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6 **Hearing on "The Shadow Banking System"**

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11
12 **COMMISSIONERS**

13 **PHIL ANGELIDES, Chairman**

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21 **JOHN W. THOMPSON, Commissioner**

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25 **PAGES 1 - 329**

1 Session I; Perspective of the Shadow Banking System

2 HENRY M. PAULSON, JR., Former Secretary

3 U.S. Department of the Treasury

4 Session II: Perspective on the Shadow Banking System

5 TIMOTHY F. GEITHNER, Secretary,

6 U.S. Department of the Treasury

7 Former President, Federal Reserve Bank

8 of New York

9 Session 3: Institutions Participating in the

10 Shadow Banking System:

11 MICHAEL A. NEAL, Vice Chairman, G.E. and

12 Chairman and CEO, G.E. Capital

13 MARK S. BARBER, Vice President and

14 Assistant Treasurer, G.E. Capital

15 PAUL A. McCULLEY, Managing Director

16 PIMCO

17 STEVEN R. MEIER, Chief Investment Officer

18 State Street

19

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P R O C E E D I N G S

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2 CHAIRMAN ANGELIDES: Good morning. Welcome to
3 the second day of hearings by the Financial Crisis Inquiry
4 Commission.

5 As the members know and as the public know who
6 have been watching us, we have been exploring the shadow
7 banking system in this country and its effect on the
8 financial and economic crisis which has gripped this nation.
9 We have been focusing on the growth, development of this
10 system and the risks posed by it.

11 As we've said before, while there's significant
12 interest, obviously, in what was done to rescue various
13 financial institutions in the midst of the financial crisis,
14 the charge of this Commission is to examine the causes of
15 the crisis and to explore how risks to the system developed
16 in the first place, what could have been done, what should
17 have been done to prevent those risks from coming into
18 being.

19 We have a full day of hearing again today.

20 We are joined first of all this morning by former
21 Secretary of the Treasury, Henry Paulson. And really, with
22 no further ado, we will begin this hearing.

23 Unless, Mr. Chairman, you'd like to make an
24 opening remark also.

25 VICE CHAIRMAN THOMAS: No. I would just like to

1 say that yesterday was useful. Today has a real opportunity
2 to be useful.

3 I cannot recall in my four decades in which we
4 have two witnesses, both of whom were former secretaries of
5 the Treasury, one who had a background on Wall Street in one
6 of the major firms and the other secretary having a position
7 in the Federal Reserve in New York, so that we get a full
8 understanding based upon our ability to ask questions of
9 both sides of the street from two different perspectives
10 over a period of time which is obviously, as we now know in
11 retrospect, very significant in the history of the United
12 States. And so I look forward to the testimony.

13 Thank you, Mr. Chairman.

14 CHAIRMAN ANGELIDES: Thank you, Mr. Vice
15 Chairman.

16 And as the Vice Chairman indicated, we will start
17 today hearing from former Secretary Paulson. We will then
18 hear from Secretary of the Treasury Mr. Geithner. And then
19 we will have a panel later in the afternoon with
20 participants in the shadow banking system from GE Capital to
21 PIMCO to State Street Bank.

22 With no further ado, Mr. Paulson, thank you for
23 being here this morning. I'd like to ask you to stand for
24 what is a customary oath of office that we administer to
25 everyone who appears before us.

1 If you would please raise your hand as I
2 administer the oath.

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

7 Mr. Paulson. I do.

8 (Witness sworn.)

9 CHAIRMAN ANGELIDES: Thank you very much.

10 Mr. Paulson, we have received your written
11 testimony, and we appreciate it very much. And we would
12 like to ask you now to--we'd like to give you the
13 opportunity, and we'd like to obviously hear an oral
14 presentation by you. We've asked in consideration of the
15 time that you keep that presentation to no more than ten
16 minutes.

17 I know you're familiar with testifying up here on
18 the Hill so you probably know there's a light on that box
19 that goes to yellow with one minute, to red when time is up.
20 And if you'd make sure your mike is on, you may commence.

21 WITNESS PAULSON: Chairman Angelides, Vice
22 Chairman Thomas, and members of the Commission, thank you
23 for the opportunity to testify today.

24 I served as Secretary of the Treasury during the
25 recent financial crisis. I am proud of the work we in

1 government did to save our nation's financial system from
2 collapse and chaos and our economy from disaster. Even so,
3 the crisis caused human suffering that simply cannot be
4 measured.

5 The American people deserve, and policy makers
6 will benefit from, an understanding of the broad and diverse
7 causes of the crisis. The job of providing that explanation
8 falls to this Commission, and it is an awesome
9 responsibility.

10 Many mistakes were made by all market
11 participants, including financial institutions, investors,
12 regulators and the rating agencies, as well as by policy
13 makers. Most of these are well understood. And
14 importantly, policy makers are currently addressing some
15 major regulatory structure and authority issues that allow
16 the pre-2007 regulatory structure and authority issues that
17 either--excuse me.

18 Policy makers are currently addressing these
19 regulatory structures that either allowed the pre-2007
20 excesses in our system or made it difficult to address the
21 crisis. Nevertheless, a number of the root causes are not
22 being addressed and remain sources of danger to our country.

23 I fully support your important mission and I hope
24 that my testimony today can assist it.

25 The roots of the financial crisis trace back to

1 several factors, including housing policy, global capital
2 flows, over-leveraged financial institutions, poor consumer
3 protection, and an archaic and outmoded financial regulatory
4 system, among many other causes. Underlying the crisis was
5 a housing bubble. And it is clear that several policy
6 decisions shaped the home mortgage market.

7 Excesses in that market eventually led to a
8 significant decline in home prices and a surge of loan
9 defaults, which caused tremendous losses in the financial
10 system, triggered a contraction of credit, and put many
11 Americans quite literally out on the street. These excesses
12 were driven in large part by housing policy.

13 From 1994 to 2006 home ownership soared from an
14 already spectacular 64 percent of U.S. households to a
15 staggering 69 percent, due to the combined weight of a
16 number of government policies and programs. Fannie Mae and
17 Freddie Mac, the government sponsored enterprises, comprised
18 a central part of the U.S. housing policy. The GSEs
19 operated under an inherently flawed model of private profit
20 backed by public support, which encouraged risky revenue
21 seeking and ultimately led to significant taxpayer losses.

22 The United States has always encouraged home
23 ownership, and rightfully so. Home ownership builds wealth,
24 stabilizes neighborhoods, creates jobs, and promotes
25 economic growth. But it must be pursued responsibly. The

1 right person must be matched to the right house and
2 consequently the right home loan. And in the years before
3 the crisis we lost that discipline.

4 The over-stimulation of the housing market caused
5 by government policy was exacerbated by other problems of
6 that market. Subprime mortgages went from accounting for
7 five percent of total mortgages in 1994 to twenty percent by
8 2006.

9 Consumer protection, including state regulation
10 of mortgage origination, was spotty, inconsistent, and in
11 some cases non-existent. Speculation on rising home prices
12 led to increasingly risky loans, including far too many home
13 loans made with no money down.

14 Securitization separated originators from the
15 risk of the products they originated. Mortgage fraud
16 increased and predatory lenders and unscrupulous brokers
17 pushed increasingly complex mortgages to unsuspecting
18 borrowers.

19 The result was a housing bubble that eventually
20 burst in a far more spectacular fashion than most previous
21 bubbles.

22 Global forces also played a significant role in
23 causing the crisis. Imbalances in the world's economies led
24 to massive and destabilizing cross-border capital flows.

25 While other nations save, Americans spend.

1 Consumption in this country is the norm, spurred on by low
2 interest rates, aided by capital flowing from
3 countries--notably China and Japan, which have high savings
4 and low shares of domestic consumption--and further
5 encouraged by U.S. tax laws that discourage saving.

6 We are living beyond our means on borrowed money
7 and borrowed time. Consumers, businesses and financial
8 institutions all over-extended and over-leveraged themselves
9 with inevitably disastrous results while our federal and
10 state governments continued to borrow heavily, jeopardizing
11 their long term fiscal flexibility.

12 Our financial institutions, including commercial
13 and investment banks, were notable examples of this over-
14 leveraging. In general these institutions did not maintain
15 sufficient high quality capital, which left them unable to
16 absorb the significant losses they incurred as the housing
17 bubble burst. Many of them did not understand their
18 liquidity positions fully. They held insufficient cash and
19 cash equivalents, and instead relied overly on short-term
20 funding sources that ran dry as the credit markets
21 contracted.

22 These leverage problems were further exacerbated
23 by a lack of transparency, which caused problems in subprime
24 to affect other classes of assets. Like a tainted food
25 scare, a relatively small batch of deadly products secured

1 by subprime mortgages led to fear and panic in the markets
2 for many mortgage securitizations, driving down the price of
3 assets which triggered huge losses and severe liquidity
4 problems.

5 Derivative contracts, including excessively
6 complex financial products, exacerbated the problems. These
7 instruments embedded leverage in the institutions' balance
8 sheets, along with risk which was so obscured that at times
9 they were not fully understood by investors, creditors,
10 rating agency regulators, or the management themselves.

11 Very importantly, a number of financial
12 institutions had woefully inadequate risk management and
13 liquidity management practices that allowed these problems
14 to grow and intensify, in a number of cases leading to
15 failure of the institution.

16 Compounding the problems at these financial
17 institutions was a financial regulatory system that was
18 archaic and outmoded. Our regulatory framework was built at
19 a different time for a different system, and it has not kept
20 pace with the rapid changes in the financial industry.

21 I noted during my time at Treasury the enormous
22 gaps in this authority, duplication of responsibility, and
23 unhealthy jurisdictional competition. No single regulator
24 had responsibility for overseeing the stability of the
25 system.

1 The result was that regulators were often unable
2 to supervise the firms they oversaw adequately. They did
3 not see the impending systemic problems that progressed
4 towards the crisis. They did not have the tools to contain
5 all the harms that unfolded as institutions began to
6 collapse.

7 In March of 2008 this led me to recommend a
8 blueprint for a major reform of our financial regulatory
9 system after a year-long comprehensive review.

10 I will turn now to the specific topics of today's
11 hearing, the shadow banking system, a term that refers to
12 the large capital and credit markets outside the traditional
13 banking system that provide credit for municipal
14 governments, corporations and individuals, for short,
15 intermediate and long-term funding needs.

16 Before the crisis these markets satisfied at
17 least half of the consumer and business credit needs and are
18 one of the hallmarks of our advanced and highly developed
19 capital markets. They have greatly benefited our nation,
20 spurred growth and prosperity at all levels of our economy.

21 They have enabled more people to receive higher
22 education, more people to purchase homes, more people to
23 start new businesses, and more people to plan effectively
24 for their children's future. They have increased consumer
25 choice, stimulated job creation, and allowed our system to

1 diversify away from the large concentrated banks found in
2 other capital markets.

3 But like all activities in the financial sector,
4 these markets were fueled by the global excesses and
5 regulatory flaws I've already discussed. When the crisis
6 hit the stress it placed on these markets exposed many of
7 these flaws. And these flaws in turn extended and
8 exacerbated some of the effects of the crisis. These
9 problems must be addressed. Our financial system cannot
10 move forward without fortifying the weak parts of its
11 infrastructure.

12 In my written testimony I have addressed some
13 specific areas of concern and my suggestions for reform. My
14 list is not exhaustive, and there are certainly other
15 problem areas in need of scrutiny. In addressing these
16 problems, however, we must make sure we retain the benefits
17 of the underlying financial innovations.

18 In our haste to deal with the flaws in the non-
19 bank financial system we should not move ourselves back to a
20 system of consolidated monolithic commercial banks. I am
21 confident that a thoughtful process can achieve this.

22 Thank you. And I'd be pleased to answer any
23 questions.

24 CHAIRMAN ANGELIDES: Thank you very much, Mr.
25 Secretary.

1 We will now commence the questioning by members.
2 And we will start with me, and then the Vice Chair, and then
3 the balance of the members.

4 And I might say just one thing I noted yesterday.
5 And that is Commissioner Born and Commissioner Holtz-Eakin
6 have served as lead Commissioners for this series of
7 hearings and have done an excellent job, and I wanted to
8 note that.

9 Mr. Secretary, I have a number of questions for
10 you. What I would like to--and they really focus on the
11 run-up to the crisis.

12 There has been, as I said in my opening remarks,
13 a lot of fascination with the bail-out, how the financial
14 system was stabilized. But for me, and I suspect some other
15 Commissioners, the real question is how do we come to point
16 where the only options were either allow the financial
17 system to collapse or to commit trillions of dollars of
18 taxpayers dollars.

19 What I'd like to do to start, though, this
20 morning is ask you just a couple of questions with respect
21 to your role at Goldman before you became Treasury
22 Secretary, and then move on to your role as Treasury
23 Secretary.

24 During the time you were the CEO of Goldman from
25 January 1st, 2004 through June 1st, 2006, Goldman issued 19

1 synthetic subprime CDOs, totaling about \$8.4 billion.

2 Let me first ask you, because this goes to the
3 shadow banking system, it goes to the system as a whole,
4 what's your sense, if any, of the--what's your sense of the
5 value, if any, of synthetic CDOs in our financial system?
6 Do they provide any real capital or benefit to the system,
7 or are they merely a device for betting in terms of results
8 on the system? Are they bets or are they actually devices
9 that provide capital and liquidity of benefit to the real
10 economy?

11 WITNESS PAULSON: Mr. Chairman, a number of times
12 I have said that I believe that we had excessive complexity
13 in financial products, and that as I think about it, it's
14 very hard to regulate against innovation.

15 I think one--one of the things that I've
16 recommended for a number of years now is that when we look
17 at some of these complex derivative products, some of these
18 products that regulators make sure that we have real
19 substantial capital charges against these products.

20 Now in terms of the deals you're talking about, I
21 don't remember the particulars of those particular products.

22 CHAIRMAN ANGELIDES: Do you think that they
23 provide--just the core issue: Do you believe they provide
24 real benefit to the financial system and to the economy, the
25 real economy as a whole, or are they just outside bets that

1 --

2 WITNESS PAULSON: Well, I would say this: To get
3 at market-making--because I think there's been a lot of
4 discussion about market making--and one of the things I
5 saw--and again I haven't been in the business for four
6 years--but one of the things I saw was that clients
7 increasingly were asking Goldman Sachs and other banks to
8 provide capital and to help them manage risk. And there are
9 just many examples of that.

10 And, you know that business I think is a very
11 legitimate business, a very beneficial business. And it
12 needs to be done with very high standards, great integrity,
13 and in a way in which you're working for your clients'
14 interests.

15 And I was, you know, thinking this morning about
16 this hearing and thinking of all of the situations where a
17 client, you know, a major sovereign nation was worried about
18 the prices of oil rising and would come to an investment
19 bank and look for a way of protecting themselves against
20 that risk. Or an airline that was worried about, you know,
21 the prices--the oil prices going up. The sovereign nation
22 would be more concerned about oil prices going down.

23 So there are many situations where customers want
24 their investment banks to help them manage risk. And I
25 think that's a very legitimate function.

1 CHAIRMAN ANGELIDES: Do you think it's legitimate
2 if there's no underlying interest, like you mentioned the
3 underlying interest: obviously airline company with oil
4 fuel, other entities that may have, you know, a commodity
5 against which they may hedge because they utilize it.

6 WITNESS PAULSON: Well, I would say this: I
7 think of all of the times when I was in the business where
8 we employed hedges. I actually think best practice in terms
9 of prudent risk management is firms hedging securities that
10 they have on their balance sheet.

