shouldn't be any oversight. Would you agree to that?

MAYO:

I'd have to think about that one.

WALLISON:

OK.

MAYO:

I think significantly less oversight. Yes, the main reason for regulation is to make sure you make those who cause the externalities pay the cost for those externalities. It would also be to make sure the whole system doesn't fail. To use the example, not being able to turn your water on in the morning. And it might also be to make sure that there's no, you know, egregious practices taking place.

WALLISON:

Every time there's a bankruptcy, there are externalities. And so we do cause people who are—who cause the externalities to pay for the externalities because the shareholders, the management, and the creditors of the bankrupt company to pay for those. So what is the reason to have any other kind of resolution system?

MAYO:

I'm going to have to think about this answer a little more.

WALLISON:

OK.

MAYO:

I mean...

WALLISON:

We'd love you to give us your view of that in writing.

MAYO:

I guess the short—I mean, you can lead me in the direction you want the answer to go. I mean, I'm not sure I'll have the answer to that...

WALLISON:

Well...

MAYO:

I guess what I'm saying is if the employee failed, the creditors failed, the shareholders failed, that's not an
externality. That's within the system.

WALLISON:

Right.

MAYO:

An externality is when you have—the taxpayers have to pay the cost...

WALLISON:

Right. Or the employees.

MAYO:

I don't consider that an externality.

WALLISON:

The buyers, the customers. GM, for example—GM was saved. Were there externalities if GM had failed?

MAYO:

I'm the one who said I don't think the prudent should subsidize the imprudent.

WALLISON:

Right. Exactly.

MAYO:

How you define that is not always easy. I feel like we've overdone it, though.

WALLISON:

OK. I want to—I'd like to go into some other things. Mr. Bass, you laid a lot of the losses in the financial crisis on the question of derivatives, presumably, credit-default swaps. How then do you explain why the credit-default swap market continued to function throughout the entire financial crisis without any obvious disruption of any kind even after Lehman failed?

BASS:

There are three parts to the derivatives market—the OTC derivatives market the way I think about it. There's the CDS marketplace...

CHAIRMAN ANGELIDES:

Excuse me, Mr. Bass. Yield the gentleman an additional two minutes.

WALLISON:

OK.

BASS:

There are three parts to OTC derivatives that you must focus on. One is the CDS market. The second is the foreign exchange derivatives market.

WALLISON:

I'm only talking about the CDS market and how it continued to function.

BASS:

OK. When Lehman failed, every single CDS contract was settled perfectly. Money was paid. Balances were transferred. Things closed.

WALLISON:

Right.

BASS:

So I wouldn't say derivatives, per se, caused it or let's say made it worse. I think that the fact that they were able to take on as much risk as they took on by not posting collateral—the point I'm making is they put too many of them together as opposed to the fact that their use is imprudent.

I think there's a great place for credit derivatives. I think there's a great place for CDS. But I think that not posting collateral to initiate positions and enabling you to take infinite risks like AIG did and like Lehman did is a problem.

WALLISON:

Well, in any transaction of the kind that people do with Lehman, they have an interest in making sure that they're protected. So if I enter a credit-default swap with Lehman and ask for their insurance, I want to be sure that they are covering me.
Why would I not ask for collateral?

BASS:
Because you're a triple-A rated counterparty.

WALLISON:
No. I want Lehman's protection. Why would I not be asking for collateral from Lehman?

BASS:
OK. I'm not following you. As far as...

WALLISON:
The collateral is posted by the person who has the obligation in order to back the obligation. And so I'm just wondering why a collateral is not required at the beginning of these credit- default swap transactions if the counter party is expecting to have the risk covered by the person who is offering the coverage.

BASS:
I think, as you entered the crisis, everyone expected everyone could pay. And as the crisis wore on a bit, the inner dealer transactions never posted initial margin, and AIG or triple-A rated counterparties did not post initial margins.

So they all trust one another. When trust started to erode from the system and people realized the enormity of the leverage in the system, they started requiring deposits. And when they required deposits, it became pro-cyclical. But they should have required them in the first place, and that's one of my key points is you need to require initial deposits from the sellers of open-ended risk.

WALLISON:

I don’t have time to finish this. Just let me finish this question, Mr. Chairman. And that is would you just submit in writing a connection between your argument about credit-default swaps and the financial crisis?

Why that occurred?

BASS:

Sure.

WALLISON:

I don’t have time to talk about it now.

BASS:

Sure.

CHAIRMAN ANGELIDES:

Great. Thank you very much.

Ms. Born?

BORN:

Thank you.

And I would like to actually follow up a little bit. You say in your written testimony that the over-the-counter derivatives market affords OTC derivatives dealers nearly infinite leverage, I assume, because they do not post collateral as a regular matter. There isn’t marking to market of the derivatives. There isn’t the kind of margin requirements and payments that you would have in a futures exchange. Is that right?

BASS:

Yes. Just with one small caveat.

Back pre-crisis, there are two margins. There’s the initial margin, and then there’s the variance margin that you’re required to post if that specific security moves against you. So they are marked to market every day with counter parties.

So what's happened post-crisis, there's still no initial margin to the best of my knowledge. Now, maybe between some dealers, there is. Between the big ones, to the best of my knowledge, there isn't. They've just narrowed the bands of variance margin. The variance margin bands used to be wide enough to drive a truck through, and now they're much narrower. So you can be on the hook for $5 million or $10 million before they force you to post it. And now, maybe it went from $5 million or $10 million to $1 million, but you're still not posting any initial collateral.

So theoretically, you could take very, very large positions and not be recognized or noticed until it starts moving against you.

BORN:
Do you think it would be beneficial to have a clearinghouse for standardized derivatives that would have initial collateral requirements and, also, do the margin calls and things like that?

BASS:
I think it's absolutely mandatory.

BORN:
You know, in 2000, Congress passed a statute called the Commodity Futures Modernization Act that virtually deregulated the over-the-counter derivatives market and also preempted most state laws from governing over-the-counter derivatives.
And I was struck, Mr. Solomon, by your discussion and your written testimony about the impact of deregulation on the financial situation and as a cause of financial crisis. And I wondered—I gathered from your written testimony that you attributed part of the deregulation that we've seen in the last 20 years to the political power of large financial institutions. Is that right?

SOLOMON:

That is correct. And I believe you are against that legislation, as I remember, freeing the derivatives. Yes, I believe that it's important that the financial institutions become more involved, be involved, and have a dialogue. But I think there is—I think the extent of their lobbying has been excessive, and I think it's—yeah, I think it's influenced legislation. I think it's influenced regulation. I think it's influenced success of administrations.

BORN:
Do you think that—I assume when you say influence regulation, do you think it has an impact on how vigorously the financial regulators have enforced their laws?

SOLOMON:
I assume there is some connection. I can't point to chapter and verse, but, yes, I would assume so. You can't have this much activity, this much lobbying, this much money spent without, I assume, these folks wouldn't do all that unless they thought they were getting value received.

BORN:
Simon Johnson has written comparing the situation that we're facing today with examples he saw as the chief economist of the IMF of crony capitalism in developing countries. If we're facing that kind of situation and that played a role in the current financial crisis, I'm concerned about how we deal with that going forward.
Any ideas, Mr. Solomon?

SOLOMON:
I wish I had better ones.

CHAIRMAN ANGELIDES:
By the way, let me just say that I'll extend a couple of minutes to finish up if you'd like it.

BORN:

Thank you.

SOLOMON:

I'll try to be brief. It's a long—it deserves a long answer. I don't have a good answer to that question. It's great worry we all have about a democracy—how much participation is there—with which we want a lot--and how much influence do we want—which we want little.

BORN:

Mr. Bass, do you have a reaction to this issue?

BASS:

Yes. It was clearly the race to the bottom what we just went through. You know, when spreads are narrowing to the levels that they narrowed to between fixed-income instruments—and the only way to achieve the prior
returns on equity was to just keep adding terms of leverage, you know, you hit the tipping point and, clearly, we hit the tipping point.

What we have to prevent is hitting that point again. And, again, I stress bringing—I thought, during the Enron, WorldCom era, we learned that off-balance sheet equaled bad. And, clearly, we didn't. So let's bring off-balance sheet on-balance sheet again. Let's compare apples to apples. Let's set leverage limits. And let's allow regulators and investors alike to make prudent decisions without having to read 50 sets of
footnotes to figure out whether we're coming or going.

So it's a long answer to saying I agree with you and there are things that we can put into place to change it going forward.

BORN:

Thank you.

CHAIRMAN ANGELIDES:

Terrific. I just have a little time left here. They'll tell me how much. Oh, I don't believe that. Oh, there you go. They added one minute just because I frowned. I'll be brief. I just have two questions very quickly. Today to the extent that what do you think are the still persistent biggest risks that exist today in the financial system? Is there still fragility? Very quickly, yes?

MAYO:

Yes. I would say I mean I have four D's. One is de- leveraging. We're seeing consumer loans go down. You're seeing commercial loans go down. Loan growth is not happening yet. One reason is because I don't think all the bad assets have been sold. And so until that takes place, we've been talking about that for two years, still hasn't happened yet. De-leveraging.

Number two, de-risking. Not just the de-risking of assets, but also the de-risking of liabilities, several trillion dollars of bank bonds that mature over the next three years that'll have to be refinanced. That'll be an issue at the same time that some of the government debts have to be refinanced. Number three would be deposit insurance or resolving all the potential failed banks.

And then number four, the deposit service charges where a lot of attention on that recently that could hurt earnings down the road. So those are issues. And as far as—yes?

CHAIRMAN ANGELIDES:

And the first two are pro-cyclical in a sense? I mean, well... The continuing problems that exist.

MAYO:

Yes. And then as far as plain old loan losses, loan losses as a percentage of loans at U.S. banks is 2.5 percent. I have a projection that goes to 3.5 percent. We'll see. If so that would be past the level of the Great Depression. So we're only midstream with the bank loan losses.

CHAIRMAN ANGELIDES:

All right. Mr. Solomon?

SOLOMON:

I think we're about the same place we were a year ago. The only difference is you're there and you're looking into it and shining light on it. But I think we're in—I don't think there's been great improvement except the management is maybe is a little less to use the word hubris is a little more humble about its capabilities at judging risk.

CHAIRMAN ANGELIDES:

Of course we're...

SOLOMON:

That's a great—yes, sir?

CHAIRMAN ANGELIDES:

Well, I was going to say that I think that just to comment on that, one of the great—you supposedly learned from—you learn lessons from your failures, but you really learn from the pain of your failures. And it's not clear that that's been...

SOLOMON:

Well, the interesting thing is we do learn. Enron the issue was, Mr. Bass just mentioned, Enron the issue was off balance sheet. We never solved that.

CHAIRMAN ANGELIDES:

Yes.

SOLOMON:

So the real problem we have is it's like that movie Hedgehog...

CHAIRMAN ANGELIDES:

Groundhog.

SOLOMON:

Groundhog. We wake up every day and it's the same thing. And the reason I point it out in my testimony, folks have mentioned too is how many crisis we've had. This is like recurring non-recurring losses.

CHAIRMAN ANGELIDES:

Right. By the way, I saw my wife laughing. It's my favorite movie because if you've ever been a candidate it is your life.

Mr. Bass?

BASS:

One thing we talk about around our office is the brevity of financial memory. I think it's only about five years when you look back through the financial marketplace. So, but to answer your first question with regard to where we are today as what is still a systemic problem, it's what Mrs. Born is focused on up there and OTC derivatives. We have to nail those down. We have—absolutely need to get not only a clearing house, but a data repository put together so that the appropriate regulator, whoever we deem to be that appropriate regulator can see everything.

Right now no one knows anything. You have to go in institution-by-institution, fund-by-fund. And these are just contracts between a buyer and a seller. There needs to be a clearinghouse, a repository and price transparency because I think that will eliminate an

enormous amount of systemic risk. And when you require collateral to be posted to enter transactions it will self police the size of that marketplace. So that's what I think is the biggest risk.

CHAIRMAN ANGELIDES:

Terrific. Thank you gentlemen very much. You've been excellent. We really appreciate your thoughts and your input. Thank you for taking the time to come here.
We will take a break of no more than 10 minutes. We will start our final panel session exactly at 3:00.

VICE CHAIRMAN THOMAS:

Thank you.
(RECESS)

CHAIRMAN ANGELIDES:

We—we'll commence again. Thank you very much to—for joining us for the final session of our public hearing today. As we have done in previous sessions and as will be our custom in our public hearings, we are going to swear in all the witnesses.