11 CHAIRMAN ANGELIDES: All right.

12 WITNESS PAULSON: I think of underwritings of
13 securities where the investment bankers or bankers needed to
14 take a short position which was part of the offering process
15 to make sure that there is a stable market.

16 You know, there are--you know, in the housing
17 there's no reason why that someone who wants to put in a
18 hedge in terms of protecting themselves against housing
19 prices going one way or another shouldn't be able to do so.
20 To me that's a very important function of a market-maker.

21 So I think what we want to do is we want to
22 separate the function and the market making function, which
23 needs to be done with the very highest standards, the very
24 highest not only in terms of compliance with the laws but
25 doing it in a way which it inspires and keeps client trust,

1 and separate that from, you know, from activity that is not
2 done properly.

3 And investment banks or banks can make mistakes,
4 commit fraud in a whole variety of areas. But let's focus
5 on the legitimate role that market making plays in the
6 capital market.

7 CHAIRMAN ANGELIDES: All right. Let me ask you a
8 very quick question because I want to get to the meat of
9 this in terms of your role as Treasury Secretary, the run-up
10 to the crisis.

11 But let me ask you one quick question since you
12 raised the standards of conduct. And I want to ask not so
13 much in the role as a market maker. But obviously--and I'm
14 not going to refer to a specific case that's been lodged by
15 the SEC against Goldman.

16 But do you think it's appropriate when an entity
17 is underwriting a security that it would contemporaneously
18 bet against that security on issuance? Is that appropriate?
19 Improper?

20 WITNESS PAULSON: Well, I would just simply say
21 that any transaction that is done in a marketplace has got
22 to be done with the highest standards, fair dealing, and
23 making appropriate disclosures.

24 Now in terms of--when you say betting against or
25 shorting, as I said, I can think of, you know, when I was in

1 the business we managed--we sold securities in the public
2 market. You sold securities as part of an underwriting
3 process. The syndicate or the underwriter had a short
4 position. Okay? Is that betting against the security?
5 That was a legitimate function and it's done to make sure
6 there's a stable market.

7 Frankly, every one of these market making
8 transactions where--or many of them--the client or the
9 customer expects the banker to take the other side of the
10 trade to help them manage risk, commit capital.

11 CHAIRMAN ANGELIDES: And so complete disclosure
12 in your mind --

13 WITNESS PAULSON: Well --

14 CHAIRMAN ANGELIDES: Complete disclosure is what
15 you think is elemental.

16 WITNESS PAULSON: I said appropriate disclosure
17 is what I think.

18 CHAIRMAN ANGELIDES: All right. All right.
19 Well, I don't want to put words in your mouth.

20 Okay. Let's move on. I wanted to just ask about
21 this. Let me talk about Treasury Secretary. Obviously you
22 know, but the Treasury Department, according to the website,
23 is responsible for--quote:

24 "...ensuring the financial security of the United
25 States."

1 You were head of the President's Working Group on
2 Financial Markets and in that regard did bring forward the
3 blueprint plan.

4 But one of the things I'm trying to get to is
5 what didn't we know. And looking forward to the risk of
6 future crises, we can have organizational structures, but
7 the real question is are we going to be able to pick up on
8 the warning signs.

9 You note in your book that there was the August
10 17th meeting, I think, a couple of months after you get
11 appointed where you indicated in that meeting, August 17th
12 at Camp David, that--quote:

13 "My number one concern was the likelihood of a
14 financial crisis. I was convinced we were due for another
15 disruption."

16 So here's what I want to ask you.

17 By the end of 2006 the leverage ratios at, you
18 know, Bear Stearns have hit 32 to 1, Goldman 31 to 1, Morgan
19 Stanley, 36 to 1, Lehman Brothers 34 to 1--not counting for
20 balance sheet management.

21 In the spring of '07, which is obviously a little
22 later than that date when you were at Camp David, the ratio
23 of level three assets, the liquid assets, assets that are
24 hard to price because there's no discernable market price,
25 at Bear Stearns are 269 percent of tangible common equity,

1 at Lehman 243, at Goldman 200, at Morgan Stanley 266. The
2 investment banks--and just as a set; they're not necessarily
3 unique--have been growing like weeds: At Goldman 26 percent
4 a year compounded annual growth rate, Morgan Stanley about
5 15 percent, Merrill Lynch 18 percent.

6 And as you point out in your testimony, there are
7 warning signs that abound. States all over the country were
8 trying to fight, in early 2000 before you become Treasury
9 Secretary, deceptive and unfair lending. They were
10 preempted by the OCC. In 2004 the FBI warns about an
11 epidemic of mortgage fraud.

12 I held this up yesterday. The Economist has an
13 article cover called Housing Prices After the Fall, which is
14 in 2005. The lead of the story says the day of reckoning is
15 closer at hand; it's not going to be pretty. How the
16 current housing boom ends could decide the course of the
17 entire world economy over the next few years. Housing
18 prices are moving up in 2003 at eleven percent; 2004 fifteen
19 percent, 2005, fifteen percent.

20 You note in your testimony that subprime lending
21 has exploded to be 20 percent of the market.

22 And by 2006 mortgage debt between 2000 and 2006
23 has doubled in this country. We have borrowed more in those
24 six years in mortgage debt than the whole 225 years in this
25 country's history.

1 There's knowledge of the opaque natures of
2 derivatives. There's knowledge of a lot of the instruments
3 in the market.

4 So here's my fundamental question: What didn't
5 you and other policy makers know when you came into office--
6 I guess my question is: What was the missing information
7 that would have allowed both policy makers and corporate
8 leaders to begin to mitigate risk?

9 WITNESS PAULSON: Well, Mr. Chairman, I think
10 with all due respect I began immediately to work to mitigate
11 risk--that within the confines of the fact that Treasury
12 Secretary has no direct responsibility for regulating
13 entities or markets.

14 But as you noted, I saw immediately the huge
15 gaping holes in the regulatory system. And so I took
16 several actions immediately.

17 Number one, regular quarterly meetings of the
18 President's Working Group so regulators could immediately
19 begin sharing information; figuring out how to work together
20 to fill in the gaps.

21 Now there was work done there right away on
22 looking at the margin requirements that--and the amount of
23 credit extended between the, for instance, the regulated
24 entities and hedge funds. I can come back to that more
25 later.

1 Secondly, I immediately started working with
2 Congress to complete regulatory reform legislation for
3 Fannie and Freddie, which had been stalled by politics for
4 years. And then I commenced this review, this regulatory
5 review. And out of this review came the blueprint. It came
6 pressing market participants to strengthen their
7 infrastructure in areas like OTC derivatives, areas like
8 that. And then ultimately we came out with the blueprint.
9 So I think we were on it.

10 Now in terms of the excesses you talked about,
11 they are there. You couldn't push a button and have them go
12 away. The bad loans have been made. We had --

13 CHAIRMAN ANGELIDES: Was the toothpaste out of
14 the tube by the time you arrived, in your estimate --

15 WITNESS PAULSON: I would say --

16 CHAIRMAN ANGELIDES: --to coin a phrase that was
17 used thirty-some years ago by someone else?

18 WITNESS PAULSON: I would say most of the
19 toothpaste was out of the tube. And there really wasn't the
20 proper regulatory apparatus to deal with it.

21 CHAIRMAN ANGELIDES: All right.

22 But my central question, I understand--I really
23 had two and you really got to the second. But was there--by
24 the time you arrive is the information that you need--and
25 essentially financial industry leaders--it's on the table by

1 2006. Because, you know, we've heard a lot in these
2 hearings. We've heard a lot about 'We're shocked, we're
3 surprised; it's a tsunami.' But even when a tsunami comes
4 you have warnings ahead of time.

5 WITNESS PAULSON: Yeah, but what was--Let me tell
6 you what wasn't clear to me. And I don't think it was clear
7 to very many people, if any, when I arrived. And that was
8 the scale and the degree of the problem.

9 And, for instance, if you, you know, referring to
10 the book, if you're going to refer there, the President said
11 to me, 'What will cause the crisis,' okay? And I said, 'I
12 wish I knew. It will be obvious after the fact; it always
13 is. No one predicted the Russian crisis.'

14 Now what was--we could see some of the problems
15 in for instance subprime and housing. But no one--at least
16 that I was talking to--predicted this massive decline in
17 housing prices throughout the United States. And when I've
18 asked myself why--why wouldn't people have predicted that;
19 why wouldn't experts have predicted it.

20 And I think it was because we were all looking
21 through the paradigm that we'd had in this country since
22 World War II where residential housing prices have
23 essentially gone up, mortgages were safe investments. And
24 so the economic models didn't project the kind of wholesale,
25 you know, significant decline in housing prices. And so

1 that was I think the--that was the thing that people didn't
2 predict.

3 But having said that, you know, if we'd seen that
4 coming I'm not sure what we could have done differently.

5 CHAIRMAN ANGELIDES: Even though--and this isn't
6 with respect to you--even though by the time all the write
7 downs are happening in places like Citigroup and other
8 institutions at the end of '07, prices have only fallen five
9 percent and they had fallen two percent I think in the early
10 '90s. But I see your point.

11 But would this be a fair characterization: That
12 people knew a storm was coming. People were concerned that
13 the levies were weak and hadn't been tested, and that--Is it
14 fair to say there wasn't a plan in place to deal with the
15 crisis that was inevitable?

16 WITNESS PAULSON: Well, there wasn't a plan in
17 place when I arrived. I think we put a plan in place,
18 because I think the only plan that I know how to put in
19 place was to get the regulators together with a very--taking
20 a different approach to the President's Working Group and
21 with regular meetings where we started working immediately
22 on what we thought the issues were going to be and how to
23 respond to them.

24 And to get working on--you know, I believe to
25 this day that the most effective thing that anyone has done,

1 either from the time I was there or since I've left, to deal
2 with housing has been the actions taken with Fannie and Freddie.
3 I think that's been the most effective to sort of stem that
4 decline in home prices. And we started working on that
5 right away.

6 CHAIRMAN ANGELIDES: All right. I'm going to
7 stop right now. I actually, when I close up before you
8 leave, I have some very specific questions about Fannie and
9 Freddie, a couple of them. But I want to stop right now to
10 get to other Commissioners.

11 All right. Thank you, Mr. Secretary.

12 WITNESS PAULSON: Thank you.

13 CHAIRMAN ANGELIDES: Mr. Thomas.

14 VICE CHAIRMAN THOMAS: Thank you.

15 That presented a whole bunch of questions that I
16 hadn't planned on in terms of that discussion.

17 But I do want to start also with you, Mr.
18 Secretary, at Goldman, not for any specific recollection of
19 product.

20 One of the things I'm trying to better understand
21 since I don't have any familiarity with the relationships in
22 these institutions on Wall Street--if you asked me about
23 Congress I could tell you a whole lot about things that
24 people don't normally appreciate result in
25 decisions--especially small group dynamics, interpersonal

1 relationships, the old business of who gets what, when and
2 how on accommodations, which are fundamental to any
3 democracy in terms of quid pro quos and other structures
4 that are simply there that make the system work.

5 What I don't understand is the relationship
6 between institutions--especially in the so-called shadow
7 banking area--because to me it's remarkable that there
8 existed this healthy and growing structure based upon very
9 short term financing overnight, a number of institutions
10 doing that so you were sharing the grazing in the pasture.
11 And yet, as has been indicated in terms of Goldman with the
12 current CEO and others, that you would take opposite sides
13 in terms of market making, that was within the institution.

14 I'm trying to understand a relationship between
15 institutions, not so much in an institution, because clearly
16 if you're the largest you can be on both sides and play
17 various roles by virtue of your size. But if you're smaller
18 you may have to be more dependent on others. And so it's
19 this business of to what extent was there a symbiotic
20 relationship with other firms, notwithstanding the fact
21 they're your competitors, or was it pretty much predatory
22 and that's one of the reasons the smaller ones went first.

23 Because going back to the congressional example,
24 I could be fundamentally opposed to someone on one day on an
25 issue. That issue is dispensed with. And the next day we

1 wind up on the same side. So one of the things you tell
2 folks when they first come is you can be opposed to somebody
3 but if you're locked in opposition to that individual you're
4 going to miss a lot of opportunities to actually advance
5 some of the things that you're interested in.

6 From your perspective, what was the culture?
7 Predominantly--I mean it had to be to a degree symbiotic,
8 didn't it?

9 WITNESS PAULSON: Well, let me--I think, Mr. Vice
10 Chairman, what you were getting at when you talked about the
11 infrastructure and you talked about secured lending was the
12 repo market and secured lending. And let me just talk a
13 little bit about that because I think it might help.

14 That many financial institutions--not just the
15 traditional investment banks--had to rely on wholesale
16 funding for a big part of their funding. It wasn't all
17 deposits. And so you have this secured lending or repo
18 market that grows up--which is a very healthy thing because
19 you shouldn't--you wouldn't want everyone having to rely
20 only on the banks for their wholesale funding. And so repo
21 is secured lending. And the lender is at least partly
22 protected during bankruptcy because their collateral is
23 protected.

24 I think the way you need to think about this--and
25 there's a market where two parties can deal with each

1 other--there are many sophisticated institutions--some
2 sophisticated, some less sophisticated--that wanted to
3 invest money. You know, some of them are pension funds,
4 money market funds, governments. They want to invest money.
5 And a safer way to do it would be to enter into a secured
6 lending arrangement with a Wall Street firm.

7 Now they could do that directly or they could do
8 it through a, you know, have a custodian administer it and
9 then handle the collateral so it would be a tri-party repo.
10 But that is the way it was done.

11 Now what happened--and here is what I think gets
12 to your question. What happened was this grew very, very
13 quickly with no single regulator having a purview of it, no
14 one looking at it and being able to get the information on
15 the whole thing. So it grew like topsy-turvy. There was
16 a--systems didn't keep up with it; the infrastructure didn't
17 keep up with it, with the procedures. And the participants
18 got sloppy in their credit decisions.

19 So it's one thing if I'm a money market fund and
20 I'm lending to a bank and I'm taking treasuries as
21 collateral. If I'm taking mortgage securities and I'm
22 asking for no margin, no haircut, that's a sloppy kind of
23 provision.

24 So now what happens is this is growing up. There
25 are excesses. And I would say to the Chairman, this was

1 something that I was not aware of, the extent of the issue.
2 I had seen it through one little lens at Goldman Sachs. And
3 so that this big market had grown up; no regulator looked at
4 it.

5 So now when the crisis comes and investors are
6 afraid, there were a number of--and so they're concerned
7 about Bear Stearns. They lose confidence. Then this
8 is--when you say it's predatory, these people--if someone is
9 afraid and they're afraid about their own institution
10 surviving, then they pull money out, or they don't roll over
11 their secured lending. Why? Because there's certain cash
12 investors that don't know what to do with collateral if they
13 got it; they're just really looking at the underlying
14 credit.

15 So again this was a shadow market that is a very
16 valuable market, should continue to be a valuable market.
17 It needs to be fixed. Okay? It just plain needs to be
18 fixed. And so there were mistakes made there by regulators,
19 by a regulatory system. Sloppy practices by practitioners.

20 And then the biggest sloppy practice of all were
21 the banks and investment banks if they didn't maintain
22 liquidity cushions.

23 Everybody talks about capital. But to me the
24 biggest lesson I learned out of all of the crisis was the
25 lack of focus by so many market participants and by

1 regulators on the importance of liquidity. And you cannot
2 place huge reliance on any short term overnight market if
3 you don't ask yourself, 'What am I going to do if that
4 market doesn't function as normal; how much of a cushion do
5 I have.'