And so, I'd like each of you to please stand together so I can swear you in. Do you solemnly swear or affirm under penalty of perjury that the testimony you are about to provide the commission will be the truth, the whole truth and nothing but the truth, to the best of your knowledge? Thank you very much. I want to thank the panelists for joining us. Thank you for giving us of your—your time and your wisdom.
And what we are going to do is, as we've done earlier today; ask each of you to make an opening statement of no more than 10 minutes. We have received testimony from you. And we're very appreciative of that. And as the vice chair has indicated earlier in the day, at the end of testimony we'll be asking questions, but also we would like the right to reserve—or reserve the right to ask you additional written questions for our benefit.
So we're going to start today with Mr. Zandi.

And so, Mr. Zandi, if you would commence your testimony. Thank you very much.

ZANDI:

Well, thank you, Mr. Chairman and other distinguished members of the commission. I—I want to thank you for the opportunity to testify today. The views I express are my own and not those of the Moody's Corporation.

The purpose of my testimony is to assess the economic impact of the financial crisis that began nearly three years ago. While the financial crisis has abated and the financial system has stabilized, the system remains troubled. Failures at depository institutions continue at an alarming rate and likely will continue for several years more to come. The securitization markets also remain dysfunctional as investors anticipate more loan losses and are uncertain about various legal and accounting rule changes and regulatory reform. Without support from the Federal Reserve's TALF program, private bond issuance and securities backing of consumer and business loans would be completely dormant.

Households and businesses are struggling with the resulting severe credit crunch. The extraordinary tightening of underwriting standards by nearly all creditors is clear in the lending statistics. Here's a very astounding statistic. The number of bank credit cards outstanding has fallen by nearly 100 million cards in just over the past year and-a-half, a 20 percent decline. Total household debt, including credit cards, auto loans and mortgage debt has declined a stunning $600 billion, or 5 percent. And outstanding C&I loans, commercial investor loans, have declined by some 20 percent since peaking in late 2008. Some of this reflects the desire of households and businesses to reduce their debt loads. But it also stems from lenders' inability and unwillingness to lend. Small banks are vital to consumer and small-business lending.

And without the ability to sell the loans they originate to investors in the securities market, banks and other lenders don't have the capital sufficient to significantly expand

their lending. The economic recovery will struggle to gain traction until credit flows more freely, which won't occur until bank failures abate and there's a well functioning securities market.

The economic impact of the financial crisis is very severe. The immediate impact was the great recession, which was the longest, most severe and broadest based downturn since the 1930s Great Depression. Just a few statistics -- household wealth fell some $12.5 trillion as house prices have collapsed some 30 percent. And stock prices, despite the recent rise, are still down 25 percent from their pre- crisis peak. Over 8 million jobs after revisions have been lost in nearly every industry and region of the country. And 26.5 million Americans, over 17 percent of the workforce, are unemployed or under-employed.

Due largely to the unprecedented actions taken by the Federal Reserve and fiscal policy makers the recession, the great recession ended this past summer. It's no coincidence that the downturn ended just as the American Recovery and Reinvestment Act began providing its maximum economic benefit. Help for unemployed workers and hard-pressed state and local government, the cash for clunkers program and the housing tax credits have been particularly efficacious. The stimulus did what it was supposed to do. It short-circuited the recession, and it has spurred economic recovery.

Indeed, the recovery strengthened as 2008 -- 2009 came to an end. Real GDP, the value of all the things that we produced, appears to have expanded by a solid well over 4 percent in the last quarter of 2009. But despite the better numbers, the recovery remains very tentative and fragile. Fallout from the financial crisis, including the lack of credit, which I discussed, the loss of household wealth and the pall over sentiment continues to cause businesses to be circumspect in their investment and hiring and consumers in their spending.

The ongoing foreclosure crisis, the fiscal problems among state and local governments and the commercial real estate bust also continue to weigh heavily on the economy.

The current fallout from the financial crisis is most evident in businesses' lack of hiring. To date businesses have curtailed their cutting as layoffs have abated, but they have yet to add to their payrolls. Initial claims for unemployment insurance, a good proxy for layoffs, are steadily declining. But those unemployed receiving some form of unemployment insurance which should be falling if firms were hiring remains at extraordinarily high levels.

Some 10 million unemployed are on U.I. roles. And what's particularly disconcerting is that many of these lost their jobs at the start of the recession two years ago and are now going to start running out of unemployment insurance benefits.
There are some reasons to be optimistic that hiring will begin soon, employment and temp help firms is increasing. Hours worked have risen off record lows. All of this is encouraging because businesses hire temps and ask their existing workers to work more hours before actually going out and hiring—hiring full-time workers.

But there are also good reasons to be nervous about the strength of any hiring pickup. Job losses in the payroll survey businesses have moderated since the recession ended this past summer, but in a separate survey of households, employment shows no indication of stabilizing. In past recoveries household employment has increased either sooner or more vigorously than payroll employment, probably reflecting what's going on in small businesses. It's not happened, and that's somewhat discouraging.

Small businesses have historically been vital to restoring the job machine coming out of a recession. Small businesses are having difficulty getting the credit necessary to expand their operations. Card lenders and small banks so important to small business credit have been particularly aggressive in tightening their lending standards, given changing laws and regulations and mounting loan losses. And nearly all businesses lack the animal spirits needed to aggressively expand. Confidence remains fragile, probably because so many businesses suffered near-death experiences during the recession and because of the heightened policy uncertainty created by debates on health care, financial regulatory reform, cap and trade and taxes.

Odds are that the recovery will evolve into a self-sustaining expansion in the coming year. But these odds will remain uncomfortably high unless hiring revives. At the very least, the transition from our current recovery to expansion will be less than graceful and may require policy makers to provide even more support to the economy.

The longer-term fallout from the economic crisis will also be very substantial. Based on the experiences of other global economies that have suffered similar financial crises, GDMP and employment will be lower and unemployment higher for many years to come. The unemployment rate is expected to peak between 10.5 and 11 percent this fall. And it will not decline back to a rate consistent with full employment until 2013.

The full employment/unemployment rate is also rising as those losing their jobs are staying unemployed for increasingly long stretches, undermining their skills and marketability as workers. There's also increasing, given the weakening in the labor force mobility, given the large number of homeowners that are under water on their homes. Historically those losing their jobs in one part of the country could readily move to another part of the country where a job was available. This is much more difficult to do if a homeowner needs to put more equity into their home before they move.
The full employment/unemployment rate was probably about 5 percent before the recession began. I wouldn't be surprised if it were to rise to closer to 6 percent when it's all said and done.

But arguably, the most serious long-term casualty of the financial crisis is the nation's fiscal situation. The budget deficit, as you know, ballooned to $1.4 trillion in fiscal year 2009 and is expected to be similar this year. The red ink reflects in significant part the expected close to $2 trillion price tag to taxpayers of the financial crisis. This is equal to 14 percent of GDP. Just to give you a context, by my calculation, the savings and loan crisis of the early '90s cost $315 billion in today's dollars, 6 percent of GDP.
It's not that policy makers had a choice in running these massive deficits. The cost to taxpayers would have been measurably greater if policy makers had not acted

aggressively to the financial crisis. The great recession would likely still be in full swing undermining tax revenues, and driving up spending on Medicaid, welfare, and other income support for distressed families.

It is a tragedy that the nation has been forced to spend so much to tame the financial crisis. Yet it has been money, in my view, well spent. But while the fiscal outlook was daunting prior to the financial crisis, it now feels overwhelming. Without significant changes to tax, and government spending policy, the budget outlook will deteriorate rapidly, even after the cost associated with the financial crisis abate. The nation's federal debt to GDP ratio will balloon to almost 85 percent a decade from now, double the approximately 40 percent that prevailed prior to the financial crisis.

Policy makers must remain aggressive in supporting the economy to ensure that the current recovery evolves into a self-sustaining economic expansion. The coast is not yet clear. But they must also work quickly to—to provide a credible response to the nation's long-term fiscal situation. Unless they do, the fiscal crisis will ensure—ensue resulting in higher interest rates, immeasurably weaker dollar, lower stock and housing values, and a weakened U.S. economy.

The financial crisis has put us in a very difficult bind, but if history is any guide, and the good work of public officials like yourself is any guide, then we will successfully find our way free. Thank you.

CHAIRMAN ANGELIDES:
Thank you, Mr. Zandi.
Mr. Rosen?

ROSEN:
(Inaudible).

CHAIRMAN ANGELIDES:

Can you turn your mic on, Mr. Rosen?

ROSEN:

I'm Ken Rosen. I want to thank Chairman Angelides and Vice Chairman Thomas, and the commission for having me here. I want to not read my testimony since you have it. But I'm going to talk a little bit about what I think is the epicenter of the crisis—where this started, how it got there, and where we are today, which is the housing market—the housing and residential mortgage market. Excessively easy credit, extremely low interest rates created a house price bubble. And the house price bubble when it burst has really caused a significant part of the problems that we had—at least the—initially. And of course it caused—helped cause the great recession where we have lost over eight million jobs.

I think the most important thing to say is how did we get here. And I would say that low interest rates is part of the blame, but really it's the poorly structured products that came about in this environment. Innovative products are important, and a good thing. And I've written papers on—on this in the 1970s and 80s while we needed innovative mortgage products. And they're good for some people—some households. Subprime—there is a need for having that. But not to the market share it got. Low down payment loans – Alt-A loans, option arms. All those made some sense for a portion of the population. What happened is we layered all these risks. We went from a conservatively written subprime loan to a subprime loan that had no down payment, and didn't document someone's income or employment.

So we made a mistake from what was a good idea by financial institutions became a bad idea for the entire overall market. And then we combine that with a second component which was I thought bad underwriting. We lowered underwriting standards dramatically. We started this in California, and it spread everywhere. We—we do this sometimes. Liars loans which are stated income loans, and there was rampant fraud at the consumer level. We've heard discussion of this at the institutional level, but I think the consumer basically really did this so they could qualify for the loan. There was some complicity on

the part of brokers and originators. I think—I do not think this was at the high level institutions, but it's at the individual originator level.

And then we had wide-spread speculation. And I submitted an article to you as a commission, which I wrote in 2006 that was published in 2007. Nearly 30 percent of all home sales in the hot markets were just speculators. And this is not a bad thing, but the speculators put down almost no money. They were flipping houses. And our mortgage system was not able to distinguish between a homeowner and a speculator.

And I think we really need to do a much better job of that in the future. We already are trying to. We're— nothing wrong with speculating, but you've got to put down hard money -- 30 percent down. Some big number so they're not destroying the market for the people who want to own and live in houses. There was a regulatory failure, and everybody knew this was happening. Everybody in the country knew this was happening by the middle of 2006 -- late 2006. One of the unregulated institutions—New Century—a mortgage broker—went bankrupt in early 2007. Everybody knew this, but it kept on going on. I tried very hard and others as well to talk to regulators about this—inform them of this—and within institutions—the Fed in particular.

There was a big debate going on. Should they do something about it? And it was decided not to. They didn't think they had the power. They didn't really believe it was as bad as it was. But there was a big debate with board members about doing something about this.
I think really the whole system of a non-recourse loan in both commercial and residential while desirable by the people borrowing has really created this problem. That there is a belief that it's a—a put option. Things go well, great.

If not, I can give it back. And this misalignment of interest at this level—the consumer level, the borrower level—and the misalignment of—of interest throughout the entire system where risk and rewards are disconnected is really how we're going to fix this.
So if I were to summarize I would say too much leverage, poor underwriting and lax regulation. But I want to take you through some of the charts I have. I know I've got

about five more minutes, but tell you where we are today. And I think you have these at the end of the testimony. They're figures. And let's take the first one, which is the housing bubble. It says, "Figure One—U.S. Housing, Single Family Starts."

You can see here that we had—hopefully you have it, but if not I'll describe the numbers. We were producing in single-family starts about 1.1 million a year on average. That's roughly the average level of single-family starts. And that's the demographic demand. During the peak moments here, we produced 1.7 million. So we were producing about -- we produced during this whole bubble about a million more new starts then demographic demand would have you produced.

And one of the reasons for that was that these—basically people were able to put down $1,000 or $2,000 or $3,000 to control a $100,000 to $200,000 house. It was a—basically a call option. And homebuilders sold them this house. They took an order, and of course they didn't have to fulfill that order. If prices went up, they take the order and flip the house. So we built about a million too many. We are now building about 500,000 houses, and as you know in many markets this has led to lots of layoffs. I think roughly 15 percent of the decline in employment is in the construction industry. So this is a—a very big negative. But we've begun to come back a little bit, and my guess is we'll slowly recover. I would agree with Mark. It's going to take three to four years to get recovery here. Maybe a little bit longer.

If we skip to this figure three—there was some reference to this earlier—is the house price bubble, which is on the second page there. And the house price bubble I think is really why we've had all this fallout. House prices went up in nominal terms dramatically. And in real terms also very dramatically. We've had big house price inflations before.