6 VICE CHAIRMAN THOMAS: Well, but wouldn't every
7 one of those institutions go to bed that night not only
8 worrying about themselves but others because they depend
9 upon this kind of short-term --

10 WITNESS PAULSON: Only--See, they didn't worry
11 until they did. It's hard to explain this. But I had --

12 VICE CHAIRMAN THOMAS: I don't think it's all
13 that hard if you use other examples. For example, obviously
14 Bear Stearns and all the others thought they were liquid
15 until they tried to put up the assets. The only ones they
16 felt comfortable--or other people felt comfortable with were
17 treasuries.

18 But the idea that an economic model in terms of
19 mortgages, didn't anyone look at how much--what a mortgage
20 was changed between the '50s, the '60s, '70s, '80 and to now
21 that there was significant erosion in any comfort level on
22 how long a mortgage could last given the rules.

23 Let me give you a quick example. I represented a
24 big area, there's a lot of desert. And folks would run in
25 the spring, when there was enough grass out in the desert,

1 sheep. We began to see a fairly high loss of desert
2 tortoises. So the BLM wanted to run an experiment. They
3 wanted to put Styrofoam tortoises out in the desert when the
4 sheep were running on the grass to see what kind of an
5 interaction there was.

6 And so I told them that my sheep men would be
7 ready to put their Styrofoam sheep out in the desert when
8 the BLM was ready to put its Styrofoam tortoises because you
9 didn't get a decent understanding of the relationship.

10 When you rely on--And I want to talk about rating
11 agencies in a minute--someone giving a AAA rating to a
12 package which fundamentally was so much different than
13 earlier packages, and you rely on that AAA rating, at some
14 point doesn't somebody look at the underlying problems?

15 What happened, frankly, in the desert was the
16 crows, as population encroached on the desert the crows
17 followed and they'd go out and flip them over in the morning
18 and have a warm meal in the evening. And until and
19 unless you controlled the crows, you were never going to
20 solve the problem.

21 And here the crow flipping it over, everyone
22 argues that we didn't have a model that could tell us what
23 was happening. I just don't understand, given the level at
24 which people were operating, which brings me to the
25 question:

1 When you became Secretary of the Treasury,
2 looking at it from not your narrow perspective but the
3 broader scope, were you shocked at the amount of weight
4 placed in the portfolios on these risky mortgage packages?

5 WITNESS PAULSON: I was --

6 VICE CHAIRMAN THOMAS: Were you surprised?

7 WITNESS PAULSON: Yeah. I'll tell you what
8 surprised me, which is related to your question that, as you
9 said, there was the rating. But a number of the firms--you
10 know, I in my testimony and a number of people have talked
11 about its importance that those who underwrite
12 securitizations have some skin in the game, hold some of the
13 securities they underwrite. I think that's important.

14 But where the big problems were, were a number of
15 institutions--two or three institutions that, not only did
16 they have skin in the game they had half their body in the
17 game because they had huge positions of these, out-size
18 positions that were over-weighted. And so --even if they're
19 rated AAA.

20 And so I think one of the lessons of this, which
21 gets to your point, is that it is very hard for experts, any
22 experts to know anything with certainty. People could have
23 been predicting this crisis for years. And they could have
24 predicted it, hedged themselves, and lost a lot of money.

25 But it's foolhardy to tie up a lot of any

1 institution's balance sheet on any particular security, no
2 matter how high the rating is, unless it's, you know, a U.S.
3 government security.

4 VICE CHAIRMAN THOMAS: Well, is that what
5 happened? They tied so much up in the mortgage market?
6 Because what I'm trying to figure out is how could the
7 weight of the securities that were created, supported by the
8 mortgage market pull down the commercial paper market, the
9 repo market, the auction rate securities market? Was it
10 that big?

11 WITNESS PAULSON: Well, that's a different--I was
12 just --

13 VICE CHAIRMAN THOMAS: No, I understand. But how
14 was it interconnected?

15 WITNESS PAULSON: There were several institutions
16 that owned too much of the paper.

17 But to get to your point, what happened, I think
18 the way to think about this is this--and I think this is
19 quite critical.

20 The subprime market by itself was a relatively
21 small--relative to the U.S. economy or to the U.S. capital
22 markets. And the problem was much bigger. There were
23 excesses, as we've talked about, in housing and across the
24 markets more broadly.

25 So one--you used an analogy of the desert. I'll

1 give you an analogy that's used a lot. There is a lot of
2 dry tinder out there. Okay? And the driest tinder was
3 subprime. That's where the fire started. But there were a
4 lot of other excesses. And that is really what happened.
5 And there were a whole lot of things coming together to
6 create this crisis.

7 VICE CHAIRMAN THOMAS: In terms of the rating
8 agencies, we have legislation now from both the House and
9 the Senate. Are you familiar enough with that legislation
10 to have any opinion as to whether it's useful, directed,
11 effective in dealing with rating agencies?

12 WITNESS PAULSON: I would say in terms of the
13 rating agency piece of this, I agree with one part of the
14 legislation which I think is controversial to certain
15 people. I think it--no matter how the rating agencies are
16 regulated--and we need more regulation and we need more
17 disclosure and we--around the rating agencies.

18 I do not like the fact that we have several
19 rating agencies that are enshrined in our securities laws,
20 in regulatory manuals, and so on, and that ratings are
21 referred to. And so I think that's just a crutch and a
22 dangerous crutch. And I think too many investors, too many
23 banks relied overly on a rating.

24 And I'm all for the rating agencies; I think
25 there should be independent rating agencies. They should

1 give their advice just like equity research houses do. And
2 I think investors should look at those as one tool. But I
3 do not like the fact--and I support the legislation that
4 would take reference to credit ratings out of our securities
5 laws.

6 VICE CHAIRMAN THOMAS: All right.

7 The Senate would create an office within the SEC
8 to administer credit rating agencies' rules and practices.
9 Good move?

10 WITNESS PAULSON: I think it's probably a good
11 move.

12 VICE CHAIRMAN THOMAS: House creates a seven-
13 member advisory board for credit rating agencies.

14 WITNESS PAULSON: I haven't really thought about
15 it.

16 VICE CHAIRMAN THOMAS: But it's safe, isn't it?
17 I mean that's...

18 WITNESS PAULSON: Yeah, it's...

19 VICE CHAIRMAN THOMAS: You could get unanimous.

20 WITNESS PAULSON: It --

21 VICE CHAIRMAN THOMAS: Both bills would require a
22 measure of certification that due diligence has been done by
23 someone, but neither one talks about who would pay for it
24 and its structure. So again, it's going to evolve outside
25 of some regulatory structure.

1 WITNESS PAULSON: Yeah. It will--I will say
2 this: No matter how you regulate this--and it needs more
3 oversight and regulation--no matter how you regulate them,
4 it will not be flawless.

5 It's hard to believe that anyone at a rating
6 agency is always going to be able to see the issues that
7 others don't see.

8 VICE CHAIRMAN THOMAS: No. I understand that.

9 WITNESS PAULSON: And so therefore that's why I
10 want to get to something which is much more basic than that.
11 I don't want the rating agencies to be held up as the font
12 of all truth and be--and have the ratings be part of our
13 securities laws.

14 VICE CHAIRMAN THOMAS: Then my only question left
15 is, just out of curiosity, how come you didn't put more
16 emphasis on the rating agencies in your testimony? I mean
17 you mentioned it, but...

18 WITNESS PAULSON: Because I --

19 VICE CHAIRMAN THOMAS: Do you think you gave it
20 due weight in terms of --

21 WITNESS PAULSON: No, I thought that this was in
22 terms of shadow banking. Yeah, I have --

23 VICE CHAIRMAN THOMAS: But you gave an overview
24 at the beginning of your testimony.

25 WITNESS PAULSON: Right. Well, I've written

1 about it quite a bit --

2 VICE CHAIRMAN THOMAS: Right.

3 WITNESS PAULSON: --in my book. And so I do think
4 the rating agencies made plenty of mistakes. I think they
5 fell into the same paradigm that so much of the rest of the
6 world did. They used economic models that didn't foresee
7 what happened.

8 VICE CHAIRMAN THOMAS: But everybody has used
9 that as an excuse in terms of not knowing the true value of
10 what they held and tried to trade.

11 WITNESS PAULSON: Yes. So clearly the rating
12 agencies in terms of--and I made a number of strong
13 recommendations, actually even before Bear Stearns went
14 down, with the President's working group about the kind of
15 disclosures you need to see from the rating agencies and the
16 kinds of processes they need to run, and the regulatory
17 oversight.

18 What I was just trying to get to was --

19 VICE CHAIRMAN THOMAS: Right.

20 WITNESS PAULSON: --something which was more
21 fundamental than that, which is:

22 I don't want to see a situation ever again where
23 a whole lot of sophisticated people can just turn and say,
24 'It's not my fault; it was the rating agencies.'

25 I want investors and big banks and regulators to

1 be forced to use rating as one tool, but do some of their
2 own work and do some thinking for themselves.

3 VICE CHAIRMAN THOMAS: Thank you, Mr. Secretary.

4 And could I ask you--would you be willing to
5 respond in writing to any other questions the Commission
6 might have as we go forward? Because, frankly, we're
7 learning as we go.

8 WITNESS PAULSON: Of course. I just hope you
9 will understand that now my staff consists of one assistant.
10 Okay? So I will--I no longer have these--but I will
11 respond.

12 VICE CHAIRMAN THOMAS: We'll try to write
13 questions that can be answered by one assistant.

14 Thank you.

15 CHAIRMAN ANGELIDES: Thank you.

16 Ms. Born.

17 COMMISSIONER BORN: Thank you very much, Chair
18 Angelides.

19 And I want to express my thanks to you, Mr.
20 Secretary, for being willing to meet with us and help us in
21 our investigation.

22 The first area that I wanted to ask you about is
23 over the counter derivatives. I fully agree with you that
24 derivatives are extremely important instruments in managing
25 and hedging risk and play an invaluable role in that

1 respect.

2 Nonetheless the over the counter derivatives
3 market had grown to more than \$680 trillion, a notional
4 amount by the time of the crisis in the summer of 2008. And
5 it was virtually exempt from federal regulation and
6 oversight because of a statute past in 2000, the Commodity
7 Futures Modernization Act, which had eliminated jurisdiction
8 of the federal agencies over the market.

9 I wanted to ask you whether in your view this
10 regulatory gap played any role. You've said in your
11 testimony derivative contracts including excessively complex
12 financial products exacerbated the problem during the
13 financial crisis. And I wondered if you would elaborate on
14 that testimony.

15 WITNESS PAULSON: Well, first of all, I think
16 your point is well taken. And in the chapter that the
17 Chairman referred to in my book, when we had that first
18 conversation with the President about the potential of a
19 credit crisis--and the topic I talked about then was over
20 the counter derivatives and how quickly this had grown,
21 citing the same numbers you cited and just talked about them
22 being outside of the regulatory purview. And we didn't even
23 have at the time the right protocols for how they would
24 function in a crisis, and, you know, the netting agreements
25 and there were big back logs of really unbooked trades.

1 So there was a lot of work being done by the Fed
2 at that time. And I was very supportive in terms of pushing
3 the industry.

4 Now I think that these, first of all, these
5 products, they didn't create the crisis but they magnified
6 it and they exacerbated it. And I think not only in the way
7 in which it's been written about a lot in terms of the
8 interconnectivity, but just in terms of masking the risk.
9 They were so opaque and complex and difficult to understand.

10 I had certain regulators when I arrived saying
11 that the system wasn't that leveraged because they were
12 looking at just the debt as opposed to what was embedded in
13 those products. Those products are hard to understand. And
14 that is why I so strongly believe that you want to
15 press--standardization is in all of our interest.

16 And so the way you I think get toward
17 simplicity--complexity just in general I think is our enemy.
18 You can't--it's hard to regulate against complexity and
19 innovation.

20 So I think the way you do this is you press
21 everything is standardized onto an exchange. And the over
22 the counter you put through a central clearinghouse where
23 you've got great oversight. And then you have, if it's
24 complex there, you put big capital charges so you penalize
25 complexity, which will help move toward greater

1 standardization.

2 And I think that's really the right way to deal
3 with it. And I think you're right on in terms of seeing
4 that as a concern. But it's not--those people that would say
5 it was the fundamental cause I think are wrong. It's not.
6 It's just something that needs to be fixed. And I'm hopeful
7 that it looks like some of the, you know, legislation is on
8 the way to fix it.

9 COMMISSIONER BORN: With respect to the remaining
10 over the counter market, assuming regulations are applied
11 that would put standardized contracts onto exchange, would
12 you advocate more transparency for that market?

13 WITNESS PAULSON: Yes. Yes. That is--In this
14 that would solve so much. And, you know, as you well know,
15 regulators had no idea. Industry participants didn't know.

16 You know, just taking General Motors as an
17 example, everyone knew how many General Motors bonds were
18 outstanding. No one had any idea how many credit default
19 swap contracts were out there on General Motors bonds.

20 COMMISSIONER BORN: Or who held them.

21 WITNESS PAULSON: Or who held them.

22 COMMISSIONER BORN: Or what the exposure was.

23 WITNESS PAULSON: Absolutely.

24 And so to me I think fortunately this is now
25 understood by just about everyone.

1 COMMISSIONER BORN: Let me ask you about the
2 political influence and power of the financial services
3 sector industry leading up to the crisis.

4 There are some reports that indicate that the
5 financial sector may have spent as much as five billion
6 dollars in lobbying expenses, federal lobbying expenses and
7 campaign contributions in the decade leading up to the
8 crisis, and that in 2007 there were almost 3000 registered
9 lobbyists in Washington who had been hired by the financial
10 sector.

11 I wonder whether some of the regulatory gaps and
12 weaknesses we saw may have been in part at least attributed
13 to this effort to influence federal policy.

14 WITNESS PAULSON: You know, it's interesting. I
15 can't comment as to how it impacted Congress. I do know
16 that it is very, very difficult to get anything that's
17 fundamental, controversial, difficult done at Congress
18 without a crisis. But there are a lot of jurisdictional
19 issues. This is complex stuff.

20 And what I saw in terms of regulators, I just saw
21 regulators seriously working to try to gather the
22 information. And it was just--if a man from Mars--when I
23 arrived if I'd had to explain to a man from Mars as to how
24 this--and I see you laughing because you know--how this was
25 regulated and why OTS regulated these institutions and OCC

1 these, and why there wasn't any regulator that had access to
2 all of the information in the shadow banking market and so
3 on, I could never have explained it.

4 And so I have no doubt that lobbying has an
5 impact. But there you would have to talk to some other
6 members of the panel that are closer to the political
7 process than I am.

8 COMMISSIONER BORN: Well, clearly there were
9 regulatory gaps or weaknesses in terms of the oversight of
10 the shadow banking areas. Don't you agree?

11 WITNESS PAULSON: Yes.

12 COMMISSIONER BORN: And did you think that the
13 effort by the SEC to create a consolidated supervised entity
14 program for the investment bank holding companies was a step
15 in the right direction?

16 WITNESS PAULSON: You know, it's--I'll tell you,
17 at the time when I was on Wall Street I did. And I thought
18 that the people we worked with at the SEC were of the
19 highest quality. And when I was in government and working
20 with them I thought that there were just some very, very
21 strong professionals there, and working very hard and very
22 diligently.

23 So it was--so I look at it from that perspective,
24 and then I just simply say if I get up to 100,000 feet and
25 look at it I just say, 'We all made mistakes.' You know,

1 when you look at, you know, there were regulatory mistakes
2 over periods of time and clearly from the bankers and the
3 investors and all the different participants.

4 But I never doubted for a minute the competence
5 and the professionalism of the regulators at the SEC who had
6 just in a very short time--remember, this program for the
7 Consolidated Regulatory Program had just recently evolved
8 and then we had the tsunami.

9 COMMISSIONER BORN: Do you think that going
10 forward it's important to try to eliminate regulatory gaps -
11 -

12 WITNESS PAULSON: Yes.

13 COMMISSIONER BORN: --like those for the --

14 WITNESS PAULSON: Oh, yes.

15 COMMISSIONER BORN: --shadow banking system?

16 WITNESS PAULSON: Well, I think--Here's what I
17 think going forward: I think these big complex financial
18 institutions, they need to have sort of a uniformity of
19 approach, and in having tough, consistent regulation without
20 some being able to find nooks and crannies.

21 And then in terms of the shadow banking there
22 needs to be--that's a big reason why I recommended the
23 systemic risk regulator concept was someone needs the
24 authority and the ability to gather all of the information
25 necessary so you can look at these big systemic issues. And

1 I do think that if a systemic risk regulator had been in
2 place they would have had more authority to deal with, you
3 know, the over the counter derivatives much earlier or would
4 have had the purview and the authority to deal with the repo
5 market.

6 COMMISSIONER BORN: Or with institutions like AIG
7 --

8 WITNESS PAULSON: Oh, absolutely.

9 COMMISSIONER BORN: --which was not really
10 overseen effectively.

11 WITNESS PAULSON: Absolutely. At the holding
12 company level. That's right. That was an example of an
13 institution that was able to arbitrage and sort of build
14 itself up by playing the gaps in the system.

15 COMMISSIONER BORN: Well, one of the questions
16 that I have is--and would be interested in your observations
17 on this--you know, obviously there were problems in
18 supervision, even with bank holding companies in terms of
19 the biggest institutions. And today some of those holding
20 companies are even bigger than they were in 2008 because of
21 consolidations, because businesses have gone --

22 WITNESS PAULSON: Right.

23 COMMISSIONER BORN: --out of business, and for
24 other reasons.

25 Are these institutions really capable of

1 effective supervision by government regulators? Indeed, are
2 they capable of effective internal management? Probably
3 your experience at Goldman Sachs could inform that issue.

4 WITNESS PAULSON: Well, I would say this to you:

5 That I think that the level of concentration
6 where we have ten big institutions with sixty percent of the
7 financial assets, you know, this is a dangerous risk.

8 Now I believe these institutions are necessary;
9 they perform a valuable role. So the way I get at your
10 question is this:

11 I say first of all, I know we can have better
12 regulation. Absolutely know better, more consistent, bigger
13 capital requirements, bigger liquidity requirements. But
14 then I come to the conclusion that regulation will never be
15 perfect. Unless you hypothesize that these institutions
16 wanted to blow themselves up, it's hard to believe that the
17 regulators are always going to be able to find the problems
18 that they can't find themselves.

19 And so there will be--there will continue to be
20 failures. There have been since the beginning of time.
21 Since the time we've had capital markets institutions have
22 failed. We've had financial crises.

23 That is why I believe in addition to
24 strengthening the regulatory system you need these
25 resolution authorities so that the government has the

1 authority that when a big institution fails to step in
2 outside of the bankruptcy process and wind it down and wind
3 it down in a way in which you're not saving and propping it
4 up in their current form. The expectation has got to be
5 that they're liquidated. And I know that's complicated.
6 But you can train regulators to do that.

7 And that's why I'm such a big proponent of this
8 will concept, you know, that these big institutions work
9 with the regulators to create a roadmap for their
10 liquidation if they do fail because I--so again, you'll
11 never get perfect regulation. But I just don't think the
12 American people are ever going to again want to see the
13 taxpayer come in and bail out or save these institutions.

14 So when they fail we need a way of liquidating
15 them and liquidating them in a way in which they don't hurt
16 the American people and take the system down. And that to
17 me--so you're right, we can never--regulation, we should
18 strive to make it as good and as effective as we can and to
19 give the regulators the tools they need and the information
20 they need so they'll be right more often. But then there
21 will be failures and we have to figure out how to deal with
22 them so it doesn't hurt everyone else.

23 COMMISSIONER BORN: May I have --

24 CHAIRMAN ANGELIDES: Yes.

25 COMMISSIONER BORN: --another two minutes?

1 I just wanted to follow up with you on a specific
2 example. For example, Goldman Sachs. You are very familiar
3 with that Goldman Sachs is like, what running it involved.

4 Do you think from your experience as the head of
5 a big institution like Goldman Sachs that it is capable of
6 an orderly wind-down in case it gets into financial
7 problems?

8 WITNESS PAULSON: Yeah. I think that any
9 institution can be wound down--It's complicated--over a
10 period of time. You can't--No institution, no matter what
11 their capital says, if you have to liquidate it right away
12 there's no institution I think that the assets will be worth
13 more than the liabilities.

14 And again, my view is that with any institution
15 there has got to be a way that if they fail that you know,
16 and the expectation is, that they're not going to be propped
17 up in their current form; that they'll be broken up, they'll
18 be changed in some way, they'll be liquidated in a way. And
19 so I believe that can be done.

20 COMMISSIONER BORN: Thank you.

21 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

22 COMMISSIONER HOLTZ-EAKIN: Thank you, Mr.

23 Chairman.

24 Mr. Secretary, thank you for joining us today. I
25 appreciate your testimony.

1 I want to go back to this observation in your
2 book that a crisis was inevitable and ask you: Does that
3 mean if there had not been a housing market crisis to
4 trigger it, something else would have?

5 WITNESS PAULSON: Well, when I said 'inevitable,'
6 what I said in the book was that our history in this country
7 has been--and certainly in modern times--is every six,
8 eight, ten years there's been some crisis. We could go
9 starting with the S&L crisis. And I could just take you
10 through the various, you know, the '94, '98 with long term
11 capital, what we had with Russia and Asia. So we've had these. And so
12 what I saw was excesses building in the system.

13 Now I could have said the same thing in 2004 or
14 '05, and, you know, I would have been wrong in terms of the
15 timing. But ultimately you were going to have these.

16 And what I saw--and I didn't realize how true it
17 was--was I said to people the difficulty or the interesting
18 thing about the next crisis is we're going to be seeing how
19 these complex instruments and some of these private pools of
20 capital, and markets away from the traditional financial
21 institutions perform for the first time under stress because
22 there had been a lot of change. And so we saw how a lot of
23 this performed under stress.

24 So, yeah, I think it's inevitable. And I think
25 as sure as we're sitting here today that the next crisis is

1 inevitable. I don't think it's going to happen right away,
2 but there will be stresses and problems in the capital
3 markets, you know, some time in the future, probably in our
4 lifetimes again. And so the key thing is how to have those
5 be relatively small manageable events.

6 They'll never be small events to those right in
7 the middle of the markets dealing with them, but so that
8 they're small manageable events to the rest of us in the
9 broader economy.

10 COMMISSIONER HOLTZ-EAKIN: But the signature of
11 this particular crisis that we sadly have to report on is
12 the housing market?

13 WITNESS PAULSON: Yeah.

14 COMMISSIONER HOLTZ-EAKIN: You would agree with
15 that?

16 WITNESS PAULSON: Yes.

17 COMMISSIONER HOLTZ-EAKIN: In your testimony you
18 said that there were several policy decisions that shaped
19 the home mortgage market. What would be the list of policy
20 decisions?

21 WITNESS PAULSON: Well, I think what you would
22 need to look at, you just need to look at the weight of the
23 whole series of decisions we made, you know, the various
24 programs for housing. It's not just Fannie and Freddie but
25 it's the FHA, their various HUD programs, state programs.

1 I'd say even just take something like the
2 mortgage interest rate deduction. You know, a million
3 dollar mortgage, it's deductible. Is that fair relative to
4 renters or--forgetting about fairness, I think you have the
5 sum total of so many things pushed housing way up.

6 I would travel around the world when I was in the
7 capital markets and other nations would look at us in awe
8 that we had home ownership above 60 percent. You know, we
9 weren't satisfied with that; we got it up to 69 percent. So
10 I just think you need to look at those policies as
11 fundamental root causes of the crisis.

12 COMMISSIONER HOLTZ-EAKIN: And on that list would
13 be the GSEs, Fannie Mae and Freddie Mac?

14 WITNESS PAULSON: Yeah. Right. Yeah.

15 COMMISSIONER HOLTZ-EAKIN: In your book you also
16 said that shortly after you arrived as Secretary of Treasury
17 you received a briefing about the GSEs and the quote is that
18 they were a disaster waiting to happen. And when our staff
19 interviewed you, you said that the business model is
20 fundamentally flawed.

21 And could you just tell us exactly what the flaws
22 were in the GSE business model and why you thought they were
23 a disaster waiting to happen?

24 WITNESS PAULSON: Yeah. Well, I sure didn't
25 predict this disaster happening the way it did. So I'll

1 tell you that. That was a phrase, you know, that I used
2 without, you know, that turned out to be prophetic. But I
3 didn't see it quite as clearly as it came about.

4 But in terms of the structure that, first of all,
5 there were the ambiguities. Okay. There was the implicit
6 government support, the Congressional charter. And then
7 private capital and private profit. And the shareholders
8 and the compensation model. So there was a contradiction
9 there.

10 Then secondly, this was a situation where
11 Congress presumed to be the regulator. They defined
12 capital, you know, legislatively defined capital. Not only
13 the level of capital but what could count as capital. And
14 some things that I considered DS capital, you know,
15 intangibles and so on were defined as capital. And so the
16 regulator was set up to be weak. I'm not saying anything
17 negative about the people that held that job, but they were
18 not given the authorities that a normal regulator is given,
19 a safety and soundness regulator to make judgments about
20 capital.

21 You had a--and then the elephant had clearly
22 gotten too big for the tent. Right? These things just grew
23 and grew and grew. And so you had--when you looked at all
24 of the--it's just hard for people when we throw around these
25 numbers to even comprehend. But you have \$5.4 trillion when

1 you look at the securities they had insured, the debt they
2 had issued.

3 So the danger, you know, if one of these--when
4 you look at the capital markets, you know, the danger they
5 posed was sort of unimaginable. You know, we could talk
6 about the failure of any one institution. But the danger
7 posed by a lack of confidence in the ability of these
8 entities to repay their debt was much greater than that. So
9 these were big.

10 And then I think the part in the book you alluded
11 to really had to do with their portfolios. This was a big
12 topic of debate because they would not only guarantee--or
13 insure mortgage pools, they then would take their low
14 funding and buy in these mortgages and hold them. And they
15 said that this was necessary for their mission to support
16 their market. But as people explained to me, two-thirds of
17 their earnings were coming from that. And their boards had
18 a fiduciary duty to their shareholders.

19 We could talk about the public mission, they
20 could talk about, you know, they could testify up on the
21 Hill about meeting their housing goals. But they had public
22 shareholders and that's where their duty was, was to grow
23 their profits.

24 So as I look at that I never so much blamed the
25 people that ran those organizations as those that designed

1 the plane we asked them to fly before they flew it into the
2 side of the mountain, you know. So it was not--it was the
3 wrong structure.

4 COMMISSIONER HOLTZ-EAKIN: So one of the things
5 we heard yesterday was that during the early part of March
6 as Bear-Stearns came under duress agency securities were no
7 longer accepted as collateral in the overnight repo market.
8 And indeed if you look back on spreads at Fannie and Freddie
9 during that period they're spiking up and showing clear
10 signs of market distrust.

11 So I want you to walk me through the thinking
12 then during that period when Fannie and Freddie were
13 actually permitted to drop the limits on their portfolios
14 and lose a capital surcharge at a time when the market is
15 saying, even with the capital surcharge and limits on the
16 portfolios they aren't very safe.

17 WITNESS PAULSON: Yeah. It was exactly the
18 opposite of what you said. I had had my staff work with
19 them to get them to raise capital, to increase their
20 capital. And so as a result of what we did Fannie went out
21 and raised seven billion dollars of capital. So there was a
22 net increase in capital. Freddie committed to increase
23 capital; it turns out they didn't. They didn't meet their
24 commitment.

25 But to step back--but that's sort of the specific

1 question you asked. But to get back more broadly, what had
2 happened was this:

3 They had--the credit crisis came in mid-2007.
4 And then most of the damage had been done by that point
5 because, you know, after that time mortgage lending
6 virtually ground to a stop away from Fannie and Freddie.
7 And there was all kinds of evidence of really very
8 responsible borrowers that wanted to buy homes and had the
9 economic wherewithal that were having trouble getting
10 mortgage funding.

11 And so now Fannie and Freddie are essentially the
12 only game in town. And they needed--and so the, you know, I
13 believe the problem was already baked. I mean they owned
14 the securities in their portfolios. They had guaranteed
15 what they'd guaranteed before the housing bubble had
16 broken--or burst.

17 And so what we were doing in March of 2008 at the
18 time when we took the action we took with Bear Stearns, we
19 also were trying to increase confidence in these
20 organizations and get them to increase their capital.

21 So again I was pressing many institutions to
22 raise capital. I was talking to many CEOs of institutions
23 and saying I've never see the CEO of a financial institution
24 lose his job by having too much capital, you know; raise
25 capital when you can raise capital. We pressed them. As I

1 said, Fannie raised--lived up to their commitment; Freddie
2 didn't.

3 COMMISSIONER HOLTZ-EAKIN: They got it from the
4 Treasury yesterday.

5 If you run the clock forward, then, knowing what
6 you know about their financial condition, I believe you said
7 something to the effect that the Fannie Mae-Freddie Mac
8 reform legislation gave you a bazooka that you would never
9 have to use. And then shortly thereafter you used it.

10 WITNESS PAULSON: I never said never. Okay?

11 COMMISSIONER HOLTZ-EAKIN: No, so --

12 WITNESS PAULSON: I didn't say never.

13 What I said was, when I got this authority I said
14 that I was asking for unlimited authority. It sounded bad
15 politically to say 'unlimited' so I said 'unspecified.' I
16 wanted to have the maximum amount of authority. And I said
17 to the extent we have--the more authority we have the more
18 confidence the markets will have, and that's the
19 greatest--and that will increase--reduce the likelihood
20 we'll have to use it.

21 And what happened was with Fannie and Freddie we
22 weren't the regulator. We didn't have the authority or the
23 people to get in and look at it. Okay? So it wasn't until
24 we actually got in--okay?--and got the authority.

25 And so I was working very hard to get the

1 emergency legislation from Congress--or get legislation from
2 Congress, reform legislation. And then confidence went in
3 these entities. And as I said, it was sort of an
4 unimaginable risk.

5 So we went and got this emergency authority. And
6 then once we got it we were able to--we had Morgan Stanley
7 working with Treasury as our advisor. We had the OCC. We
8 had the Fed working with FHA go in and look at these
9 entities. And it was only then we were able to get our arms
10 around sort of the scope and the magnitude of the capital
11 problem.

12 And then the fact that we had these authorities,
13 for the first time we could address the problem. We could
14 do something about it. We had the authority to put in
15 capital and to put them into conservatorship. So that's
16 sort of the story there.