In the late 70s we had that happen. But that was accompanied by overall inflation. This time house prices went up, and we did not have overall inflation. So real house prices went up dramatically. And only one other period of time have we ever seen a—a

drop in house prices that was in a big way, and that was in the 1930s. It really didn't happen in the post-war period. But we've seen a cumulative price decline based on realtor data of about 21 percent based on another index Kay short about 30 percent.

So this bubble bursting is what's caused I think the bad loan issues in the financial sector with mortgages being a big part of it. The chart below that though is what was referred to by Mr. Bass earlier—key thing—housing became unaffordable during 2003, 4 and 5. The affordability—that is the income relative to the payments you had to make wasn't there. And so that is why we had these new mortgage instruments come about. Because people could not afford to buy the house. And so they had to find an instrument that allowed them to make a lower initial payment.

This would not have been a bad thing if they had fully verified the person's income, they'd have laid down 20 percent, did all the things that made sense. Unfortunately we layered these risks, and that did not happen. So it was the affordability problem that really and partly caused the bubble. But because the bubble itself made people go to these instruments that were at least much more risky.

From the investment community side, of course as you said earlier, that people wanted to get higher yields. They weren't getting them cause the interest rates were so low. So they—investor also wanted these instruments. The fall out is figure five, which is unfortunately not over. In a way you're investigating what caused this, but we're still in the middle of this crisis from the point of view of the consumer, and—and Main Street. Wall Street feels great, but Main Street does not feel great. And this just shows you that the delinquency and foreclosure the total non-performing loans continue to mount for all of the—both the risky loans, and also for non-risky loans.

Remember, there's $11 trillion of mortgages. There are about $3 trillion of the risky category. There's $7 trillion of what is called prime mortgages. And those are going bad

because house prices have dropped so much, people have lost their jobs, and there's no end in sight of this. I think 2010 is going to be a bigger year than 2009.

And then of course our friends at Fannie Mae and Freddie Mac. Again you can see delinquency rates are rising there dramatically. They are much lower than the—the risky mortgage types even though after some time these numbers are going to continue to rise as far as we can see. The next figure on figure seven shows you the same thing is happening with FHA. Big rises in delinquencies in the FHA mortgage program.

So to summarize, we're not done by any means. The cost to the government so far has been large with the bailouts. But I think that we—we see continual further losses over the next year, year and a half, in the residential mortgage market. So we're not at all done. I do have some other data which we'll be able to take in questions. But I—
I'm hoping that I will be able to give you some advice in how this happened, and how it—we can make it not happen again.
Thank you very much.

CHAIRMAN ANGELIDES:
Do you actually have a timer there, cause you ended at one second to go?

ROSEN:
I did.

CHAIRMAN ANGELIDES:
Oh, I thought you were pressing. I thought it was—all right.
Ms. Gordon?

GORDON:

Good afternoon Chairman Angelides, Vice Chairman Thomas, and members of the commission. Thank you so much for the invitation to participate in this hearing. I'm Julia Gordon, Senior Policy Counsel at the Center for Responsible Lending, a non-profit, non-partisan research and policy organization. We're an affiliate of the Community—of the Center for Community Self Help—a community development financial institution that makes mortgage loans in lower income communities.

At the end of 2006 our organization published a study projecting that one out of five subprime mortgages would fail. At the time we were called "wildly pessimistic." Given the resulting devastation, we sincerely wish our projections had been wrong. Instead, we were far too optimistic.

In this morning's panel, several of the CEOs talked about some sleepless nights last September right before the government came in to bail out the banks. Right now there's 6.5 million people having a sleepless night, night after night, because they fear that their family won't have a roof over their head tomorrow. These families are either late with their payments, or many are already in the foreclosure process. More than two million foreclosures have occurred in the past two years alone, and the problem has spread far beyond the subprime market.

By 2014 we expect that up to 13 million foreclosures may have taken place. Beyond the losses to the foreclosed owners themselves, the spill over cost of this crisis are massive. Millions of families who pay their mortgage very month are suffering hundreds of billions of dollars in lost wealth, just because they live close to homes in foreclosure. Those who don't own homes suffer too. One study found that 40 percent of those who have lost their home due to this crisis are renters who's landlords were foreclosed on. And of course foreclosures hurt all of us through lost tax revenue, and increased costs for fire, police, and other municipal services.

I can summarize my testimony this way. Today's foreclosure crisis was foreseeable and avoidable. And the loan products offered absolutely no benefit whatsoever to America's

consumers over standard loan products. Subprime lending didn't even increase home ownership. Through 2006 first time home buyers accounted for only 10 percent of all subprime loans. And now in the aftermath of the melt down, there's been a net loss of home ownership that set us back a decade.

The only reason for these products to have been mass marketed to consumers was for Wall Street, lenders, and brokers to make a huge profit by selling, flipping, and securitizing large numbers of unsustainable mortgages. And the bank regulators who, as many have talked about today, had ample warning about the dangers posed by these loans, either were asleep at the switch or actively encouraging this high-profit, high-risk lending.

The impact of foreclosures has been particularly hard on African American and Latino communities. This crisis has widened the already sizable wealth gap between whites and minorities in this country and has wiped out the asset base of entire neighborhoods.
The foreclosure crisis was not caused by greedy or risky borrowers. The average subprime loan amount nationally was just over $200,000 and is much lower if you exclude the highest priced markets such as California. A majority of subprime borrowers had credit scores that would qualify them for prime loans with much better terms, and researchers have found that abusive loan terms such as exploding rates and prepayment penalties created an elevated risk of foreclosure even after controlling for differences in borrowers' credit scores.

It's also not the case that widespread unemployment is in and of itself the reason for the spread of this crisis to the prime market. For the past 30 years, foreclosure rates remained essentially flat during periods of high unemployment because people who lost their jobs could sell their homes or tap into home equity to tide them over. Unemployment is now triggering an unprecedented number of home losses because loan flipping and the housing bubble have left so many families underwater.
Most important, it's crucial to put to rest any idea that the crisis was caused by efforts to extend home ownership opportunities to traditionally underserved communities. Many

financial institutions, our own included, have long lent safely and successfully to these communities without experiencing outsize losses. Legal requirements such as those embodied in the CRA had been in effect for more than two decades with no ill effect before the increase in risky subprime loans, and fully 94 percent of all subprime loans were not covered by the CRA.

What caused this problem was, as has been stated by previous panelists, risky loan products that existed for only one purpose. It was these loan products forced repeated refinancings that would continue to line the pockets of originators. It's also important to note that contrary to what we heard earlier today, Wall Street was not just an impartial ATM giving out money to originators. Wall Street was asking for the riskiest loans. In one New York Times article, a CEO of a lending company told the reporter, "They were paying me more for no-doc loans, so I told my people to have the customers put their W-2s away."

For the most part, consumers did not ask for these products. These products were push-marketed to consumers. Lenders paid their independent broker originators extra money for placing consumers into interest rates above par, and got even more money for locking them into those rates with prepayment penalties. Both private and public responses to the foreclosure crisis have been too little and too late. The Obama administration has created a promising framework with the Making Home Affordable program, but the program has not lived up to expectations because servicers either can't or won't make the necessary modifications.

Considerations of both economic recovery and basic fairness demand that we do much more to help. We consider the following four steps to be crucial to mitigating the foreclosure crisis. First, we should ensure that families have adequate equity in their homes to continue with successful home ownership. With one out of four mortgage holders underwater, a modification program will not be successful at avoiding re-defaults unless mortgages are realigned with current values. Yet even as loan modification activity ramps up, principal reduction is still relatively rare.

The large banks, who own most of the second liens, are locked in a game of chicken with investors and neither of them will agree to write-down their holdings if the other doesn't. Servicers, for their part, continue to have conflicting financial incentives that sometimes push against the interests of both the borrowers and the loan owners.

The administration fears moral hazard, but we did not let very significant moral hazard concerns stop us when we bailed out the banks. Second, we should require all mortgage loan servicers to attempt loss mitigation prior to initiating foreclosure and to document their efforts. As we all now know, voluntary foreclosure prevention programs do not work. Third, we should lift the ban on judicial modifications of primary residence mortgages. Modifications of loans in bankruptcy court is available for vacation homes, farms, commercial real estate and yachts. Permitting judges to modify mortgages on principal residences carries zero cost to the U.S. taxpayer, would address the moral hazard objections to other proposals, and would serve as a stick to the HAMP's program's carrots.

Fourth, we should make the MHAP program fairer and more effective, especially by stopping the parallel foreclosure process while loans are being evaluated for modifications. And last, I want to talk about what we need to do stop this crisis from happening again. It's crucial that we create an independent consumer financial protection agency. Federal bank regulators could have prevented this crisis,
but regulatory capture, charter arbitrage, the equating of safety and soundness with profitability, and the ghettoization of consumer protection prevented the system from working.

Finally, we must enact common sense rules of the road for mortgage origination. It will be truly stunning if we emerge from the wreckage of this foreclosure crisis without instituting a baseline requirement that lenders make only those loans that borrowers have the ability to pay, and without demanding that all participants along the mortgage securitization chain share an interest in the loan's performance over time.

We stand ready to assist the commission over the coming year and we look forward to your findings on these matters of utmost importance to America's families.
Thank you very much.

CHAIRMAN ANGELIDES:
Thanks, Ms. Gordon.
Mr. Cloutier?

CLOUTIER:
Thank you very much. Chairman Angelides, Vice Chairman Thomas and members of the commission, my name is Rusty Cloutier, and I am pleased to testify today on the current state of the financial crisis and in particular the effect it has had on the small-business lending community. I am president and chief executive officer of MidSouth Bank, a $980 million community bank headquartered in Lafayette, Louisiana, with locations throughout south Louisiana and southeast Texas.

I am also the author of the book "Big Bad Banks," which details how a few megabanks and powerful individuals fueled the current financial and economic crisis. I'm proud to testify today on behalf of the Independent Community Bankers of America and its 5,000 community bank members nationwide.

Mr. Chairman, it is difficult to talk about the effects of the financial crisis without speaking to the root cause. Too-big-to-fail institutions and the systemic risks that they pose were the heart of our financial and economic meltdown. Equally responsible were those institutions making up the unregulated shadow banking industry operating just not outside of legal parameters, of the regulatory framework, which made most of the subprime exotic loans and brought the housing markets to its knees. For far too long, these institutions have enjoyed privileges of favorable government treatment, easier access to cheaper funding sources, lower or no compliance cost, and little if any oversight. A little more than a few years ago, a key element of the financial system nearly collapsed due to the failure of these institutions to manage their highly risky activities.

These reckless and irresponsible actions by a handful of managers with too much power nearly destroyed our equity, real estate, consumer loan and global financial markets and cost the American people some $12 trillion in net worth.

This crisis also has pushed our nation to the brink of insolvency by forcing the federal government to intervene with trillions in capital and loans and commitments to large, complex financial institutions whose balance sheets were overlevereged, lacked adequate liquidity to offset the risks that they had recklessly taken. We're at the point where some of the world markets are even questioning if the United States dollar should be retained as the world's reserve currency.

All of this was driven by the ill-conceived logic that some institutions should be allowed to exist even if they were too big to manage, too big to regulate, too big to fail, and above the law of the United States of America. By contrast, community banks like mine, highly regulated, stuck to their knitting and had no role in the economic crisis. Even though community banks did not cause the economic crisis, we have been affected by it through a shrinking of our asset base, heavier FDIC assessments, and suffocating examination environments.

The work of this commission is important if Congress is already actively advancing dramatic financial sector reforms. The ICBA wants Congress to pass meaningful financial reforms to rein in the financial behemoths and the shadow financial industry to ensure that this crisis like this never happen again to the American people. We need a financial reform that will restore reasonable balance between Wall Street and Main Street.

So where are we today? While the financial meltdown and deep global recession may be over, economic growth remains too weak to quickly reverse the massive job losses and asset price damage that is resulting. After more than a year and a half of economic decline, the United States economy grew by a modest 2.2 percent in the third quarter

of 2009, unemployment is still at a 26-year high and new hiring remains elusive at this modest growth level. The long, deep recession has dramatically increased the lending risk for all banks, as individuals' and business credit risk have increased with the declining balance sheets and reduced sales in most cases.

Today bank regulators are far more sensitive to lending risk and force banks to be much more conservative in underwriting on all types of loans. While this is to be expected after a deep recession, the regulatory pendulum has swung too far in the direction of overkill and choking off credit at the community bank level. Indeed, the mixed signals that appear to be coming out of Washington have dampened the lending environment in many communities. On one hand, the administration and lawmakers are saying lend, lend, lend, and on the other, that message seems to be lost on the examiners, particularly in the parts of the nation most severely affected by the recession.

Bankers continue to comment that they are being treated like they have portfolio full of subprime mortgages and even though they had no subprime on their books. Under the climate community bankers may avoid making good loans for the fear of an examination criticism, write-down and resulting loss of income and capital. Community banks are willing to lend. That's how banks generate a return and survive. However, quality loan demand is down. It is a fact that demand for credit overall is down as business suffered lower sales, reducing their inventory, cut capital spending, shed workers and cut debt.

In a recent National Federation of Independent Business survey, respondents identified weak sales as the biggest problem they face, with only 5 percent of the respondents saying that access to credit is a hurdle. I can tell you from my own bank's experience customers are scared about the economic climate and are not borrowing. They are basically panicked. Credit is available, but businesses are not demanding it.
The good news is that my bank did make $233 million in new loans this past year. MidSouth is extremely well capitalized and would do even more if quality loans were available.

For example, my bank's lines of credit usage is down to the lowest utilization in 25 years. I am pressing my loan officers daily to find more loans, but demand is not there. All community banks want to lend. Less lending hurts profits and income. For the first time in my 44 years in banking I have witnessed a decline in assets in my banks due to lower loan demand.

In total, my loans were down from $600 million to $585 million this past year. Most businesses I work with are using cash flow only and are not interested in taking on new debt. The key reason they cite for not seeking credit is their uncertainty of the economic climate and the cost of doing business going forward. Until their confidence in the economic outlook improves, businesses will be unlikely to borrow from any bank.
The financial meltdown should be a lesson learned in supporting diversity in the banking and in community banks. Community banks represent the other side of the financial story in credit markets. Community banks serve a vital role in small-business lending and local community activity not supported by Wall Street, who has only an international view.

For their size, community banks are enormous small-business lenders. Community banks represent only about 12 percent of all bank assets, they currently make up 31 percent of the dollar amount of all small business loans less than a million dollars. Notably, more than half of all small business loans under $100,000 are made by community banks. In contrast, banks with more than $100 billion in assets, the nation's largest financial firms, make only 22 percent of small business loans.

Community banks in general rely more on local deposits to fund local lending. So they don't rely on the Wall Street capital markets for funding. In fact, small banks of $1 billion in asset size or less were the only segment to show any increase in net loans and leases year over year in the latest third quarter 2009 quarterly FDIC data.
However, small business loan demand is down in general, because businesses and individuals are deleveraging and reducing their reliance on debt after the current meltdown. The FDIC quarterly banking profile for the third quarter of 2009 showed a

record $210 billion quarterly decline in outstanding loan balances. Net loans and leases declined across all asset size groups on—in a quarterly basis in the third quarter of 2009.

Despite a quarterly decline of net loans and leases, at 2.6 percent annual, community banks with less than a billion dollars in assets were the only group to show a year over year increase in net loans and leases of 0.5 percent. While modest, these gains were the best in the financial sector. Our nation's biggest banks, who were here earlier today, cut back on lending the most. The institutions with more than $100 billion in assets showed a quarterly decline of 10.9 percent annual rate and a 10.5 percent decrease, year over year. Banks $10 billion to $100 billion asset banks, had net loans and leases decline at an astounding 17.8 percent annual rate over the previous quarter.

In conclusion, highly regulated community bank sector did not trigger the financial crisis. We must end too big to fail, reduce systemic risk and focus regulation on the unregulated financial entities that caused this economic meltdown on Wall Street. The best financial reform will protect small business from being crushed by the devastating effects of one giant financial institution stumbling. A diverse, competitive financial system will best serve the needs of small business in America.
Thank you, and I'm prepared to answer any questions.

CHAIRMAN ANGELIDES:
So, let's start with our questioning, and I will lead off.
Let me ask each of you a question or two. And, again, brief, succinct, direct.
Mr. Zandi, and I shouldn't do this, but if people haven't read your book, it's worth reading, "Financial Shock." How's that for a cheap plug?

ZANDI:
Yes. I hear it's good on Kindle, too.
(LAUGHTER)

CHAIRMAN ANGELIDES:

You refer to “animal spirits,” in the context of your remarks today. To what extent do the animal spirits extend beyond the housing market? In other words, as we look at causes, perhaps—I don’t want to characterize it—it was certainly a large fire burning, but what were the other fires burning—what were the other areas of excess within the economy in the last few years, in your judgment? If any?

ZANDI:

I think the...

CHAIRMAN ANGELIDES:

And by proportion?

(LAUGHTER)

ZANDI:

I think the hubris in the financial system was widespread. I think it was clearest and most evident in the residential mortgage market, thus the focus on that. But I think it extends well beyond that, and, as we can see to this day, into commercial real estate lending, which many small banks are now struggling with, to corporate lending, all various kinds of—of corporate lending. It was evident more broadly in financial markets, in the derivatives market, stock prices, obviously in commodity markets at certain points in time. So I think the hubris among investors, global investors, was extraordinarily widespread and cut across lots of different markets, a whole range of markets.

In fact, it would be more difficult to identify the markets that weren’t affected at the height of this by that hubris.

CHAIRMAN ANGELIDES:

Is there any way of measuring proportionality?

ZANDI:

Well...

CHAIRMAN ANGELIDES:

How insane it got in different sectors, to see whether it was so deep and widespread in terms of
its genesis versus a set of particular circumstances that might have fueled it in one arena?

ZANDI:

Well, the way I think about it is that the hubris was probably running as thick in nearly every market. I mean, just go to junk corporate bond market. The junk corporate spread over treasury at the height of the euphoria in 2007 was 250 basis points. That's the lowest it had ever been. Average is 500 basis points. At the worst of the crisis and the panic, it was 2,000 basis points.

But I think what was important is the magnitude of the—of the lending in these markets. So, to give you context, the residential mortgage market is $11 trillion deep. Right? The commercial mortgage market is $4 trillion deep. The junk corporate bond market is $1 trillion, $1.5 trillion. So what really made the mortgage market so important is the magnitude of the problem.

CHAIRMAN ANGELIDES:

But did we see—last question—I said one question, but this is interesting—did we see the evolution of, I hate to use the word innovation, but did—you know, in the same way we saw a whole new set of products was it matched in those other sectors?

ZANDI:

It was in every single market, every single market.

CHAIRMAN ANGELIDES:

I mean, I saw it in commercial real estate, but...

ZANDI:

No, now, the CDOing that was going on—CDO would be like the best example of the wildest euphoria, meaning we were bundling up securities and putting them—putting them into one big security, that CDOing was going on with every single security out there at the height of the—at the height of the hubris.

CHAIRMAN ANGELIDES:

OK.

Mr. Rosen, you were talking about the development of bad products, bad underwriting and fraud in the marketplace. And obviously it was—went all the way up the chain. And in terms of those products then moving throughout the system. I guess my question is, to what extent were those products available historically as predatory loan products? In a sense, to what extent did what used to be considered predatory loans, focused perhaps on certain neighborhoods, essentially get transported to the larger economy? Because there were lenders who offered some of these products on a narrow basis, correct?

ROSEN:

They were, and many of these practices have been around for a long time, very successfully done, not the risk element—we heard that earlier—but narrowly based. It's when they became—layered the risk. So if you underwrote a subprime mortgage but underwrote the person's income, gave them counseling, did all the right things, you didn't have this issue. Defaults were always higher, but not dramatically higher.

Same thing with option ARMs. What happened is we layered the risk. We decided to give a person a subprime mortgage, not verify their income, give them no down payment. And I have charts in the paper which I sent to you guys that—it was hard to believe they were doing it; it's layering all the risks.

And it is because the owner of these mortgages was distant from the origination process. I think that's why it happened. So the proliferation of products that were sound for certain categories of people with the right underwriting, became—underwriting just disappeared, and it proliferated throughout the system, so we ended up writing, instead of

5 percent subprime mortgages, all of a sudden, it was 20 percent.

Also, we had, I think, some of the predatory things that we heard from another witness that I think we did have people focusing and steering people. You've seen—I don't have evidence of that, but we've seen lots of anecdotal evidence of that, and that certainly was a problem.

CHAIRMAN ANGELIDES:
All right. You said you talked to the Fed—directly, unequivocally?

ROSEN:
Speeches at the Fed...

CHAIRMAN ANGELIDES:
Speeches at the Fed.

ROSEN:
... and talked to, specifically, people involved with the real estate side. One of the board members,
Ned Gramlich, tried very hard to convince them that this was an important issue, wrote a book on it before he passed away. And so there was—and there was an internal Fed paper which was great, 80 pages long, about the risk layering, which I got the change to read and review. And they knew everything that was going on.

CHAIRMAN ANGELIDES:
Was that an internal document to the Fed?

ROSEN:
It was an internal document, but somehow I got it, so they must have let...

CHAIRMAN ANGELIDES:

Well, if you got it, we'll get it.

ROSEN:

Anyone could get it. It—it wasn't confidential, I don't think, anyway.

CHAIRMAN ANGELIDES:

OK. Well, good. We'll instruct our staff to get it.

ROSEN:

But it was a great paper. They knew exactly...

CHAIRMAN ANGELIDES:

But was this a robust, ongoing debate within the Fed?

ROSEN:

I think it was, clearly, from Gramlich said and reading this paper, they knew exactly what was happening. And now, this, again, would be 2006. We're not saying 2004 but 2006.

CHAIRMAN ANGELIDES:

That's the time frame you're aware of?

ROSEN:

Right.

CHAIRMAN ANGELIDES:

All right.

Ms. Gordon, very quickly—and I know that some of this is in your testimony, but I'm interested in data. You don't have to spill it out today. But in terms of the data that you mentioned, I want to know, for example, when you talked about 94 percent of the product not being CRA, were you talking about originated by entities not regulated by
or...

GORDON:

Correct.

CHAIRMAN ANGELIDES:

OK. And you have data for that?

GORDON:

Yes.

CHAIRMAN ANGELIDES:

Anecdotal or—or based on...

GORDON:

No, real data.

CHAIRMAN ANGELIDES:

And have you provided the underlying data to us?

GORDON:

I—I can only say I assume I dropped A footnote but if I didn't, I will get it to you.

CHAIRMAN ANGELIDES:

OK. But we certainly would like to see that. All right.

And I guess I would ask you to what extent did you see these products migrate out from, you know, a narrow band of the population to a larger band?

GORDON:

Well, I actually want to divide things into a couple of different categories, so we don't conflate different things. In terms of lending to people with lower credit scores, which is sometimes what people call subprime lending, that is something that our organization does. And there are ways to do that safely and sustainably for the people involved.

CHAIRMAN ANGELIDES:

Can I ask a question on that?

GORDON:

Sure.

CHAIRMAN ANGELIDES:

What's been your loan volume over time?

GORDON:

Well, we—we do loan origination and we also do a much—which is relatively small—and we do a much larger secondary market guarantee program for—for Fannie.

CHAIRMAN ANGELIDES:

And the scale of that?

GORDON:

And the scale of that is, maybe, $5.5. billion, something like that.

CHAIRMAN ANGELIDES:

So relatively small?

GORDON:

Yes, yes.

CHAIRMAN ANGELIDES:

But you have data on loan performance and there's not...

GORDON:

Yes. You know, what we've observed over time with traditionally underserved borrowers or people with lower or nontraditional credit histories is that we always had higher delinquency rates than was typical in the prime markets but our actual loss rates always ran under 1 percent. And part of that was because—part of how to run a successful operation, lending to these communities, includes understanding that there can be different kinds of income interruptions and vicissitudes of life and working with borrowers through those periods to keep the loan performing.

And so, really, we—you know, now, of course, we've been impacted by the larger crisis. But just—then what's become what we now talk about as subprime lending is loan products that had risky features and, as Professor Rosen's discussed, lots of layers of risk. And these were not products, for the most part, except in the narrowest, narrowest sense—for the most part, these were never products that provided particular benefits to the consumers. They were products that were push-marketed to, you know, more vulnerable populations and then spread out as the bubble grew and housing became more unaffordable for most families.

CHAIRMAN ANGELIDES:
All right. Thank you very much.
And, last question here, before we move on, which is that—do you have data on—and maybe, again, it's contained. I've read a lot, but at 56, I don't retain all. And that is, do you have data on the extent to which community banks engaged in subprime origination?

CLOUTIER:
Yes, we—we—I'm sure we have data on that, but it was very, very little. Let me—can I just add on to both of these comments...

CHAIRMAN ANGELIDES:
Can you—well, let me just say, can you get us some data on...

CLOUTIER:

Yes, yes, we'll do that. But let me—let me add on, too, that you need to be well aware that the subprime crisis was brought – the products were brought to Citicorp when it was acquired by Sandy Weil, who was a -- who had become very big in commercial credit. And so they developed it. And a lot of the people that were unregulated were mules for the larger Wall Street firms that were pushing these products. But we will get you some data. We appreciate it.

CHAIRMAN ANGELIDES:
All right. Thank you very much. Ms. Murren? Oh, Mr. Vice Chair—oh, gosh, I'm in trouble now.