17 COMMISSIONER HOLTZ-EAKIN: I want to--I don't
18 have much time, but I also wanted to go back and talk about
19 the Bear Stearns episode itself. I wanted to get your views
20 on whether Bear could have been allowed to fail.

21 What we heard yesterday --

22 WITNESS PAULSON: Whether Bear could what?

23 COMMISSIONER HOLTZ-EAKIN: Be allowed to fail.

24 WITNESS PAULSON: Yeah.

25 COMMISSIONER HOLTZ-EAKIN: And we heard yesterday

1 fairly convincing testimony that the purchase of Bear set
2 the expectation that other institutions would get help. And
3 that when Lehman went down and did not get help that was a
4 great shock and surprise to the market.

5 So I was wondering if you would give us your
6 views, particularly about setting the precedent, having, you
7 know, seen intervention with Fannie and Freddie set
8 expectations, how you thought about doing that with Bear.

9 VICE CHAIRMAN THOMAS: Mr. Chairman, if we could
10 give the Commission five extra minutes.

11 WITNESS PAULSON: Okay. I would like to answer
12 that question because in terms of convincing testimony, you
13 will never hear convincing testimony from anybody on this
14 who was close to the markets, in my judgment.

15 COMMISSIONER HOLTZ-EAKIN: And we're getting you
16 time to answer, so go.

17 WITNESS PAULSON: Because--Here's what I would
18 say.

19 First of all, let's look at the timing on this
20 because Bear was rescued in March and we got the emergency
21 legislation on Fannie and Freddie in July, and they were put
22 in conservatorship in September.

23 I believe that if Bear had not been rescued and
24 it had failed the meltdown that we began to see after Lehman
25 had gone would have started months earlier, and we would

1 have really been in the soup because it would have
2 started--now that I look at it, with hindsight--before
3 Fannie and Freddie were stabilized. Could you just imagine
4 the mess we would have had?

5 If Bear had gone there were hundreds, maybe
6 thousands of counter parties that all would have grabbed
7 their collateral, would have started trying to sell their
8 collateral, drove down prices, create even bigger losses.
9 There was huge fear about the investment banking model at
10 that time, and--because of the lack of Fed oversight and
11 access to the discount window and so on. So I think you
12 would have seen other investment banks go very quickly.

13 Now those that make that argument are missing, to
14 me, one fundamental fact: That as the Chairman said--used
15 the expression once, toothpaste out of the tube.

16 Once the--the crisis had been going on for seven
17 months when Bear went. The system was very, very fragile.
18 You didn't see excessive risk-taking. You didn't see
19 speculation. As a matter of fact, there were a lot of
20 prudent loans that weren't being made. Investors were even
21 afraid to buy student loan securitizations where the
22 government was behind it.

23 Sovereign wealth funds and other foreign buyers
24 that had come in to Morgan Stanley, CitiGroup, Merrill
25 Lynch, and all lost a lot of money. People were scared. So

1 it wasn't like people said, 'Gee, they bailed out Bear. Now
2 we can go and let Lehman be profligate.'

3 You know, the losses that Lehman had and that
4 others had were in positions that were already on their
5 balance sheet that were illiquid positions that just had to
6 be marked down as the economy turned down and as the--and as
7 home prices dropped. So again, you know, I think you would
8 have had a hard time finding any buyer for any institution
9 if the government had--again, if Bear had failed.

10 COMMISSIONER HOLTZ-EAKIN: Thank you.

11 One last question. You talked about the
12 investment bank model sort of being in trouble. What we
13 heard yesterday from the SEC is that investment banks had
14 voluntarily brought themselves to a Basel II capital
15 standard, had liquidity requirements in excess of those
16 required of commercial bank holding companies, that by the
17 standards of regulation they were fine.

18 And so my question specifically is: Is there a
19 real difference in the performance of commercial versus
20 other entities during the crisis? We saw failures across
21 the board.

22 WITNESS PAULSON: Now I may have a bit of a bias
23 given where I came from. But I will tell you this:

24 Analytically that I think--people throw around
25 the leverage ratios. And if you had adjusted for accounting

1 differences, the fact that investment banks had the
2 discipline of marking securities to market--that I think
3 that they were at least as well capitalized as the
4 commercial banks--I believe that the issues--I
5 think this was a confidence issue.

6 I think that it started--I think you had a couple
7 of investment banks in Bear and in Lehman Brothers that had
8 big exposure to the housing market--and Bear in particular
9 probably wasn't as diversified as some of the others. And I
10 think it really comes down to liquidity management and
11 liquidity cushions. And I think I saw the same lack of
12 liquidity management. You know, I saw it across the board
13 with banks and investment banks.

14 But--so my comment didn't get to the relative
15 strength or weakness; it really got to a concern and a lack
16 of confidence. And when the market loses confidence in an
17 entity in the middle of a crisis it's very hard for that
18 company to continue to exist.

19 COMMISSIONER HOLTZ-EAKIN: Thank you, Mr.

20 Secretary

21 CHAIRMAN ANGELIDES: Thank you.

22 I'm going to take a couple of minutes of my time.
23 I just want to follow up on something that Mr. Holtz-Eakin
24 raised.

25 At our last hearing when we had Fannie Mae in

1 front of us the Vice Chairman and I described a timeline
2 which we've now verified. And I'd like to enter it into the
3 record as well as the underlying documents.

4 COMMISSIONER HOLTZ-EAKIN: And it gets to what's
5 happening in that late February-early March time frame and
6 culminates around what you might call the Bear weekend.

7 WITNESS PAULSON: Right.

8 CHAIRMAN ANGELIDES: And let me see if I can
9 describe this very quickly.

10 There's obviously concerns about the meltdown of
11 the private side of the mortgage market. You had expressed
12 some pretty darn big concerns about Fannie. You've also
13 said both publicly and in the interview with our staff--what
14 you said to our staff is 'they'--meaning Fannie and
15 Freddie--were the game in town; they were the only game in
16 town.

17 But it looks like what's happening here is the
18 portfolio caps are going to be lifted. I think that happens
19 February 28th. So that Fannie and Freddie will keep lending
20 now into a market with big headwinds.

21 And the deal I think that you and your team are
22 trying to broker--and I don't know if that's an accurate
23 characterization, but certainly involved in--involves them
24 continuing to lend in, having their capital surcharge
25 reduced some--in fact instantly, I think, reducing their

1 capital by ten percent on the promise to raise more capital.

2 Is that a fair assessment?

3 WITNESS PAULSON: Well, I would say this:

4 It was a--they made a commitment to raise more
5 capital. And Fannie raised seven billion dollars --

6 CHAIRMAN ANGELIDES: Fannie did and Freddie
7 didn't. Right.

8 WITNESS PAULSON: And Freddie didn't live up to
9 the commitment.

10 And so there was net more capital raised. And
11 there was the deal which the regulator and the GSEs working
12 with my staff brokered was a lifting the capital surcharge
13 to raise capital and it was to--and I just can't say
14 strongly enough--it was to raise capital.

15 The other thing I will say, when you're saying
16 lending into headwinds, I object. I think just the
17 opposite. I think what you will find is that the markets
18 had declined dramatically in housing prices and they were
19 continuing to decline. So everyone was aware of the issue.

20 And so the losses they had didn't stem from--I
21 think you're going to find didn't stem from going ahead and
22 doing risky things in here. It had to do with what was
23 going on in the housing market, and what had gone on in all
24 of the loans that they'd guaranteed before that and put on
25 their balance sheet.

1 CHAIRMAN ANGELIDES: Well, see, and I think we're
2 going to have to look at this. But here's what I wanted to
3 get to the nub of, which is: It's clear there's deep
4 concerns. Lockhart--in fact there's an email March 16th in
5 which Mr. Steele writes to Mr. Mud--quote:

6 "Lockhart needs to eliminate the negative
7 rhetoric because it looks like the regulator is not really
8 wild about this."

9 But interesting also, he says, 'I was leaned on
10 very hard by Bill Dudley, who worked for Mr. Geithner, to
11 harden substantially the guarantee. I do not like that and
12 it has not been part of my conversation with anyone else. I
13 view it as a very significant move, way above my pay grade
14 to double the size of the U.S. debt in one fell swoop.' And
15 the day or two before the transaction gets done Lockhart
16 objects by saying, 'This idea strikes me as perverse as I
17 assume it would seem perverse to the markets that a
18 regulator would agree to allow a regulatee to increase its
19 very high mortgage credit risk leverage without any new
20 capital.'

21 Now I understand that part of this was to raise
22 more capital. But here's my essential question.

23 You had deep doubts. And I'm just trying to get
24 a sense of how you saw the markets in March. Bear had just
25 been--quote, unquote--well, acquired, but there was a rescue

1 involved because the Fed's involved.

2 At this point in a sense you're striking a deal
3 that allows them to stay in the market. You have deep
4 concerns about solvency. Is there a view at that point
5 that, look, we're now in the business of a bailout.

6 Does the bailout start in March or do you
7 genuinely believe things are going to right themselves?

8 WITNESS PAULSON: Neither one. I didn't believe
9 things were necessarily going to right themselves, and the
10 bailout didn't start in March.

11 This--I just cannot say it clearer and more
12 definitively. This was about getting them to raise capital.
13 That's what this was about. And guess what--it did. Okay?

14 Fannie raised seven billion dollars in capital.
15 Freddie committed to raise capital and then later their
16 lawyer said, 'Well, we need to wait until the second quarter
17 numbers are out.' And by the time the second quarter
18 numbers are out we had gone and gotten the emergency
19 legislation.

20 But this was solely about raising capital.
21 Because what we were dealing with, we were dealing with a
22 situation where the markets were on edge. They were the
23 only game in town. And I was pressing--this was not unique
24 to them. We were pressing financial institutions to raise
25 capital.

1 And to me it was an unimaginable risk that these
2 things posed. I had no idea that we would need to go at
3 that time to Congress and get these authorities. And I had
4 no idea that we could have got those authorities. Because
5 remember, I had seen Congress, Fannie and Freddie were a
6 political football like you wouldn't believe. I had seen
7 reform stymied for years. And we were working to try to get
8 the kinds of authorities we needed.

9 And so I had no idea that we were going to need
10 to get the authorities, get the authorities we got, which
11 let us get in with the real experts to get their arms around
12 the problem, and then get the tools we needed to address the
13 problem.

14 So working with the limited tools we had without
15 being the regulator for Fannie or Freddie we pressed them to
16 raise capital. And I think that was the right thing. I
17 think that was a sign of confidence when they announced it
18 and then when they went and Fannie raised capital.

19 CHAIRMAN ANGELIDES: All right.

20 You know, at some point I think--given your one
21 staff person--I'd like to follow up a little on this. But I
22 think there's a bigger objective here, which is also trying
23 to understand as markets are wobbling --

24 WITNESS PAULSON: Right.

25 CHAIRMAN ANGELIDES: --this kind of dichotomy I

1 think you faced.

2 And maybe--and I'm going to really move on to
3 other members. I'll just state it and we'll ask in a
4 written question. Between trying to stabilize the markets
5 versus also acknowledging publicly the state in which
6 they're in. But I'll--let me do this. Let me --

7 WITNESS PAULSON: Well, obviously we--I would
8 just simply say this:

9 What you need to recognize--and I'll say this and
10 I'll answer it in writing and answer it the same way--is
11 that Treasury is not the regulator. We didn't have the
12 authority, we didn't have the people, we didn't have the
13 capacity to really get in there. Okay? So what we were
14 doing was pressing them to raise capital.

15 It was only when the markets lost confidence and
16 we needed to get these authorities that we had the tools to
17 get in there and get our arms around the problem.

18 CHAIRMAN ANGELIDES: All right. Thank you.

19 Senator Graham.

20 COMMISSIONER GRAHAM: Thank you, Mr. Chairman.

21 And thank you, Mr. Secretary.

22 I would like to ask three questions that relate
23 to lessons learned. As you say, this is not going to be the
24 final financial crisis that this country is going to have.

25 One of those relates to a continuation of the

1 Bear Stearns story, and that is when you faced the issue of
2 Lehman Brothers you were, in addition to dealing with
3 Lehman, you were establishing a principle, which was that
4 Bear was not a precedent for all future similar
5 circumstances; that you were not going to rally the Federal
6 Government to the salvation of every institution.

7 What were the factors that caused you to make the
8 case by case decision that Lehman was not worthy of a
9 federal-assisted transition?

10 WITNESS PAULSON: Thank you for asking that
11 question because, despite the fact I've written a book and
12 answered this hundreds of times, people tend still not--and
13 despite the fact that we've had Ben Bernanke and Tim
14 Geithner say the same things--people still question us on
15 this a lot because it's hard to understand.

16 But the fact is that Bear faced a liquidity and a
17 capital problem. And we were very fortunate to have a buyer
18 in J.P. Morgan to come in and solve the capital problem and
19 be able to guarantee Bear's trading books during the
20 pendency of the shareholder vote. And so we were--and we
21 learned there that the government--how limited our
22 authorities were. We couldn't--no one had the authority to
23 guarantee an investment bank's liabilities or to put in
24 capital. And so--and we didn't have resolution authority.

25 After that I made a number of speeches where I

1 talked about the need for this. Lehman came along. We
2 unfortunately were unable to get any bank to play the role
3 on Lehman that JPMorgan played on Bear. And so we tried
4 very hard to do that and we were left, frankly, powerless.
5 And so we prepared for the, you know, for the bankruptcy.

6 So this was not something we did intentionally.
7 And it was just a--we just had a flawed regulatory system
8 and powers.

9 COMMISSIONER GRAHAM: The second area is
10 conditionality of funds to financial institutions through
11 RARP or other bail-out practices. In contrast to what seems
12 to be the perception of the U.S. where there were relatively
13 few requirements, in the United Kingdom--for instance, the
14 Royal Bank of Scotland was required to accept certain
15 conditions as to what its lending practices would be,
16 limitations on dividends and compensations.

17 Why were there not similar conditions attached to
18 the bail-out of U.S. financial institutions?

19 WITNESS PAULSON: Well, this was a totally
20 different program. We did not want to be dealing with
21 institutions as they serially failed, as they did in the UK.

22 We diagnosed the problem as being a big capital
23 shortfall in the banking sector. And so we designed a
24 program that would be attractive to healthy banks so that
25 they would want to come in and voluntarily participate.

1 And we put in preferred, which was passive--we
2 didn't want it to look or be like a nationalization--and
3 designed so that the government would get the money back
4 because it was senior to the common. And so that was the
5 whole purpose of the program.

6 And, you know, interestingly enough, you know, I
7 was hopeful when we announced it that we'd get a couple
8 thousand banks that would participate, two or three
9 thousand. But right after we announced it we had critics
10 start saying, 'You've got to force them to lend.' They
11 didn't say how much or how you were going to make them lend
12 or what the government would do. 'You've got to control
13 their compensation,' understandably. And then
14 understandably, a number of the banks said, 'Wow, I'm not
15 sure we like this deal.'

16 And so we had a good number of banks apply for
17 TARP, get accepted, and then pull back. And we had about
18 700 not quite take the money. And it was a big success
19 because it prevented their collapse and the government's
20 going to get the money back with a profit.

21 But I think if it hadn't been stigmatized by all
22 those that wanted to put the various controls on it that we
23 would have had two or three thousand banks; they would have
24 had the money for three to five years. And that would have
25 done far more than any stimulus program to get the economy

1 going again.

2 But you know, again, I think some of those who
3 say the program didn't work because there wasn't enough
4 lending were those people that stigmatized it. So again, we
5 were trying to deal with healthy banks and make it
6 voluntarily come in. So we weren't trying to nationalize
7 banks like the British government had done. And we were
8 tired of dealing with them serially when they failed.