VICE CHAIRMAN THOMAS:
Ms. Gordon, in terms of your Center for Responsible Lending, do you deal with folks with credit cards as well?

GORDON:
We do work on credit—credit card issues.

VICE CHAIRMAN THOMAS:
Have you run any comparisons in terms of those who got upside down on their homes versus also in significant debt with a credit cards?
Is there a correlation there?

GORDON:
We haven't run any data like that. One of the things that's most difficult about the mortgage work that we do is that data is so hard to come by.
There's some data that we get through the Home Mortgage Disclosure Act on the higher-cost loans, and then we do purchase some proprietary databases to work with. But for the most part, it's very hard to get loan level data that could then be matched with, you know, consumer-to-consumer or bucket-to-bucket.

VICE CHAIRMAN THOMAS:

I'd be interested in any comparisons in terms of profiles. I'm actually a child of the '50s in Southern California, and so your goal was to get into anything because if you could barely make the payment, the next year was a little easier. The year after that, it was a little easier. And you rode the savings a place. You said they had a roof over their heads.

Most of the folk that we knew, the first house my folks were able to purchase was in Garden Grove for $13,500. Just incidentally, it happened to be a four-bedroom, four-stair, hardwood floor home with a two-car attached garage for $13,500. Ten years later, it was sold for over $130,000. That was the way America was. You got into a home. It appreciated. That was your savings. If you could never get on the first rung, as houses went up, it became more difficult to get on the first rung. But if you could sell your first house, you could get into your second, and so on.

So we've heard a lot of testimony about the kind of predatory structures that you're talking about, but for a lot of people if you were told you could get into a place without putting 20 percent down or you could do this or you could that, it's like the Better Business Bureau warning you about all these cons that are out there. People may know about it, but they still take an opportunity to get, as someone says, something for nothing. Mr. Cloutier, we've had—in Central California we have a lot of independent banks, as you know. Small, entrepreneurial, they start up small and they grow or they're picked up by a little larger bank, but they survive quite well. They were not involved in the subprime market. What they were involved in was commercial loans to solid businesses that were growing in the old-fashioned way.

And I don't know if you're familiar with San Jouquin Bank. It's no longer in existence because it was the commercial loan that many of those folks operated the same way people who purchased homes operated. It was their equity. That was their savings. They moved to a larger building. They would sell it. I wouldn't call "flip" it because

three years or four years was a long time in continuing that turnover. Do you know, in terms of the community banks that you're familiar with, of the failures, has it been primarily commercial loans?

CLOUTIER:

It has been primarily a couple of things. A number of them have failed because they did buy Fannie and Freddie preferred stock and that has closed a number of them. The second thing that has closed some of them is, you know, in markets that have just been devastated—and let me tell you, in 1980, I lived in Louisiana and Texas and went through the '80s recession or depression there that was very bad, and I've seen how far real estate could fall, and it's brought down a lot of banks.

VICE CHAIRMAN THOMAS:

That was the savings and loan crisis.

CLOUTIER:

Well, it was a bank crisis. If we would have—let me—let me make a comment here. If we were to fail, Continental Illinois and failed Chrysler in 1980, I don't think we'd be here today. That's when too-big-to-fail started. And it was a banking crisis. Every bank in Texas failed—the large banks. There's only one exception, that's Frost National. So we had a lot of experience with that.

But what happened, Vice Chairman Thomas, is that a lot of banks, when the whole economy goes down, is I had a good friend in Merced that lost his bank. The unemployment in Merced is just rampant right now and it's hard for a community bank that is in one community to survive, but when it comes apart—I listened to the governor of California the other day about all the problems in California. A community bank has a very difficult time when unemployment skyrockets in the community.

VICE CHAIRMAN THOMAS:

But just let me say, and I'll end on this, Mr. Chairman. I don't want to be too personal. But community banks, community hospitals, the structures that rely on the local economy, the service sales and the rest, we like to talk about what's happened on Wall Street, but some of the changes that are now occurring in a number of small communities in which community banks are present. You sit down and you try to pencil out, Mr. Rosen, how they're going to recover in terms of bootstrapping. And you can always recover with bootstrapping, but if you only have socks, it's pretty difficult.
Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES:
Ms. Murren?

MURREN:
Thank you, Mr. Chairman.
Mr. Cloutier, if you could please talk a little bit about how you assess risk at a community bank, and maybe the distinctions between how you undergo that process versus some of the big banks that we heard from this morning.

CLOUTIER:
Certainly. Well, first of all, I have the opportunity to manage my bank, and nothing against the large banks you heard this morning, but there's no one on earth who can manage $2.3 trillion, nor can they regulate it. It's just not possible, it's 24 hours a day. So when they talk about risk management, it's impossible.

But at a small community bank like we have, we have a very strong risk management function. We have very strong loan review. We spend a lot of time visiting with our customers, one on one, talking to them, feeling out what is happening in the community and evaluating loan credits, and understanding what is happening in the community.
I mean, just a perfect example, we do a lot of oil field, gas field lending—natural gas.

Last couple of weeks have been pretty good, with the cold weather across the country so it's helped our customers. But being very closely in contact. Now, the negative is that we're not international, but I—I think we spend way too much time worrying about the international banking situation. And I go back to Mr. Thomas' question. You know, we have sacrificed Main Street for Wall Street. The deposits are leaving Main Street to go to Wall Street.

Let me give you a perfect example. Ally Bank is now—I've got customers pulling money out of my bank to put it in the Internet bank, Ally Bank, which is nothing more than GMAC which just got another government bailout. And they just changed their name and kept right on ticking.

So—but how we assess risk is a day-to-day basis and, you know, we live with it every day and live with our customers. That's the only way we know how to do it at community bank level. And you know, we see these people everywhere we go—to church, to community events and whatever, and we get a pretty good sense of what's going on.

MURREN:

I had an opportunity to speak with a couple of the members of the National Association of Manufacturers over the last couple of weeks, and one of your points was that there isn't demand for credit. And from their perspective, at least, you know, the couple that I was able to speak with, there is a demand certainly for short-term lines of credit. But in their estimation what has changed in their ability to utilize that source of funding to do things like buy equipment is that the collateral that they're being asked for, even by community banks, changed pretty dramatically.

For example, some of these people are small business owners and they're being asked now to personally guarantee loans or put their house up for collateral, as opposed to the equipment itself, which would have been the norm.

Is this as a result of the changes in—in the way that you're being looked at by the regulators? Or what is—is
there a remedy for this? If you could comment.

CLOUTIER:
Well, what happens—I have a good friend that lives in Zachary, Louisiana, and he says "they get the gain, we get the pain." And certainly, that's happening again to us. The large financial institutions got into trouble. The regulators get beat on. The only people they can regulate are the community banks, and so we catch a lot of the flack
that comes out of that.

I don't care what the big four said here this afternoon. They have no idea what an examination is like at a community bank because I can't pick up the phone and call Ben Bernanke or President Obama or whoever. You saw the rock stars here this morning. The cameras left. OK? And so we are heavily regulated, heavily beat on by the regulators. And I can tell you, our—our customers are feeling that.

Like I said, we have sacrificed Main Street for Wall Street, and we're so worried about are we going to upset Wall Street that Main Street is really hurting. And certainly, we have done a big campaign in my area. I ran billboards all over the place. I was featured in New York Times for the story that said Rusty Cloutier has money to lend. We're trying to make loans. But I had an automobile dealer come in this week. They're sales have fallen by two-thirds in the last two years. Nothing I can do to help him. I mean, the regulators would be all over me in 10 seconds from that standpoint. And they had a larger bank that they were asked to leave, and I mean, I understand their problems because people out there are hurting.
Certainly, every community banker wants to do all they can to save their community because we see what's happening over a period of time.

MURREN:
Thank you.

CHAIRMAN ANGELIDES:

All right. Senator Graham?

GRAHAM:

Thank you, Mr. Chairman.

I'd like to pick up on the last comment that you made, Mr. Cloutier. What's—in what specific areas do you think that the attention on the Wall Street financial institutions have adversely affected the community banks?

CLOUTIER:

Well, I mean, you know, what happens with the Wall Street Firms, I mean, you know, all we hear about is systemic risk, and so nobody's going to regulate them. They're above the law. You know, we heard today, pass more laws, pass more regulations. I would ask you, you know, FIRREA is still on the books. Sarbanes-Oxley is still on the books. All of those laws are on the books.

I served on the commission for the SEC—the Sarbanes-Oxley. It costs me 8.5 percent of my profits every year. Nobody was indicted on Sarbanes-Oxley on all these false financial statements. So what happens is that Wall Street can continue to operate the way it wants, can continue to move ahead the way it wants. And as we say, they're too big to fail. We're too small to save. In your state, Senator, we have a lot of community banks in Florida that are going to go down the tubes, but I guarantee you, the large financial institutions that made a lot of those loans in Florida are still rocking and rolling and continuing to move on. And they say, well, you know, "we survived." Yes, they survived.

They were bailed out by the federal government. It's like saying that GM survived. I mean, it survived. It survived because they got a bailout.

That is the difficulty that we face.

GRAHAM:

So – Do I understand what you're saying is that the Wall Street banks are now calling for more regulation, which you think are going to redound to the detriment of the community banks who already are adequately regulated.

CLOUTIER:

Correct. I mean, you know, one example is if they had to live with my capital levels. I had 12 percent capital. When I heard them talk about their capital levels here earlier today, I wondered how in the world they got away with that. Because I guarantee you, if I walked and told my regulator I was going to have 6 percent capital, I'd have a C&D in the morning on my desk.

You know, it's an unfair system. So when they say send more regulation, more regulation only means that's more stuff that I don't have to worry about and that's an easy way to go out the back door. You know, when we had the crisis at Enron, they passed—which by the way, Citicorp and them were deeply involved in. You know, they paid big fines for. It didn't affect them at all. It was crushing to small business. It was a crushing event.

Gramm-Leach-Bliley, when they changed the rules, it didn't affect them. It affected us. So more regulation usually doesn't have much effect. My question is, and the question this commission should ask: Why wasn't the regulations on the books enforced? And then that would be an amazing question to ask. And I think most of the answer is is that they're a member of the FAC they're very closely interlinked into the Washington circles.

GRAHAM:

Ms. Gordon, you made some very strong statements about the fact that there was a preference given to the worst mortgages and actual economic incentives to create harsh conditions and possibly overprice to the consumer mortgages.
What is—do you have some evidence to substantiate those charges?

GORDON:

Absolutely. One of the phenomena that I talked about was the yield-spread premium paid by the lender to the broker. How many of you have ever seen a broker rate sheet? The lender sends out to all the brokers— faxes it out the brokers—I guess now they e-mail them—a rate sheet that tells them, you know, it gives you bands of credit scores and other information, and says, you know, if you sell a loan at this interest rate, which is what goes with this credit score, you get this amount of money from us. But if you add this amount to the rate, you get this much more money from us. And then if you add a prepayment penalty, you get this much more money from us. That is the...

GRAHAM:

Excuse me. The "Us" in that is a...

GORDON:

The lender.

GRAHAM:

... is a regulated financial institution?

GORDON:

Regulated by someone, sure.

And that—and—and that's not talking about a rate bump that maybe a consumer chooses to pay a broker fee. That's a rate bump that the consumer generally does not understand at all is going on. It's just basically a kickback system. And that was part of what caused so many people to be put into more expensive loans than those for which they qualified. And I think it's important—something that Vice Chairman Thomas talked about earlier about people getting the -- getting onto the first rung of the ladder of home ownership. Most of these subprime products were refinancings or were people going from one house to another. The refinancings were often made to people who had actually climbed quite a way up the ladder and then someone chopped the ladder out from under them.

And they were so heavily and aggressively marketed and deceptively marketed and marketed knowingly to people who couldn't afford them. You know, we—we also do some litigation, and we have cases where monthly payments were more than the monthly fixed income of the senior who is receiving the loan. So, you know, the system was filled with those incentives.

Similarly, the word from Wall Street was we pay more for no-doc loans. And, you know, if you are the one producing the loans, you're going to produce more no-doc loans, which means you're going to say to your brokers, "Don't ask for the customer's W-2s." I can show you rate sheets that say that.

GRAHAM:
Well, I'd like to ask if you could provide us with the documentation of those circumstances.

CHAIRMAN ANGELIDES:
Would you like any more time, Senator? Are you done?

CHAIRMAN ANGELIDES:
OK, terrific, take a minute-and-a-half of my time anyway. But thank you, Senator.
Douglas Holtz-Eakin?

HOLTZ-EAKIN:
Thank you, Mr. Chairman.
Thanks, everyone, for coming today.
Mr. Rosen, you've done a lot of work, I know, over the years over the determinants of homeownership. And I was just wondering if you could sort of briefly list the elements of federal policies which are intended to induce people to own homes in the United States.

ROSEN:

Well, Doug, as you know, we—we've done some of this together years ago.

HOLTZ-EAKIN:

What's your favorite paper on the topic?

ROSEN:

Our paper, that's right.

HOLTZ-EAKIN:

Very good.

ROSEN:

But, seriously, I think that the number-one incentive, really, has—really has been the subsidized tax system, as we know, federal income tax system. And it's there. Homeownership is a goal we all seem to have wanted, and we've had, at peak, 69.2 percent homeownership. We're down to 67.7 percent today.

I would say that the second-most important one is the subsidized mortgage system that we have, and it's very heavily subsidized. I've argued, as you know, in papers I've written with Dwight Jaffree and others that it doesn't seem reasonable that 80 percent of the mortgages should be guaranteed by the government. It doesn't make any sense. We've argued for a limited role. Fannie and Freddie, which were 20 percent of the market for many, many years, provide liquidity, all of a sudden, it became 80 percent of the market. And the system changed dramatically.

There is another agency called Ginnie Mae that was supposed to help directly for those who are trying to do loans for low- and middle-income households, and that's appropriate, to do FHA and VA secondary market, but Fannie and Freddie went on their own—let's put it that way—beyond. I think those are the two major elements I would think of, our mortgage system and the tax system.

HOLTZ-EAKIN:

But—but in the recent years, we haven't seen dramatic changes in that aspect of policy, but we did see a big jump in the homeownership rate.

ROSEN:

Right.

HOLTZ-EAKIN:

I mean, those facts are right?

ROSEN:

Right. And that came through what I would say this—and it was unregulated. Almost every one of the institutions that made these loans, aggressive loans, have now been put out of business, bankrupt. I hope a number of people are going to go where they should, to jail that did the predatory lending. They're mostly gone. But that came from that source. It wasn't Fannie and Freddie who did it, primarily. It wasn't the tax system being changed. I think it was these—I won't say deceptive, but loans that looked too good to be true, and they were.

Underwriting standards were—just disappeared. Low down payment loans became such a high portion of the market, low down payment meaning 100 percent, you know, loan, and so you're asking for trouble when you do that.

HOLTZ-EAKIN:

Right. But—but my point is, is simply that, for years, our policymakers have been trying to get the homeownership rate to move. Suddenly it moves exactly the way they want. It's hard to imagine them being upset with what they saw on the surface.

ROSEN:

I think that's probably right. And I'd say 4 million people who became homeowners probably shouldn't have become homeowners. We put them in a situation which wasn't really tenable.

HOLTZ-EAKIN:

And in the fallout from that, we had a large financial crisis. And, Mark, I know you've thought a lot about this. From the fall of 2008 going forward, we've had a series of interventions—the Capital Purchase Programs, we did stress tests, we had suspension of mark-to-market rules—and, I guess, I want your opinion, out of the array of the financial market interventions, which do you think are deservedly credited with the turnaround we've seen to date—I don't want to overstate it—and which do you put on a lower rung?

ZANDI:

I think the Capital Purchase Program was a necessary condition for stabilizing the financial system. I don't think the system would have stabilized without that injection of capital at that point in time, so I think that was absolutely vital.

I think the thing that really ended the—the panic once and for all were the stress tests. I think they were incredibly therapeutic, to my surprise. I—I did not expect them to go as well as they did. And, in fact, I think that is a very therapeutic process to be adopted going forward. We do a lot of risk modeling. We try to incorporate economic information into the risk processes, the financial institutions, something we've done in the—in the wake of the crisis. And it is to my great surprise that these institutions did not have any systematic way of stressing their portfolios.
And actually some of the larger institutions—interestingly enough, they are quite sophisticated, but they're very siloed. So the credit card folks would do it one way; the mortgage guys would do it another way; the corporate bond— the corporate lending folks another. There was no sort of across the entire balance sheet.

And this stress test process for the 19 bank-holding companies was, in fact, that, and it was, I thought, very well done and ultimately restored confidence in the system and is

where we are today. Now, the one part of the system that's not working and the system will not work well without it is the process of securitization. Ironically, that's what got us—the flawed securitization process goes to your point. That's how we got that homeownership rate up. That's how we got all those bad loans being made.
And $2 trillion in private bond issuance in 2006 at the height of the...

VICE CHAIRMAN THOMAS:
Additional two minutes?

HOLTZ-EAKIN:
Thank you.

ZANDI:
Oh, I'm sorry.

HOLTZ-EAKIN:
That's fine.

ZANDI:

OK.

HOLTZ-EAKIN:
High-quality answers. Keep going.

ZANDI:
OK. Two trillion dollars in private bond issuance at the height of the issuance is clearly overdone. It's— it's unhealthy. That's how we got all these bad loans being made. But in 2009, we had $150 billion in issuance, all of it TALF-supported. That is clearly unhealthy, and the banking system won't work with that, either. We need something in

between so that the system can work properly and credit will start to flow. Until that happens, the system is going to remain quite troubled.

HOLTZ-EAKIN:

And I guess this goes to my last question for Mr. Cloutier. And you may want to weigh in. What I hear again and again is there is on the ground demand for credit. That suggests that there's a business that could be made in supplying that credit, makes profits. Why is it that we don't see the entry of new community banks to meet this observed need?
And at the back end of that, if you've got new banks with pristine balance sheets there should be very little difficulty in securitizing their loans, why is this not happening?

CLOUTIER:

I don't think the regulators are very interested in starting any new banks. They have to deal with the current crisis they have, so there's not a lot of new charters coming right now. Raising capital is still somewhat difficult in a new environment. You don't raise that on Wall Street. You raise it in the communities. As I said in my opening statement, communities are very, very nervous.

And there is a need for the loans. The problem is, is that a lot of the customers are very weak, and the scores have been increased. Let me—let me say one thing that the committee could ask Ms. Bair tomorrow when she testifies would be very interesting—I would love to know this myself—is, how many memorandums of understanding or cease-and-desist orders were put against the largest financial institutions in America versus the numbers that have been put against the community banks in America, percentage-wise? I can pretty much guess the percentage on the high end, on the higher bigger boys.

And, I mean, once they come and threaten you with an MOU, they just shut down shop at the community banks. I'm being honest with you. They really do.

CHAIRMAN ANGELIDES:

Mr. Georgiou?

GEORGIOU:

Dr. Rosen, you know, you said in your testimony on page two that securitization should require partial risk retention by originators and packagers to prevent a proliferation of mortgages to unqualified borrowers.

Could you elaborate on that a little bit? And I guess I would ask you, have you been here all day...

ROSEN:

I've listened to the testimony this morning. I was watching on TV. I was here this afternoon.

GEORGIOU:

Right. I just wonder whether—what you think might be certain—other methodologies we might use to—to ensure that there's—responsibility remains on the part of originators for the consequences of the securities that they originate?

ROSEN:

I think that my idea here is that, if you get the risk and reward aligned so that, let's say, after a loan is seasoned three years or so, and they can get the full fee that they earned, but it's put in some sort of trust or something until—and they—they have to keep it there, and earn interest, do whatever they like, but then they can get the full fee at the time when it's—this loan has seasoned.

And we have a lot of these. If any of you have any done—any deals, you always have stuff put in some sort of escrow account to handle these type of things. This is the way businesses are sold, and I think securities would make some sense to do that. So there

would be a little bit more alignment of risk and return. And I think, you know, some of the really excellent banks do that. There's a large one in California—I shouldn't give names—but they exactly do that. They take the riskiest piece themselves, because they know they've underwritten it well.

GEORGIOU:
They take—I'm sorry?

ROSEN:
They take the riskiest piece of a security, they've underwritten it, and they feel confident of that underwriting and they keep that, and they've got a premium on the marketplace for their securities because they do that, the securitizations they do in the commercial mortgage area.

GEORGIOU:
Is there a reason why you wouldn't identify that bank or...
ROSEN: It's Wells Fargo bank, and they've—that's been their tradition. They believe in their own underwriting, and so they keep the riskiest piece in their own portfolio, risky only in the sense it's at the, you know, bottom of the capital stack, and so—and they've had a premium in the marketplace. They're not—they don't do a lot of securitization, but it seems to me that if you get the risk return alignment better, I think it's less likely you're going to have some of the stuff that was done in this environment.

GEORGIOU:
Right.
Dr. Zandi, I wonder if you could comment on the disparities of—of the impact of the recession in certain areas, as opposed to others. I mean, I happen to—actually, Ms. Murren and I now live in—both live in Nevada, where we have something like 75 percent of the homeowners owe more money than they—than their homes are worth and the economic—the underemployment rate has been extraordinarily high.

How do you predict the long-term recovery? And how long do you think that recovery—how much longer will it take in circumstances like that?

ZANDI:

Well, first, let me say that one of the hallmarks of the Great Recession was how broad-based it was across industries and regions of the country. I mean, in past recessions, you always had a large region or two that avoided the recession, and that was a safety valve. People could move from Michigan and go to Florida or move from California to Nevada, and that wasn't the case in this downturn.

Now, having said that, obviously, there are some areas that are harder hit than others and those that suffer— well, were in the housing boom and bubble and now suffered the housing bust are the most severely hit, and that would include Nevada, Las Vegas, Arizona, California, particularly the Central Valley of California, Florida, Rhode Island, interestingly enough, for various reasons, and, obviously, parts of the industrial Midwest. And it will take much, much longer for an economy like Nevada and Florida to turn because its economic base is much less diversified. Obviously, it's related to leisure and hospitality, which is a discretionary purchase and will not turn, and migration flows. And as I mentioned earlier, migration is going to be significantly impaired because one-third of homeowners with first mortgages, by my calculation, are underwater and can't move or won't move as easily. So Nevada's problems are very severe and will be very long lasting.

VICE CHAIRMAN THOMAS:

Isn't it also home construction? I mean, that was one of the fundamental industries in all those areas. And when that's the problem and you can't do it, you implode.

ZANDI:

Well, I—I would say housing in its totality, so that would include housing transactions, home sales. That's demand, house prices ... and, obviously, housing construction.

GEORGIOU:

And construction, right.

ZANDI:

Let me just give you a statistic. Of the 8 million jobs lost after revision, almost 20 percent are in the construction trade.

GEORGIOU:

No, I think I'm fine. Thank you. I'll yield the rest of my time.

ZANDI:

Good luck with that home.

CHAIRMAN ANGELIDES:

Mr. Thompson?

THOMPSON:

Thank you, Mr. Chairman.

Many of the questions I had have been addressed, but I do want to ask a few specifics.

Ms. Gordon, to what extent, in your opinion, might CRA have been a contributor in any way to the housing bubble?

GORDON:

We don't see CRA as a contributor to the—the crisis that occurred. CRA had been working for several decades to get some more lending to people who were qualified for the loans that they were getting. CRA was not intended to put unqualified people into home loans. It was intended to get lending to otherwise qualified people who weren't being serviced by the financial institutions.

THOMPSON:

And you would agree with that, Dr. Rosen?

ROSEN:

Yes, I would. I think that's—the data seems to show that.

THOMPSON:

Yes, OK. Ms. Gordon, you talked about predatory practices, and you specifically said it seemed as though some of that might have been targeted at minorities, African-Americans and Hispanics. Do you have evidence to support that statement? And are there lawsuits or activities underway that would suggest that this is not just predatory, but perhaps illegal?

GORDON:

Well it's well documented that African American and Latino families disproportionately received the expensive and dangerous subprime loans that we've been talking about. You—you know, there—there are Federal Reserve papers on this. The HUMDA data will show that to you, because it collects the demographic data that you need to get this.
I think—in one—one data point I have in my testimony is that in 2006 among consumers who received conventional mortgages for single family homes, about half of African Americans and Hispanic borrowers received a higher rate mortgage compared to about one fifth of White borrowers. You know, our—our research has shown that African Americans and Latinos were much more likely to receive higher rate subprime loans.

Another study has shown that minority communities were more likely to get loans with prepayment penalties even after controlling for other factors. You know, and like I said while it's hard right now to get really good demographic data on foreclosures, you know, given that we know which loans have the highest rates of default, it's not
that hard to connect the dots.

THOMPSON:

Dr. Rosen, in your written testimony you gave a number of very thoughtful things that people should do as they thought about originating mortgages. And these seem to be

quite simple. Better underwriting standards, better mechanisms that discourage speculation, so on and so forth. And since these seem so simple yet so necessary, in your opinion, why weren't they done?

ROSEN:
Well during most of our lending history, they were done. I think common sense would say that you verify a person's income. If you can't verify his income, why would you give him a loan? I mean, he can't give you a document that tells you his income. I mean, you appraise the house. Common sense. But they stopped doing all this.