9 COMMISSIONER GRAHAM: Well, there was a public
10 perception that one of the justifications for this was to
11 stimulate the economy by making credit available.

12 WITNESS PAULSON: Yes.

13 COMMISSIONER GRAHAM: And there was
14 disappointment when there were perceptions that that wasn't
15 happening.

16 WITNESS PAULSON: You're right. You're
17 absolutely right. And, of course, that was our whole reason
18 for--and I didn't make this point and I should have--the
19 whole reason for designing the program was so many banks
20 would take it, would have the capital, and that would lead
21 to lending. That was the whole purpose.

22 But in a funny way, as soon as we announced it
23 before the first banks ever got the capital people were
24 saying, 'Make them lend; why aren't they lending more.' Of
25 course, now if you're a bank do you really want this deal.

1 And how is Big Brother going to help you step in and tell
2 you how to make these lending decisions.

3 And so I think what happened was then some banks
4 were reticent to take the capital.

5 Now I think it did help. And it did help with
6 lending. But it could have been much more effective.

7 COMMISSIONER GRAHAM: Is what you're saying that
8 banks didn't want to take the capital which would put them
9 in a position to be a more effective contributors to the
10 economy because they felt that they would be under external
11 pressure to do that very thing?

12 WITNESS PAULSON: That's right. I think a number
13 of banks did. And so we had almost 700 banks take it. But
14 I think even those banks rushed to pay it
15 back--okay?--because of the extent to which they were
16 stigmatized.

17 And so I think banks were understandably
18 concerned. So you had this paradox. People wanted them to
19 lend more. But by clamoring for somehow or other there to
20 be strings attached. And I was never quite sure what
21 those--you know how people--you know, how much people wanted
22 the banks to lend; more than they'd lent in the middle of
23 the crisis during the excesses? Or, you know, how much
24 lending was--what was the right level and how was the
25 government going to determine that.

1 Clearly this was about lending and getting the
2 banks the capital they needed so that they could lend.

3 COMMISSIONER GRAHAM: Could I have two minutes?

4 The third question relates to a topic that you
5 have alluded to, and that is the role of Congress. And
6 you've said that Congress had barriers such as its tendency
7 to wait until the crisis had occurred before acting and then
8 some of the jurisdictional restraints on dealing
9 comprehensively with problems.

10 From your experience in the executive branch
11 trying to influence Congress to be more proactive and to be
12 more comprehensive in its response, do you have any
13 recommendations of what the executive branch could do
14 facilitate Congress being a more effective partner or what
15 Congress ought to do within its own domain to enhance its
16 contribution?

17 WITNESS PAULSON: I could say my own experience
18 with Congress was very positive because twice I needed to go
19 to Congress with extraordinary requests and twice they
20 reacted before disaster struck--okay?--the crisis.

21 And Democrats and Republicans--I don't have
22 any--Like a lot of people, I don't like partisanship. And
23 I--but I saw people on both sides of the aisle come
24 together. I think in terms of how to solve the issue you've
25 got to--you can get some experts up here that are more

1 equipped than I am to deal with that question.

2 COMMISSIONER GRAHAM: Thank you, Mr. Chairman.

3 CHAIRMAN ANGELIDES: Thank you, Senator Graham.

4 Mr. Wallison.

5 COMMISSIONER WALLISON: Thank you, Mr. Chairman.

6 Mr. Secretary, it's good of you to be here. I
7 appreciate it very much. We all do.

8 I'd like to follow up a little bit on some of the
9 questions that my colleague, Douglas Holtz-Eakin, had asked
10 about: the rescue of Bear Stearns, because to me this was
11 one of the most consequential decisions that has ever been
12 made by our government. I think there's a
13 substantial argument that it gave rise to moral hazard that
14 made the Lehman collapse much more significant than it
15 otherwise would have been if it would have occurred at all.
16 And I want to point out, for example, that once Bear Stearns
17 was rescued it certainly encouraged Lehman to keep its price
18 somewhat higher than it might otherwise have been in dealing
19 with potential acquirers because, on the other side, Lehman
20 had a reasonable expectation that it might also be rescued.
21 And I think the chairman of Lehman indicated that in some of
22 the testimony he's given to Congress in the past.

23 In addition, creditors of Lehman, such as the
24 Reserve Fund that caused so much difficulty, would probably
25 have rid themselves of the commercial paper that they were

1 holding that would immediately have lost value if Lehman had
2 actually been allowed to fail. And so when Lehman did fail
3 they were stuck with this commercial paper. And, of course,
4 as you remember, that particular money market fund, reserve
5 fund actually broke the buck and there was a run on money
6 market funds.

7 So the consequences of rescuing Lehman in terms
8 of its moral hazard were quite significant. So I would like
9 if I can just to follow up your reasoning a little bit more
10 carefully.

11 If I may make just a couple of other points.

12 Yesterday we heard from officers of--and former
13 officers of Bear Stearns--and from Chairman Cox of the SEC.
14 And we learned--I was surprised to learn that Bear Stearns
15 was actually solvent at the time that it was rescued. It
16 had not actually become insolvent, at least according to
17 Chairman Cox and according to those former officers of the
18 company.

19 And so the first question I'd like to ask you is
20 whether you were aware that Bear was in fact a solvent
21 company. Now I understand there was a liquidity problem.
22 But were you aware you were dealing when you got Bear to be
23 rescued that you were dealing with a solvent company?

24 WITNESS PAULSON: I think that is almost a
25 ridiculous statement. We were told on Thursday night that

1 Bear was going to file for bankruptcy Friday morning if we
2 didn't act. So how does a solvent company file for
3 bankruptcy?

4 You know, it is--When institutions, financial
5 institutions die they die quickly. It's a liquidity crisis.
6 They die because the market loses confidence.

7 When they die I don't care what someone has got
8 on their books--okay? Assets, if you had to sell them, are
9 not worth, you know, more than liabilities. So make no
10 mistake about it: We were told, 'The jig's up; we're filing
11 for bankruptcy tomorrow morning.'

12 And you know what? If--And at the time, you
13 know, we almost found out whether your hypothesis was right
14 because if J.P. Morgan hadn't emerged there was nothing that
15 was going to be done here.

16 But so, okay. That's your first question.

17 COMMISSIONER WALLISON: Now I would say that
18 companies can file for bankruptcy even when they're solvent
19 if they are illiquid because one of the definitions of
20 bankruptcy is you cannot pay your obligations as they come
21 due. It's not simply being legally insolvent.

22 WITNESS PAULSON: This is a financial
23 institution.

24 COMMISSIONER WALLISON: Yes. But let's not get
25 into that point. But the point is--

1 WITNESS PAULSON: Well, I think that's a huge
2 point.

3 COMMISSIONER WALLISON: The point is I just want
4 to be sure that we are talking about a possibility that we
5 could rescue firms that are in fact insolvent.

6 Now the officials of--the officers of Bear
7 Stearns we talked to, and Chairman Cox--although Chairman
8 Cox was not speaking as chairman of the SEC--both said they
9 did not think that Bear Stearns was too big to fail, and
10 that if it had failed it would have caused--they did not
11 believe it would have caused the kind of disruption that we
12 normally consider as necessary to rescue an institution that
13 is too big to fail.

14 Why did you think that Bear was too big to fail?

15 WITNESS PAULSON: Okay.

16 First of all, I don't take moral hazard lightly.
17 If Bear Stearns, if this had happened at a time--this
18 occurred at a time when the credit crisis had been underway
19 for seven months and the system was very fragile, throughout
20 the system.

21 Secondly, we didn't have the tools, as I said, to
22 wind them down outside of a bankruptcy process.

23 So what I saw in the marketplace was a market
24 gripped with fear, and that Bear was not the cause. Bear
25 was a symptom of fear and panic in the market and of this

1 broader problem of illiquidity. And so, as I said to you, I
2 believed that if Bear had failed that there were all sort of
3 counter parties which would have grabbed their collateral,
4 sold it. It would have led to bigger losses and bigger
5 write downs, you know.

6 And, for instance, your comment about the reserve
7 fund holding Lehman paper, yeah, darn right. If Bear had
8 gone down the reserve fund wouldn't have held Lehman paper
9 and neither would any other fund. And, you know--or many of
10 them. And so you would have--it just would have triggered
11 it quicker. You would have had Lehman going I think almost
12 immediately if Bear had gone, and just the whole process
13 would have just started earlier.

14 COMMISSIONER WALLISON: All right.

15 Well, if that's true then how could you not have
16 rescued Lehman under those circumstances? Because what
17 you're saying is that--you had implied that you were going
18 to rescue everybody else for the same reason: There was
19 fear in the market.

20 WITNESS PAULSON: Yeah. We looked at every one
21 of these, you know, on their own circumstances. But we
22 tried hard to come up with a solution for Lehman, very hard.

23 Again, if there had been a buyer for Lehman like
24 there was for Bear we would have done the same thing.

25 COMMISSIONER WALLISON: Let me just turn the

1 questioning to one other point, if I can ask you a question
2 on a different subject.

3 You said that subprime mortgages were a
4 relatively small part of the problem, although they were a
5 triggering element --

6 WITNESS PAULSON: Right.

7 Commissioner Wallison. --I think, in your view of
8 this.

9 Are you aware that there are views that the
10 number of subprime and Alt A mortgages in the market is much
11 larger than the 20 percent you cited? As much as half of
12 all mortgages by 2008, as much as half of all mortgages were
13 subprime and Alt A, and thus were ready to fail when the
14 bubble that we were experiencing began to flatten out.

15 If you had known that at the time --

16 Vice Chairman Thomas: Mr. Chairman, yield the
17 Commissioner additional three minutes.

18 COMMISSIONER WALLISON: Thank you.

19 If you had known that at the time would your view
20 about what was likely to happen or the importance of
21 subprime mortgages have been different?

22 WITNESS PAULSON: I'm not sure. First of all, I
23 don't know that.

24 But I don't--I think the big question--and I
25 think where you and I agree is that housing policy and

1 housing was the big issue here that we dealt with. And as I
2 look at the problem, there were excesses throughout the
3 market but that it was housing policy and mortgages more
4 generally, okay?

5 So I'm not as focused on, you know, I think
6 subprime was, you know, was obviously where the most
7 egregious excesses took place. And I have no doubt--You
8 know, people use this e. coli example or mad cow disease.
9 That I think first came from me and Treasury and we use it
10 in the book. And I do think that it's a good example
11 because there was so much uncertainty about that it
12 infected, you know, so many of the others in securitizations
13 in terms of the way investors concern. So it was a big
14 concern.

15 But I'm not sure that if I had--that that would
16 have made a big difference.

17 COMMISSIONER WALLISON: Let me tell you why I
18 think it's significant to think about it in these terms.
19 And that is--we've had questions here yesterday, and we
20 might have some further ones today--and that is that both
21 regulated banks, which are heavily regulated, as you know,
22 and investment banks failed in roughly the same
23 circumstances. There were runs in effect on both.
24 Confidence was lost in both.

25 And so the question really is if there were

1 circumstances that were so severe coming out of some event
2 which seems unprecedented in at least the last 70 years,
3 wasn't it a significant fact that there was no way that our
4 regulatory system could have prevented or did prevent the
5 loss of--not only among investment banks, as we've been
6 talking about, but also among regulated real banks.

7 WITNESS PAULSON: You know, I take your point. I
8 mean the fact is this was a--this event was--it's hard I
9 think to go back in history and find any event that was more
10 extraordinary in terms of the extent of the crisis, the
11 magnitude of some of the things that were witnessed here.
12 And so I think your thesis is, you know, has got a lot of
13 truth to it in terms of the housing.

14 COMMISSIONER WALLISON: Thank you.

15 CHAIRMAN ANGELIDES: Mr. Georgiou.

16 COMMISSIONER GEORGIU: Thank you, Mr. Chairman.

17 And thank you, Secretary Paulson, for joining us
18 here today.

19 I want to turn to a portion of your testimony
20 with which I agree. And I'd like to highlight it if I
21 could.

22 On page four of your testimony on securitization
23 you say:

24 "Because securitization separated mortgage
25 originators and underwriters from holding the risk of the

1 loans they originated it enabled subprime lenders to stop
2 focusing on the creditworthiness of the loans they made and
3 instead focus solely on their ability to sell those loans
4 upstream to underwriters. Underwriters in turn relaxed
5 their underwriting criteria, relying on their ability to
6 sell the securities into a booming market."

7 You go on to say:

8 "Reforms are unquestionably required. Better
9 disclosure is necessary. Underwriters and originators
10 should be required to retain some portion of what they sell.
11 Requiring underwriters to keep some "skin in the game" will
12 properly align their incentives with those of investors who
13 end up holding the bulk of the risk."

14 And then you go on to say:

15 "These changes will provide the securitization
16 market with powerful incentives to focus on creditworthiness
17 and will lead to more responsible lending practices."

18 And then yesterday we heard from Chairman Cox.

19 And in this written statement he said words to the effect:

20 "If honest lending practices had been followed
21 much of this crisis quite simply would not have occurred.
22 The nearly complete collapse of lending standards by banks
23 and other mortgage originators led to the creation of so
24 much worthless or near-worthless mortgage paper that as of
25 September 2008 banks had reported over one-half trillion

1 dollars in losses on U.S. subprime mortgages and related
2 exposure."

3 One-half trillion dollars, 500 billion dollars, 500,000
4 million, which was, you know, an extraordinary amount of money in
5 light of the capitalization of a lot of the institutions
6 that had to write down this paper.

7 And yesterday when James Cayne and Allen
8 Schwartz, the last two CEOs of Bear Stearns testified, I
9 asked them what they thought of the idea of requiring
10 investment bankers to hold--take some of their fees in the
11 actual securities that they create, whether that might
12 enhance the diligence and, you know, align the interests of
13 investors more closely with those of the underwriters.

14 And of course they both said that sounded like a
15 great idea, but Mr. Cayne said, you know, they're not going
16 to like it, he said about the investment bankers.

17 And I just want to harken back to your successor
18 at Goldman, whom I asked a similar question of back at our
19 first hearing in January. And he said, 'Well, we could take
20 those securities but then what we would do would hedge
21 them,' and essentially not, you know, not effectively have
22 the exposure to it. And of course I said, 'Well, the whole
23 idea would be for you to be long on it so that in your
24 underwriting obligations when you were representing to
25 investors that these would be sound investments you would

1 actually be side by side with them in the long haul.'

2 All of which is to lead me to a question which I
3 really think bears more on your experience at Goldman Sachs
4 and on the street generally than at the Treasury of, the
5 Secretary:

6 How could such a notion be implemented in light
7 of the different responsibilities that investment banks have
8 in at least three of their roles:

9 One is as an underwriter in which they undertake
10 to have a fiduciary duty to investors and represent that a
11 security is--that they're selling is not just the right to
12 sell it but to actually represent that it will perform as
13 represented;

14 Two, as a market maker, which is essentially what
15 Mr. Blankfein was suggesting, which is that people ask for
16 positions and they offer their clients the opportunity to
17 invest long or short or hedge their positions in various
18 respects;

19 And really third, as proprietary traders
20 investing for their own account.

21 And the reason I say that--and I'd just like your
22 thoughts in this regard--is if people were required to hold
23 those securities, one, how would you enforce them holding
24 them and staying long on them, not hedging them; and is that
25 realistic in light of the differential obligations of these

1 investment banks?

2 WITNESS PAULSON: That's a very good question.
3 And a lot of people have recommended what I've recommended.
4 And this recommendation is short on--long on policy and
5 short on how you would implement it. And I'll tell you: I
6 think it is difficult to implement for the reasons you
7 suggested.

8 But I would--And I think your question has got
9 the nub of the way you need to think about it because I
10 think a market making function is not really what we're
11 talking about here, you know. If a bank is in the
12 marketplace and it's got a client that wants to sell or
13 wants a bank to commit capital or help manage risk, that's
14 one situation. So it's really as an underwriter.

15 And I don't know that I even have a problem--and
16 I probably need to think about this some more--but even as
17 an underwriter putting a hedge on, again the hedge if it's
18 constructed properly you could have a hedge against, for
19 instance, the mortgage market overall. But this particular
20 security you're going to want to perform better, right?

21 COMMISSIONER GEORGIU: Correct.

22 WITNESS PAULSON: Because you have done such good
23 due diligence.

24 And so I think the only caveat I would say is you
25 want to have some skin in the game--and I made this comment

1 earlier. But you don't want to have too much because
2 actually those firms, some of them that got into the most
3 problem were those that kept an extraordinary amount of the
4 paper they had underwritten, which was rated AAA, and were
5 holding so much on their balance sheet that they almost
6 failed because of it.

7 COMMISSIONER GEORGIU: Oh, that's what John Mack
8 said. He said--I asked him whether they ought to eat their
9 own cooking. He said, 'Well, we choked on our own cooking,'
10 is what he said. And he got stuck with those securities on
11 their books.

12 But that wasn't his intention. His intention was
13 to originate and distribute them. But he wasn't able to
14 sell them all.

15 WITNESS PAULSON: That's right. That institution
16 and two others choked on their own cooking.

17 COMMISSIONER GEORGIU: Right.

18 WITNESS PAULSON: And so what we're talking about
19 here, I'm not talking about something that's different from
20 prudent risk management. I don't think we ever wants to ask
21 financial institutions to do things that's not going to
22 involve prudent risk management. But there's got to be a
23 way that as you underwrite that there's some piece of what
24 you've underwritten that you continue to have to live with
25 and own.

1 COMMISSIONER GEORGIOU: Right. Live with really
2 maybe even as long as the security is intended to produce.

3 WITNESS PAULSON: Right.

4 COMMISSIONER GEORGIOU: And maybe the bonuses
5 that were paid to the people who did the deal and were
6 responsible for the diligence ought to be paid in part in
7 the securities that they created.

8 I mean one of the thoughts is--that many people
9 have suggested here is that the fact that underwriters were
10 paid exclusively in cash, you know, the credit rating
11 agencies were paid exclusively in cash. The mortgage
12 brokers were paid exclusively in cash when the issue was
13 sold and didn't have any--didn't retain any risk for the
14 failure to perform as projected was a problem.

15 I'm sorry, could I have a couple of minutes? Two
16 minutes more, please?

17 CHAIRMAN ANGELIDES: Absolutely.

18 COMMISSIONER GEORGIOU: Thank you.

19 Yes, sir.

20 WITNESS PAULSON: I would think that formulaic
21 compensation just in general is a problem. Giving--and
22 particularly--and then paying it in cash makes the problem
23 much greater.

24 COMMISSIONER GEORGIOU: Not paying in cash?

25 WITNESS PAULSON: I'm saying paying it

1 in--formulaic compensation is a problem.

2 COMMISSIONER GEORGIU: Right.

3 WITNESS PAULSON: And then paying in cash is
4 another problem because again I strongly believe that when
5 looking at compensation it's very important to align
6 interest and for there to be a long tail on that
7 compensation. So, as you say, that those that underwrite
8 the securities, however it is done, an important part of
9 their compensation should be how well they do their job.
10 But how well they do their job has got to be the quality of
11 their job, not just the short-term profit.

12 COMMISSIONER GEORGIU: Right.

13 And I think that it also has the beneficial
14 impact of aligning their interests with the investors who
15 purchase it.

16 WITNESS PAULSON: Yeah.

17 COMMISSIONER GEORGIU: And avoiding
18 untoward--being on the opposite side.

19 I wondered if I could ask you in just the last
20 few seconds I have here to reflect a little upon this
21 question and maybe you could respond in writing if you come
22 up with any thoughts from your long-time experience on the
23 street as to how this might work. Because this is an
24 element, I think, that many people are looking for a
25 solution to that could improve diligence and improve the

1 quality of the paper sold, which could avoid the problem
2 going forward in the future.

3 WITNESS PAULSON: Like so many things, it's
4 easier to discuss this at 100,000 feet than it is to figure
5 out how to implement it.

6 COMMISSIONER GEORGIU: Right.

7 WITNESS PAULSON: I will give it some more
8 thought.

9 COMMISSIONER GEORGIU: Thank you so much, Mr.
10 Secretary. And thank you for your service.

11 CHAIRMAN ANGELIDES: And we're going to keep that
12 one assistant of yours real busy between now and December.

13 VICE CHAIRMAN THOMAS: Could I have just a
14 minute.

15 CHAIRMAN ANGELIDES: Absolutely. You can have
16 just a minute; absolutely.

17 VICE CHAIRMAN THOMAS: I'll give myself a minute
18 out of my own time.

19 There are some of us on this Commission who are
20 admitted non-economists. And so there's a jargon that's used
21 which we sometimes have to translate.

22 WITNESS PAULSON: I will join you in that. I'm
23 an admitted non-economist.

24 VICE CHAIRMAN THOMAS: Yeah. I'm also an
25 admitted non-attorney. So there's a whole lot of things I'm

1 admitted 'non' on.

2 But in trying to understand both in terms of the
3 shadow banking system and the point that Mr. Wallison makes
4 so clearly about the subprime Alt A mortgages, the flawed
5 mortgage packages, I think most people would understand
6 interconnectedness, i.e., you've got five men climbing a
7 mountain, they're all roped together. One falls, he pulls
8 the other four with him.

9 But contagion and common shock that are terms
10 that are being used are for me a little more difficult to
11 parse.

12 When you use the e. coli example, my argument is,
13 coming from the ag background and the other stuff, that if
14 you told me that spinach, packaged spinach--which was an
15 actual case--had e. coli, you could go ahead and eat
16 lettuce. You don't have to worry about getting e. coli
17 because it isn't the spinach. And then common shock would
18 be that everybody had it.

19 So where do you place the mortgage packages? Did
20 everybody have them and that pulled everyone down and then
21 all the other assets became devaluated?

22 WITNESS PAULSON: You see, here's what happened.
23 And I'll try to explain this in simple terms.

24 VICE CHAIRMAN THOMAS: I can usually handle
25 complex terms if they're defined.

1 WITNESS PAULSON: But this will be--you can
2 handle very complex terms --

3 VICE CHAIRMAN THOMAS: Okay.

4 WITNESS PAULSON: --as anybody who's read the tax
5 code knows.

6 But what had happened was there were these very
7 complicated securities that were hard to understand. People
8 bought them on a rating. And they knew there were problems
9 in subprime.

10 And so once the problems occurred then there
11 were--anything that even looked like securitization in the
12 mortgage area or complexity caused people to pull back
13 because they said--and it wasn't a matter of pricing. It
14 became illiquid. That's why the e. coli thing, you know, if
15 McDonald's reduced the--if there was a big concern about
16 beef somewhere and McDonald's reduced the price of their
17 hamburgers more people wouldn't buy it if they were scared.
18 People --

19 VICE CHAIRMAN THOMAS: But what about the plague,
20 for example?

21 WITNESS PAULSON: Yeah.

22 VICE CHAIRMAN THOMAS: See, Bear Stearns kept
23 saying, 'We weren't very big in subprime.' Well, they were
24 big in Alt A.

25 WITNESS PAULSON: But what happens is that was

1 it. So people then said--investors became concerned, even
2 if there was a very low likelihood. And so what happened is
3 when one asset class becomes illiquid--okay?--no one can
4 sell it, then what happens, people all run to sell another
5 asset class. And so they go to sell the mortgages that are
6 salable. And pretty soon those become illiquid because
7 everybody's trying to sell them. And everyone's sitting
8 around the same risk control table trying to sell the same
9 thing, and all the buyers are in the hospital.

10 VICE CHAIRMAN THOMAS: So it's contagion rather
11 than common shock?

12 WITNESS PAULSON: It's contagious because
13 illiquid, you try to sell something that becomes illiquid
14 because of fear it can't be sold. So then securities that
15 shouldn't be related, you know, that they're not supposed to
16 be correlated do become correlated because they're what
17 everyone else tries to sell.

18 VICE CHAIRMAN THOMAS: And Bear Stearns at the
19 end said the only thing they could really deal with were
20 Treasuries.

21 WITNESS PAULSON: Well, I would just simply say
22 that counter parties in the repo market lost confidence in
23 Bear Stearns. And they were unable to borrow against
24 certain securities.

25 VICE CHAIRMAN THOMAS: Notwithstanding the fact

1 others had the same?

2 WITNESS PAULSON: Yeah, there were others--No,
3 others had--this was a loss of confidence. Others were
4 experiencing similar problems, but not nearly to the same
5 extent. This was focused on Bear Stearns.

6 VICE CHAIRMAN THOMAS: So it was degree.

7 WITNESS PAULSON: But let me also say to you that
8 lending practices were very sloppy, and borrowing practices.
9 It's one thing if I want to repo a Treasury. Okay? If I'm
10 redoing a mortgage security and you're giving me 100 percent
11 of the value lending on that, not asking for a haircut,
12 that's sloppy.

13 And so what happened was there was an assumption
14 you could keep borrowing at--quote--full value on these
15 securities when they were dropping in value.

16 VICE CHAIRMAN THOMAS: Okay. I'll have to ask my
17 colleague, Doug Eakin--an admitted economist--if sloppy is a
18 term of art.

19 CHAIRMAN ANGELIDES: Mr. Hennessey.

20 COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

21 What I'd like to ask you to do is to focus on
22 three specific firm failures--I guess four if we package
23 Fannie and Freddie together. And we were just talking about
24 why those firms failed. But instead what I'd like to ask is
25 for you to explain your thinking about scenarios that you

1 feared might happen if they were not bailed out or
2 rescued--whatever your favorite term is.

3 So Bear, Fannie and Freddie, and AIG; because as
4 I understand it, the scenarios, the really bad scenarios
5 that might have happened if those firms had failed were
6 somewhat different, in particular thinking about counter
7 parties.

8 With bear it sounded like what you were
9 describing was if Bear was the slowest deer and the lions
10 got it that the next slowest deer might fall prey to the
11 lions, whereas there were other scenarios, as I understood
12 it, for what would happen, you know, to the system if Fannie
13 and Freddie failed or what would happen if AIG failed.

14 So could you compare and contrast?

15 WITNESS PAULSON: Well --

16 COMMISSIONER HENNESSEY: What concern --

17 WITNESS PAULSON: I would say it's one thing--I
18 have to really be very careful here because doing it with
19 what I know today in terms of what I knew then. Okay?

20 So with Bear Stearns, what I knew then, I
21 wasn't--I knew enough to know that the system was very
22 fragile and that there were so many unknowns in terms of the
23 counter parties that this was a very dangerous risk to take
24 and an imprudent risk to take to have them go down.

25 What I know today is that what was waiting for us

1 in terms of Fannie and Freddie, which I didn't know then,
2 and what was--you know, and how severe the overall situation
3 was. But there's no doubt that--and Bear was the kind of
4 firm that I believe if it had gone down like a Drexel or
5 whatever during a more normal market, as opposed to one
6 where there was huge stress and fragility. And what I saw
7 beneath the surface, you know, throughout the institutions
8 in Europe and the U.S., it caused me concern.

9 Now you mentioned Fannie and Freddie. That's
10 just a different order of magnitude. As I said, that just
11 posed sort of an unimaginable risk to me.

12 It's just the whole--if there had been a loss of
13 confidence that they didn't have the ability to pay back
14 their securities--I mean there was 3.7 trillion held in the
15 U.S., 1.7 trillion outside of the U.S., they just sort of
16 flowed through the financial markets almost like water.
17 They were liquid securities, they were considered to be.

18 So that would have--if there had been a big
19 disruption there no one in the world would have had any
20 confidence in our ability to deal with this.

21 COMMISSIONER HENNESSEY: Can I interrupt you for
22 a second?

23 What you're describing I think are two different
24 things. With Bear it's that if Bear fails, it's not that
25 other people would be holding Bear securities and that would

1 push them under. It's that the same problem that affected
2 Bear might then affect another firm.

3 WITNESS PAULSON: It would start a chain
4 reaction.

5 COMMISSIONER HENNESSEY: Right. Whereas with
6 Fannie and Freddie what you're describing is that there were
7 actual firms that held Fannie and Freddie debt on their
8 balance sheet and Fannie and Freddie's collapse would have
9 caused problems on their balance sheet.

10 WITNESS PAULSON: Yeah. But, Keith, it's more
11 than that.

12 It's just the whole thought--okay--that something
13 of this magnitude, you know, that was chartered by the
14 United States of America, with our housing bubble that we
15 were going to stand behind that. There would be--well, why
16 would any institution be safe.

17 And then, you know, when you talk about Lehman, I
18 will say to you that --

19 COMMISSIONER HENNESSEY: Actually it was about
20 AIG.

21 WITNESS PAULSON: Oh. AIG. Okay.

22 Well, AIG is an order of magnitude bigger than
23 obviously Lehman or Bear. It was one that we knew the least
24 about because there was no one regulator that had, you know,
25 a clear line of sight. So we knew the least about it. But

1 we knew that it was huge in terms of the size and the
2 interconnectedness and the credit default swaps with all the
3 counter parties. It's a real example of rating.

4 You know, I have a--you know, the danger of a AAA
5 rating where--and again liquidity. Many people entered into
6 contracts with them without getting normal margin because
7 they were AAA. They entered into contracts where they would
8 have to post collateral if there was a downgrade, you know,
9 without saying, well, how do we make sure we have the
10 liquidity to deal with a downgrade.

11 And then, of course, you touch so many
12 individuals because they had these--they guaranteed through
13 their--get contracts and other retirement plans for teachers
14 and health care workers and others. So you get tens of
15 millions of Americans there. You get, you know, the
16 insurance.

17 So it again was, you know, it's like Lehman
18 squared or whatever.

19 COMMISSIONER HENNESSEY: Okay.

20 Yesterday--a different topic. Yesterday
21 consistently from the Bear executives we heard non-specific
22 hypotheses that there was someone who was strategically
23 inciting the panic; that there were actors out there who
24 were actively trying to bring Bear down to make money. You
25 hear this crop up a lot, but you never hear anyone actually

1 name names and say, 'Here's who I think was behaving
2 strategically.'

3 I'm not going to ask you to name names. But do
4 you think that there were participants out there who were
5 trying to bring down Bear or any of these other firms?

6 WITNESS PAULSON: I do. First of all, I don't
7 ever mean that this is the fundamental cause. I think that
8 there was--where there's smoke there's fire, number one.
9 And it was about a loss of confidence. I believe short-
10 selling is essential for the price discovery process in the
11 U.S. But I don't use the word 'collusive' because that's
12 got a legal connotation.

13 But I would say that when you see serial
14 attacks--okay?--not just sort of an industry overall but
15 serial attacks. And it was the easiest trade to short the
16 stock and then bet on the credit default swaps to widen and
17 do that. And to see it go sort of like from, you know, the
18 wolf pack trying to pull down the weak deer.