And it is because of the gatekeeper, which for many years was the rating agencies became the toll taker. So there was no gatekeeper in this whole process. And if someone would buy it, they did it. But I think the consumer should not be given a free pass here. Cause I think a number of consumers lied in their loan applications about their income. Now a stated income loan, you know you're—I mean no one's verifying it, so you do it possibly. I would also say that a lot of these investors –help them stay in that unit. And so there's a lot of things that could be done. Also they're idea of a non-recourse mortgage. Well in many ways it's what you want from a borrowing point of view, it's probably not a wise thing. You want someone to be responsible for the debts they're taking on.

THOMPSON:
So your net point is that the regulatory schema around this failed us?

ROSEN:
The regulatory scheme, common sense, I've talked to a lot of the large financial institutions, and some kept those same criteria. Others thought, "We're not holding it. We're selling it, so it doesn't
matter." If you're holding it in your own portfolio, you would not do these things.

THOMPSON:

So beyond Wells Fargo, are there others that you would say…

CHAIRMAN ANGELIDES:

I'm—I'm going to cede a couple of more minutes. Take...

THOMPSON:

Are there others that you would say manage this process?

ROSEN:

Oh, I think you can look at who's got the—the best delinquency, and default data. I—I don't want to give individual names. I just know at Wells Fargo they actually—there is an actual person talked to me about it. Said, "We're blaming you on why we're not making these loans. It's your fault. We're telling our guys we're not going to do these things, because..." I've known it for many years, and they use that as a way to shield—cause they get a lot of pressure from the sales people to compete. I think that's the nature of the marketplace. And it doesn't mean they didn't do some things they regret also—they did. But I think that it's a competitive market. And it all goes to the lowest common denominator it seems in the mortgage area. And if there's securitization involved, there's no consequence it feels like to people. Holding your own portfolio as community banks do, you make a bad loan; you're going to see it.

THOMPSON:

So you live in California. And you've lived through the hubris of the dot com bubble.

ROSEN:

Right.

THOMPSON:

Can you make a comparison for us between the experiences beyond the significantly expanded impact that this one has had on the local....

ROSEN:

I—I think the dot com bubble—the—the main problem there was again, I think related to the underwriting of unprofitable companies. It used to be you had to have, you know, a year of profit under your belt before you could go public. That was the Wall Street standard. They enforced it. Then that all changed. So it's really the same thing. The lowering of standards, because you could get it done, and there were investors to buy it. This housing problem is much more serious though, because it is such a large sector as Mark said -- $11 trillion.

It's—every financial institution has this. It is larger than the public debt that we have, you know? And that's why it's so important, and so why the bubble is so much bigger.
I would say the dot com bubble set up this bubble though. Because to clean up the last bubble, the Fed kept at rates too low too long. Their idea of not trying to do something about the bubble is either regulatory or through policy I think is—really is the core of the problem.
Monetary policy is poorly—was poorly done under the last chairman.

THOMPSON:

So you would give monetary policy a shot in the eye for its...

ROSEN:

Oh I think...

THOMPSON:

... role here?

ROSEN:

... there's no question about it that they set this one up, and used the wrong words. Matter of fact in 2007 the chairman who I respect a lot did say that it is demographic demand that was causing the housing market. I wrote a

paper that he had read that said it wasn't true. It was the credit bubble. But based—these demographic demand, all
these other things which just the data don't support it.

THOMPSON:
Thank you.

CHAIRMAN ANGELIDES:
Actually on my time just a quick question. Mr. Zandi just a quick couple of comments on what Mr. Rosen said. Any divergence? Any nuance?

ZANDI:
Well, my interpretation of this discussion is what is the root cause of this mess? And my answer is there are many—it's a mélange of problems. But three things—first is the surfeit of global saving, which provided the fodder for all this lending. Second was the failure of the process of securitization.
The intent of securitization was to take all this global saving and funnel it into good loans, and it failed to do that. And there are a lot of bad actors in that process. And then third was the regulatory failure. There was no regulatory oversight, and this is where I would agree with—with Ken. That the key regulator is the Federal Reserve. It failed in that process.

CHAIRMAN ANGELIDES:
All right. Thank you very, very much...

ZANDI:
I wouldn't ascribe it to monetary policy per se—you know there's a lot of reasonable debate about that. But it's clearly the regulatory failure I would agree with.

CHAIRMAN ANGELIDES:
So you—because one of these always—I wondered to the extent that there's still the

global and savings imbalance if you accept that that's the reason and the only reason which I'm not prejudging it. It dooms you to the same result unless you believe there are other things that occurred that could have been controlled.

ZANDI:

Well, unless you...

CHAIRMAN ANGELIDES:

Actions of humans as well as both in the private and public sector.

ZANDI:

Unless you fix the process of regulations and regulatory reform, and you fix the process of securitization through some of things we're discussing or with—how much do you hold on your balance sheet?

CHAIRMAN ANGELIDES:

Right, let's...

GEORGIOU:

Mr. Chairman, could I snatch back my—a minute of...

CHAIRMAN ANGELIDES:

OK. And then you'll get—it will come out of my—mine at this point. Take 30 seconds quick.

GEORGIOU:

Just out of one—just one second. You know, the—we haven't talked about commercial property mortgages. Which it seems to me is the big balloon out there that's still ready to come forward over the next couple of years. And if people can't refinance those mortgages, it's going to put a number of institutions into further—at further risk of failure. Could somebody—Dr. Rosen, perhaps you could comment on that?

ROSEN:

The good news is it's a smaller dollar amount. But it's a big dollar amount.

GEORGIOU:

It's—less than—it's about $1 trillion isn't...

ROSEN:

The loss number is going to be somewhere between $500 and $700 billion out of $3.5 trillion debt component.

GEORGIOU:

Right.

ROSEN:

So it's a much smaller number. We have something called a mend and extend happening now where they are mending and extending loans. But the same bubble that happened in residential happened somewhat in commercial. Big value increase and now a 40 percent value decline. So there's a—a lingering issue that's going to be there. I—it - it doesn't all hit at once.

The good news is it's stretched out over the next five years. So I think we're OK. It's not good. It—but I think the residential losses going forward for the next year and a half are going to be bigger still, than the commercial over five years.

GEORGIOU:

Except that the commercial loans are bigger—each one is bigger. And so they—they—some of them pose a bigger risk to—to...

ROSEN:

Some institutions.

GEORGIOU:

Some certain institutions. Right.

CHAIRMAN ANGELIDES:

Mr. Thomas, you want to take...

VICE CHAIRMAN THOMAS:

Mr. Chairman, I'll take a—a minute, and then ask the question in terms of the distribution of the commercial loans vis-à-vis subprime and the rest. We had big banks in. Is there a greater strain on community banks in terms of the commercial loans versus the subprime being consolidated, and taken to a higher level? And that I think is something that should cause a lot of concern. Because if you get a collapse at that level, and we haven't seen the response to recover or protect at that level, you're going to have a far more fundamental erosion of locales than you would based upon what happened in the subprime.

GEORGIOU:

Do you agree with that?

ROSEN:

I'd say there's—what you're really talking about is the construction and development loans. There's $550 billion of that outstanding, and that is at the smaller bank level.

ROSEN:

And—and we've already seen 170 banks—I guess there's five or 600 more.

VICE CHAIRMAN THOMAS:

Oh, yes.

ROSEN:

And it's a big number. And there really isn't the policy response to this other than close them.

VICE CHAIRMAN THOMAS:

Right.

ROSEN:

Which is—has bad effects for many medium and small sized communities.

VICE CHAIRMAN THOMAS:

Thank you.

CHAIRMAN ANGELIDES:

Mr. Hennessey? You are at the plate.

HENNESSEY:

Excellent. Ms. Gordon, in the category of irresponsible types of loans that were pushed on borrowers, would you classify zero down payment loans in that category?

GORDON:

High LTVs were—were definitely part of the problem. I will say that Self Help has made in the past zero down payment loans under certain controlled conditions as we were—a financial institution specifically aimed at working with families trying to do the first rung on the ladder that we were talking about before.

But yes. For the most part this was part of the risk layered into these loans. And not just 100 percent LTV loans, but the 80-20s. What we've seen now in trying to clean up from this foreclosure crisis is one of the single biggest obstacles has been all of these second liens out there. We even—we were—when we were looking at the option arms, which were loans that had the potential to negatively amortize, and—and most of them did. What was stunning was when we saw that even—I can't remember the exact

number, either a third or 40 percent of those had second liens—simultaneous seconds on—on top of them. And yes, that's a very risky factor.

HENNESSEY:

OK. Thanks.

Dr. Zandi, I want to understand a little better sort of your view of where we are in the recovery. And in particular, we've got an ongoing flow of fiscal policy of stimulus dollars going out the door. That will gradually taper off starting next year—like 2011 -- 2012...

ZANDI:

No, this year.

HENNESSEY:

This year is when it starts to taper off?

ZANDI:

By—by the end of the year it will be a drag.

HENNESSEY:

Oh, OK. And then the Fed is at least starting to talk about dialing back the liquidity that they've got. So you're—you're going to have fiscal policy, and monetary policy both starting to be reined in. And yet you're talking about an unemployment rate in the 10.5 to 11 percent range if I thought I heard you right at the end of this year.

ZANDI:

Yes.

HENNESSEY:

And not getting to anything, but like a 6 percent new full employment measure three to four years from now -- 2013?

ZANDI:

Right.

HENNESSEY:

First question. That's a long time to get to 6 -- 6 percent.

ZANDI:

Yes.

HENNESSEY:

Is that because we're starting from 10, and still have a ways up to go, and it's just a long way to go down? Or is it that the pace of job growth is going to be particularly slow because of the type of shock that we're recovering from. Is it the nature of the recovery, or just the distance that we've got to go?

ZANDI:

It's both. It's both. I mean, we've got a huge gap. And we have a—it will grow quite large. One point to consider—it will—it will grow larger before it narrows in large part because the labor force is declining right now, which is—it's not unprecedented, but it's incredibly unusual. You have to go back into the 50s when we were going in an out of wars to see something like this. And the labor force will start growing again, and that will cause unemployment to rise. And then we've got to absorb all those folks that are going to come into the labor force. So it's going to be—it's the gap and the nature of the recovery.

HENNESSEY:

OK. And now if we could, let's talk a little about the trade off between the deficit impact and the jobs impact. And maybe I'm inferring too much, but like a lot of people you seem to be saying look, we've got to be thinking about deficit reduction especially in the

medium term and long run. But you've got to worry about the short—short term impact on the macro economy.

ZANDI:

Right.

HENNESSEY:

But your—your short-term impact on the macro economy is three to four years at this point. If you had a magic wand, would you have policies increase the deficit over the next year to two years to get the jobs impact, or would you have them decrease the deficit? How would you trade off between the two?

ZANDI:

If—if I were king for the day I'll take the magic wand. I would run a larger deficit in the very near term -- 2010 -- perhaps early 2011 to make sure that the recovery is evolving into a self-sustaining economic expansion. And I wouldn't argue that if we were at a 6 or 7 percent unemployment rate. I would take the chances, because we've got a very large fiscal problem. But we're at a 10 percent unemployment rate with a zero percent funds rate target. If we go back into recession, it's going to be a mess. It's going to be a mess.

HENNESSEY:

OK. Let's limit the power of your magic wand a little bit. So it's the best policy you can imagine Congress enacting over the next year period. How big of an impact can that have? So instead of—so you wave that wand, that policy happens. Instead of a ten and a half to 11 percent unemployment rate at the end of the year, you're looking at what kind of range?

ZANDI:

I think if we had a package that was couple of hundred -- 250 billion spread out in calendar year 2010 into 2011...

VICE CHAIRMAN THOMAS:

Mr. Zandi, I hate to do it to you again. It's just a random selection.

The gentleman can have an additional two minutes.

HENNESSEY:

Thanks.

ZANDI:

I think that would significantly raise the odds that this recovery would evolve into an expansion, and I'd feel much more comfortable with how things are going. I think it would also be, though, very appropriate if policy makers could make a credible step towards that long-term fiscal discipline because that would make it measurably easier to do these things in the near term.

HENNESSEY:

OK. You're saying—so if I'm hearing correctly, you're saying it reduces the probability we have a double dip. Do you think that it lowers the expected value of unemployment? Do you think the ten and a half, 11 forecast, you know, what's the first...

ZANDI:

You asked that, and I'm sorry I didn't answer that. That ten and a half to 11 percent, all that assumes is that the Federal Reserve does not tighten policy in 2010 -- does not raise interest rates—begin to tighten policy but not raise interest rates. The only other additional money I'm assuming is $50 billion for UI for 2010 unemployed.

So that's what I'm assuming to get to ten and a half to 11. We could make a measurable difference by the end of the year, I think, if we had a—if properly designed—couple hundred billion dollar in additional…

HENNESSEY:

and measurable difference...

ZANDI:

Yeah. I think we would be close to 10 percent by year-end.

HENNESSEY:

OK.

ZANDI:

Headed in the right direction.

HENNESSEY:

So what you're buying for that couple hundred billion dollars is you're knocking the rate down by maybe a percentage point, and you're buying more security that you're not...

ZANDI:

It's really the latter that matters to me.

HENNESSEY:

OK.

ZANDI:

It's the certainty to get the risk off the table.

HENNESSEY:

And if I could, in the time remaining, your written testimony was somewhat critical of the HAMP, I think is the acronym—the mortgage modification program.

ZANDI:

I'd say quite critical.

HENNESSEY:
OK. How big of an impact do you think that ideal policy can have on that? I mean, a lot of mortgages are—it's not preventing a lot of foreclosures. Again, sort of your magic wand works as well as you could expect, how much better do you think—how much bigger of an impact do you think you can have on foreclosures?

ZANDI:
Well, I think if we implemented a program that had principal reduction—and I can describe that in gory detail, if you'd like, exactly how that would work. Use the money that we've allocated in the TARP for housing policy that will not be used because HAMP and HARP are not working. Just use that money towards principle reduction, I think that would make a very meaningful difference to 2010.

HENNESSEY:
Thank you.

CHAIRMAN ANGELIDES:
Thank you. Mr. Wallison?

WALLISON:
Thanks very much.

Mr. Rosen, Fannie Mae and Freddie Mac have become insolvent. The reason, I think, is that they have large numbers of subprime and Alt-A loans that are failing at very high rates. The numbers that I have seen indicate that they have about 10.7 million subprime loans and Alt-A loans. And that is in addition to about four and a half million FHA, VA loans which are also subprime and Alt-A.

So that's about 15 million subprime and Alt-A loans. How do you square that with the idea that the subprime and Alt-A loans originated from irresponsible lenders by unregulated mortgage brokers?

ROSEN:

So I don't have those numbers on Fannie Mae and Freddie Mac with me, so I can't—but I do know that Fannie Mae and Freddie Mac got to the party late; that they did not do them early on at all. They came on board in 2006 and '07. They did not start this. They were not the buyers of this.

The vast majority of them, as you can see I have a chart here if you can take a look, on page nine, the vast majority of them were put in the CDOs which Fannie and Freddie are not involved with. Those were private securities. So I don't have the numbers in front of me, but I have the paper. Somewhere in the order of 80 percent were done privately, and Fannie and Freddie were certainly at the end, did more. And those are—they shouldn't have done them. They admit that now. But they did more. But they were certainly not the originators of this whole process.

WALLISON:

Well, with all respect, it's very hard to believe that mortgages that were acquired in 2006 and 2007 would have caused them to become insolvent.

ROSEN:

That is actually—the 2006, '07 books were the bad books.

WALLISON:

Well, yes, they're terrible.

ROSEN:

Before that, the books...

WALLISON:

2005 and 2004 are also bad. 2003 are much better. But my point is it's important to understand what their portfolios consist of if we are to understand where these bad loans came from. And if the bad loans actually came from Fannie and Freddie wanting those loans and FHA wanting those loans, and those loans are a majority of the loans that are outstanding in our economy, that is a majority of the total bad loans that are outstanding in our economy, then that says something about why these loans were created.

And it wasn't just, I think, the desire for profit on the part of unregulated mortgage brokers. So I'm trying to—trying to understand whether you would agree with that if, in fact, the numbers are correct.

ROSEN:

Those numbers—I've seen the numbers, and the numbers on Fannie and Freddie are small relative to the size of the market what I've seen. And I—we certainly think we should—you should get the actual numbers and check as a commission.
But Fannie and Freddie, they've documented exactly how many subprime and Alt-A they've got and, certainly, they're bad. No question about it. But that is certainly not anywhere near the majority of the subprime mortgages and Alt-A mortgages. That, I am certain of.

WALLISON:

Have you seen the disclosure of Fannie and Freddie in their 10-Q for 2008 where they said how they had defined subprime loans?

ROSEN:

I have not looked at it in detail.

WALLISON:

All right. Well, the disclosure says that they defined subprime loans as subprime loans that they bought from subprime issuers or subprime originators. It doesn't say that they bought those loans that were subprime in nature from all other kinds of sources, part of which were from ordinary banks and other originators that were regulated originators.

ROSEN:

It is true. But, again, the vast majority of origination of the subprime mortgages came from unregulated lenders, most of who are gone now. Again, there are numbers that you should, as a commission, get those numbers, of course.

WALLISON:

And those numbers will be supplied to the commission, and I am hoping that the commission will look at them very seriously. Are you aware, also, that Fannie and Freddie reported their 10 million subprime loans as prime loans?

ROSEN:

I'm not aware of that, no.

WALLISON:

Yes, well, that is also something that they admitted in that 10-Q report. So it is—it's important, I think, for us to have the right data in mind when we try to make a decision on these questions. Ms. Gordon, we talked about—you talked about CRA. You are, I assume, familiar with an organization called the National Community Reinvestment Coalition?

GORDON:

Yes.

WALLISON:

Mr. Commissioner, an additional two minutes?

WALLISON:

Yes. In their annual report, the NCRC said that, between 1997 and 2007, they had succeeded in getting commitments for four and a half trillion dollars in CRA loans. Were you aware of that?

GORDON:

I haven't seen the NCRC document that you're talking about. There's been, certainly, a number of loans made under CRA for which institutions get CRA credit.

WALLISON:

Right. OK. I just wanted to be sure. That's a large number—four and a half trillion dollars in CRA loans is large. And so when you said that CRA are not an important part of the subprime problem, I just wanted to make sure that you went back and took a look at the annual report of the NCRC and verified that. That's—those are the only questions I have, Mr. Chairman.

CHAIRMAN ANGELIDES:

Well, actually, I'm going to pick up on that just a little.

I am a big person for data. So I don't know, for example, on the four and a half trillion number what you put out, Mr. Wallison, whether those were commitments as opposed to loans made. I don't know, for example, if it includes low-income housing tax credit program loans, multi-family, was it solely single family?

WALLISON:

I don't know that they were solely single family, but I can tell you that there were 3 million -- $3 trillion in loans actually made from the four and a half...

CHAIRMAN ANGELIDES:

Right. Well, then the question is, does it include, for example, private-purpose tax-exempt debt for a multi-family couple with 4 percent tax credits, at 9 percent tax credits. There's a number of CRA eligible activities. So what I'm going to suggest—which I think is important, and I want to say this to the commissioners—is I think one of the things we have to do here is get to actual numbers. And so I'm going to ask our staff to make sure that sooner than later we put together the best numbers from the most credible sources about what, in fact, does exist, for example, with the Fannie and Freddie portfolio. What's the nature of it?

And if there's divergence, let's get the facts on the table. I think we ought to get the best facts we can about the contour of loans made by CRA and non-CRA regulated institutions. And I just want to say, you know, I want to say let's get the numbers and the facts on the table and make sure we're dealing with apples to apples. I think that's important.

That was on my time.

Ms. Born?

BORN:

Thank you.

Listening to your testimony, it strikes me to ask where were the regulators. Mr. Rosen, you said that the Federal Reserve Board had a lot of data about the predatory lending that was going on. They had been given the authority and responsibility by statute to oversee and prevent predatory lending. Do you know why the Fed failed to act in this respect?

ROSEN:

It's very puzzling because they wrote the right paper. A key Federal Reserve Board member was pushing it very hard. It was—and I don't know why it didn't happen. The chairman was a pretty strong guy, and I suspect that was it. But maybe read Ned Gramlich's book because he's written a whole book on this topic before he passed away. I think it would be worth it to find out why they didn't do it. A lot of them did believe, though, there was—it wasn't really happening; it was demographics. It wasn't predatory; it was just market innovation at work.

Chairman Greenspan said—encouraged people to take these loans. Remember one of those statements he made, and I couldn't believe he said that. And he did. He apologized after the fact for it. But he did say it.

BORN:
Ms. Gordon, do you have any input on this?

GORDON:
My only input is to agree that the regulators—all of them, not just the Fed—had ample information to know that there was a problem. When we did our report on subprime mortgages in 2006 and looked back at the longitudinal performance of loans by origination year, I mean, we could see that the subprime loans had very high failure rates from very early on—from 1998 through 2001. And the regulators, presumably, would have had the same ability to find this information as we did.

You know, by 2005, quite a number of the subprime originators had already collapsed or been the targets of major law enforcement actions. There was, you know, Household and an associates and Ameriquest—there was a ton of stuff out there. You know, the OTS had examiners on site at WaMu. I don't know what they were doing, but they weren't noticing the risky loans that were going on.

BORN:
Well, and all the federal banking supervisors should have had examiners in the national banks, the bank-holding companies, the thrifts. And they should have been examining for prudential—for prudential standards, shouldn't they?

ZANDI:
Can I give my $0.03 on the topic?

BORN:

Please.

ZANDI:

I think two fundamentals—the question being where were the regulators. I think the first point is that the Federal Reserve is the key regulator, and it had a philosophical predisposition towards regulation during this period—had faith in the securitization process that failed us.

But, secondly, the regulatory structure also failed us. The Federal Reserve, along with other regulators, would come together and issue interagency guidance with respect to all kinds of lending activity. And this is a very cumbersome process to get consensus among these groups of regulators is very difficult. And to get explicit guidance is nearly impossible.

And you can see that, in—with respect to the guidance issued on Alt-A and ultimately subprime, it came well after the fact. So it was this philosophical predisposition but I think it was also the structure of our regulatory framework that doomed us to not having this regulatory oversight.

GORDON:

I mean, we—you know, our view is that, as long as consumer protection remains, kind of, the— the stepchild at agencies, we're not likely to get better results through the same incentive structure for the regulators, which is why we do support an independent regulator of products—financial products aimed at consumers.

CLOUTIER:

And I would—I would add, I've testified many times—I think, most probably, 13 times, here— but I remember one that sticks in my mind. Congressman Richard Baker was having a hearing. This was about 2001.

And, Congressman Baker, if you remember, used to love to hold hearings on Fannie and Freddie. That was—he did a lot of that. And he talked about systemic risk. And—and the groups on the panel that day, in the—it was a large consumer group in the audience, complaining about Citigroup merging with another finance company, and that—their predatory lending practices they had.

And, of course, you know, Congress said we're going to get the Fed to look into it. Well, it never really came that way. It ended up being that the attorney general of New York, filed charges against them for their practices of credit life insurance, which they finally pled nolo contendere to and just moved on.

So, you know, you're absolutely right. There's been a very lackadaisical treatment of that situation that continues to go on. As I said, a very interesting question for this commission. With all the problems you've heard about the large banks -- ask how many MOUs or cease-and-desists they're under. I think the answer will be not many.

CHAIRMAN ANGELIDES:
Would you like some more time, Ms. Born?

BORN:
No, that's fine.

CHAIRMAN ANGELIDES:
Because we've got two, three minutes on the clock.

BORN:
I am—I'm done.

CHAIRMAN ANGELIDES:
You're sated? All right.

VICE CHAIRMAN THOMAS:

Mr. Chairman, I do want to state one of the fundamental rules around here is, you have the time, it isn't necessarily required to use it.

(LAUGHTER)

CHAIRMAN ANGELIDES:

Oh, I—I'm going to use every second of it.

(LAUGHTER)

No, no, I'm not.

Thank you very much for your time and your insights and your testimony. And we will be asking you, based on today's conversation, for more information, particularly on—I know, data on Fannie, Freddie, CRA, working with our research staff. So whatever you can do to help us in that regard, we're very appreciative.

Mr. Thomas, I see your light on.

VICE CHAIRMAN THOMAS:

No, I just wanted to say that apropos the discussion about the data and whether or not we have it, I had said earlier that, if people have questions, that certainly they can reach us at www.FCIC.gov.

Actually, it's also true of those who have information because, again, given the time frame we have, you are our resources, but it's just amazing—frankly, you were indicating, Mr. Rosen, you were watching the show—we have an opportunity to pull into the website a significant amount of information that we would otherwise have to acquire.

And so I just wanted to say, Mr. Chairman, those of you—and a lot of folks follow it closely and they have expertise and they have data—if you want to send the data to assist us in reaching conclusions and/or ask questions that we'll try to get the answers to, we're going to be very versatile, FCIC.gov. Thank you.

CHAIRMAN ANGELIDES:

And I want to now conclude this hearing for today. I want to thank everyone in the audience who stayed with us and everyone who viewed this via our website and on television. We will reconvene at 9 a.m. in the morning tomorrow. Our first panel will be Sheila Bair from the FDIC, Mary Schapiro from the SEC, the Attorney General, Mr. Holder, as well as the assistant attorney general, Mr. Breuer. And we will convene at 9 a.m. in the morning.

And I'd like to ask the commissioners to stick around just for a minute or two for a—a brief media availability.

Thank you very, very much.

END