19 So I'm not saying there was behavior that was
20 illegal. That was something that I'd want--and I'm sure
21 they were--the SEC to investigate. And I'm sure if they
22 found something that was illegal like collusive or
23 manipulative they would have acted--or they will act.

24 But I do think that, like so many things, we had
25 rules that were there to serve us well in normal times. But

1 when we had extraordinary times like this we needed to take
2 some extraordinary actions with regard to short-selling.
3 And I still think those that are thinking about circuit
4 breakers or ways of addressing, you know, short-selling
5 during times of crisis or when a stock moves too far, you
6 know, are important things to do.

7 And I do think--it sure looked to me like some
8 kind of coordinated action.

9 COMMISSIONER HENNESSEY: Thank you.

10 CHAIRMAN ANGELIDES: Thank you, Mr. Hennessey.
11 Ms. Murren.

12 COMMISSIONER MURREN: Thank you.

13 And thank you, Mr. Secretary, for spending so
14 much time with us talking about these important issues.

15 I'd like to talk to you actually about a
16 fundamental assumption that people seem to have. And I
17 would like to challenge it and get your response to it.

18 People often say that financial innovation is a
19 great thing. It's important. It's necessary and it serves
20 an important purpose. But when I think about innovation I
21 think about cancer research, technology.

22 And it seems to me that when you look at
23 financial innovation over the last let's say decade, you've
24 got MBS, CDS, CDOs, that all of these really seem to have
25 led to a common lack of understanding about the instruments

1 themselves, both on the selling side of it and on the buying
2 side of it. It could extend all the way down into mortgage
3 products that have become increasingly complex.

4 And yet they don't seem to protect the people
5 that would use these kinds of innovations to protect
6 themselves against a natural business exposure. They do not
7 seem to have strengthened the U.S. economy and helped the
8 real economy to evolve. But really what it has served to do
9 is to enrich all of the intermediaries throughout this
10 process and to create a lot of unpredictability and a lot of
11 volatility, which leads us to where we are today.

12 So I guess with that, do you really believe that
13 financial innovation beyond a certain point is a positive
14 thing?

15 WITNESS PAULSON: No, I don't. But here is a
16 problem. And we really get to the problem we were talking
17 about earlier, is how to deal with this. Because there's no
18 doubt in my mind that a lot of innovation has been good. I
19 mean the fact that we have strong markets, efficient markets
20 away from, you know, the banks, that I think the concept of
21 securitization is a good one, and, used properly, it's
22 great. I think the repo markets are.

23 But we have had excessive innovation and
24 complexity. And I think particularly--I think excessive
25 complexity is a problem in a lot of places, even with tech

1 companies bringing out new products. And you just learn you
2 can only--you're just bound to have mistakes the more
3 difficult, the more complex something is.

4 And, of course, with the kinds of complexity we
5 have with these financial products, it is a real problem.
6 And so again the only way I can think to practically deal
7 with it, because I think it is very difficult to write a
8 rule that said you can do this and you can't do that on
9 behalf of the government, so I just think that regulators
10 should be pushing towards standardization.

11 And I think the right way to deal with it is with
12 capital charges, and big capital charges. If something
13 is--and, you know, transparency. Just pushing
14 toward--fighting toward transparency, disclosure, and
15 penalize complexity with capital charges.

16 COMMISSIONER MURREN: Thank you.

17 I'd like to follow up on that issue of
18 transparency, in particular looking at the conversation we
19 were just having about--indirectly about hedge funds and
20 their behaviors within the market. And one of the salient
21 moments for Bear Stearns was when their hedge fund
22 operations declared that they were insolvent, I guess.

23 When you think about the activities of hedge
24 funds surrounding the crisis there was a fair degree of lack
25 of transparency in that regard. Do you think that these are

1 entities that should be included in what you just described,
2 which is a regime that more adequately discloses not only
3 the positions but also perhaps the motivations of the
4 various players within the markets?

5 WITNESS PAULSON: Yeah, it's very interesting
6 because we focused on hedge funds early on with the
7 President's Working Group. And one of the first things we
8 did was to audit the relationships between the prime brokers
9 and the big banks, you know, and the hedge funds and make
10 sure that the regulated institutions had plenty of capital
11 and plenty of margin. And as it turns out, this wasn't
12 where the problem occurred.

13 And I think that work was good because it didn't
14 have a problem. But the problem was right under our nose in
15 the regulated entities. And, you know, we weren't focused
16 on the citizen conduits, you know, we were focused on the
17 hedge funds.

18 But having said that, I recommended that in the
19 blueprint we put out that hedge funds that were big and
20 complex enough to be systemically important be
21 chartered--Okay?--and have that regulation. And I am all
22 for that. And so I do think that's important.

23 COMMISSIONER MURREN: Thank you.

24 One final question. One of the things that's
25 striking to me in talking to everyone that we've talked to

1 so far is there really hasn't been anyone yet who has
2 admitted that they've made mistakes in this whole thing,
3 that they would do differently. I know that you've said
4 that from 10,000, or is it at 100,000 feet that everybody
5 makes mistakes? I'm wondering if you'd like to be the first
6 to tell us what mistakes you might have made in the course
7 of the crisis.

8 WITNESS PAULSON: Well, I would say there's a
9 good number of mistakes because the--you know, and I think
10 my mistakes were primarily communications mistakes. And I
11 hardly know where to begin there because, you know, let's
12 start with the TARP.

13 When we sent the outline we sent a three-page
14 outline up to Congress. We should have had a press
15 conference and should have said, 'This is not take-it-or-
16 leave-it; this is not complete; this is a starting point for
17 negotiations.'

18 I was never able to explain to the American
19 people in a way in which they understood it why these
20 rescues were for them and for their benefit, not for Wall
21 Street--never, ever to make that connection. And the
22 rescues today remain very, very, very unpopular.

23 I think that the things that are generally
24 pointed out as mistakes that we made are in most cases
25 situations like Lehman Brothers where we didn't have the

1 authorities. Okay? And, you know, again looking at it for
2 100,000 feet, I think the major decisions we made--and I
3 think with 20/20 hindsight it's easier to say this--working
4 with imperfect tools and authorities were the right ones.
5 Okay? And I look back on those and I think they were the
6 right ones.

7 But along the way there were plenty of mistakes
8 made by everyone. And, you know, I sure wish I communicated
9 better a lot of the time.

10 COMMISSIONER MURREN: When you look around at the
11 other people that were involved in this could you give us
12 maybe just the top two or three mistakes that you saw made
13 that might have made a difference in all this?

14 WITNESS PAULSON: Well, I think understanding of
15 liquidity. I just can't say that over enough. It's so easy
16 to look at capital.

17 But capital is a number and it is, you know,
18 whether it's eight percent or ten percent--and you've got to
19 look at that in relation to the overall balance sheet. And
20 so when you find a bank taking a prime brokerage account and
21 taking those securities and using them to finance itself
22 overnight, but then making a 30-day or 60-day loan to the
23 prime broker so the prime broker now takes the securities
24 out, you can't finance yourself overnight but you've still
25 got that 30-day loan to them. I wonder how people do those

1 things.

2 And so I think those--I think liquidity and
3 understanding liquidity. And then other than that I really
4 believe despite--you know, we could just talk about all the
5 mistakes the bankers made, all the mistakes the rating
6 agencies made.

7 But I think this Committee, if you don't get to
8 the root causes of these we'll be sitting down with another
9 Committee in a number of years and it will be worse because
10 there will be still those mistakes all those different
11 market participants make but we'll still have the root
12 cause, which is we'd better change our housing policy, we'd
13 better restructure and really scale back and shrink the
14 mission of Fannie and Freddie at a minimum; we'd better do
15 some things with our tax policy and do some things to
16 encourage savings in the United States and discourage over-
17 borrowing.

18 So again that would be my two cents worth.

19 COMMISSIONER MURREN: Thank you.

20 CHAIRMAN ANGELIDES: Mr. Secretary, thank you.

21 Just one technical matter. When I started
22 today--

23 Oh, I'm sorry, Mr. Wallison. Two minutes?

24 COMMISSIONER WALLISON: Right.

25 CHAIRMAN ANGELIDES: All right. And then I have

1 a very quick close and...

2 COMMISSIONER WALLISON: Yeah. I just wanted to
3 follow up on something I thought was very important that
4 Vice Chairman Thomas talked about, the issue of common shock
5 and liquidity.

6 It seems to me the significant fact is that
7 because of the big losses on subprime and Alt A loans, as
8 you probably know, the mortgage-backed securities market
9 came to a halt basically in 2007--that is, couldn't buy or
10 sell mortgage-backed securities and CDOs and so forth, but
11 basically mortgage-backed securities. And this meant, it
12 seems to me, that financial institutions couldn't sell a
13 substantial portion of their assets and they became largely
14 illiquid. And in fact they had to write down some of their
15 assets because of the rules for accounting at the time.

16 So for that reason these institutions looked like
17 they were unstable or perhaps insolvent. They were
18 certainly illiquid and that is very important, as you
19 pointed out. So the regulation of banks and investment
20 banks simply couldn't cope with that. This is the
21 disappearance of a major asset class; it just was no longer
22 there. There was no market for it any more.

23 And I would like to have your reaction to that as
24 a person who is familiar with markets.

25 WITNESS PAULSON: Yeah.

1 There is no doubt there was real liquidity
2 problems, huge liquidity problems. And that makes it hard
3 to value assets. And I know your view on mark-to-market
4 accounting. And I know there are a number of very
5 thoughtful people that blame mark-to-market accounting, fair
6 value accounting. I'm not one of them.

7 In other words, I believe the problems would have
8 been worse without it. I believe if more financial
9 institutions had mark-to-market accounting the excesses
10 wouldn't have built up to the point that they built up. It
11 would have been more apparent. And I frankly don't know how
12 you run an institution if you don't have the discipline of
13 having to mark these assets and put a real value on them
14 rather than a historical value on them continually.

15 So again, I'm a proponent--and I think--and I had
16 people during the crisis say, 'I've got an idea. Let's just
17 stop mark-to-market accounting and the problem will go
18 away.' And of course that really would have scared
19 investors. And investors wanted more visibility and
20 transparency.

21 But again, I understand your view. And I've
22 spent a lot of time talking about this with thoughtful
23 people. And there's no doubt that during the crisis mark-
24 to-market accounting accentuated some of the issues.

25 COMMISSIONER WALLISON: I shouldn't have

1 mentioned mark-to-market accounting. I want to just clarify
2 that I was talking simply about the lack of liquidity that
3 came from the fact that people couldn't value their assets
4 any more.

5 WITNESS PAULSON: Absolutely.

6 COMMISSIONER WALLISON: There was no market for
7 their assets.

8 WITNESS PAULSON: There was not a market, or at
9 least a market they wanted to accept.

10 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin. Very
11 quickly.

12 COMMISSIONER HOLTZ-EAKIN: Thank you.

13 I just wanted to dig down in the weeds on two
14 failures and get your opinion on what happened. One is, you
15 know, the overnight repo market failed pretty dramatically.
16 And we've talked about that.

17 But something that also failed was the sort of
18 traditional role of the commercial banks as a conduit to the
19 investment banks. In particular Bear Stearns went for \$30
20 billion to J.P. Morgan, who knew them, knew their
21 collateral, and was unable in the crisis to have that loan
22 take place. And this is related to remarks made yesterday
23 by the officers of Bear Stearns, who said that, you know,
24 one of the things that went in the past is when things got
25 bad the investment banks could go to the commercial banks

1 who had a lender of last resort and that that mechanism was
2 available to ameliorate difficulties.

3 What went wrong in this crisis that that didn't
4 happen?

5 WITNESS PAULSON: Well, I think you need to
6 expect in any crisis if it's severe enough that an
7 institution is going to do what it takes to preserve itself
8 and not overexpose themselves to credit risk. And the--I
9 think that, you know, Tim Geithner, who you'll be talking
10 about later probably can tell you a lot more than I can
11 about the tri-party repo market. But remember how that
12 works:

13 You've got the custodian banks, and then
14 after--there's a big time during the day when they, for
15 almost for administrative convenience were the ones that had
16 the collateral. But during the crisis of course they were
17 the ones that had all of the--you know, they owned the risk.
18 And that was an uncomfortable spot for them to be in, and it
19 was an uncomfortable spot for any particular institution
20 that was on the other side to be in to be so dependent on
21 one or another institution.

22 But I don't--I can't comment beyond that, just
23 simply saying that it is very difficult at a time when
24 everyone is worried about markets and--to ask institutions
25 to extend a lot of credit when the confident goes and a run

1 has started.

2 COMMISSIONER HOLTZ-EAKIN: All right. Thank you.

3 CHAIRMAN ANGELIDES: Just one technical matter.

4 Early on I referenced when I began the
5 questioning some documents provided to us by Goldman with
6 respect to CDOs. I'd like to enter two pages from Goldman
7 Sachs, one from the Senate Permanent Subcommittee on
8 Investigations and a page compiled by our own staff from
9 other Goldman documents, just for clarity.

10 (INSERT.)

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1 Just as a closer at least for me very quickly,
2 Mr. Secretary, because it's been gnawing at me. So when
3 Paul Reverse saw the lantern, one if by land, two of by sea,
4 he jumped on his horse and said, 'The British are coming.'
5 And I referred earlier to this kind of dilemma you may have
6 faced.

7 Here's my question:

8 Why is it in 2007 that no one from the public and
9 financial industry leadership saddled up like Paul Reverse
10 and warned about the coming crisis?

11 WITNESS PAULSON: In 2007 why no one...

12 I think a lot of people saw excesses. But
13 remember, we'd had the nine markets for some time. And why
14 is it that, you know, almost any bubble becomes obvious
15 after the fact. And they all have certain things in common
16 when you look at them. They all have, you know, they're
17 usually benign markets. There is almost always excessive
18 risk-taking, too much debt, and not a lot of transparency.

19 But here I think that many people knew there were
20 excesses. And I think there were very few of us--I
21 certainly didn't--that saw something of the magnitude we
22 saw. It's pretty hard to predict a 100 year storm.

23 CHAIRMAN ANGELIDES: Even as late as late 2007?

24 WITNESS PAULSON: Well --

25 CHAIRMAN ANGELIDES: Because late 2007 you were

1 worried --

2 WITNESS PAULSON: No, no. In late 2007 --

3 CHAIRMAN ANGELIDES: Were you worried about
4 shaking the markets?

5 WITNESS PAULSON: Yeah. I would say in late 2007
6 I think we knew the markets were fragile. But in late 2007
7 I think that I--and I've said this a number of times
8 before--I think I was as concerned as anyone around me.

9 And I underestimated in late 2007 and in early
10 2008, I underestimated--I knew there was a problem. I
11 underestimated the magnitude and the scale of what we were
12 dealing with--It was just so big--really, almost every step
13 of the way.

14 Now I look back and say if I'd been omniscient
15 I'm not sure what I would have done differently with the
16 powers. But this was--as I think back on it today it's even
17 hard to imagine what we were going through. It keeps me--I
18 don't like to think about it.

19 CHAIRMAN ANGELIDES: All right.

20 I know the Vice Chair would like to make a
21 comment. But I'm going to let him close this.

22 I just want to thank you for coming today. We
23 probably could ask you many more hours of questions. But
24 we're going to take 15 minutes for lunch after the Vice
25 Chair makes his closing remark.

1 Thank you, Mr. Secretary.

2 VICE CHAIRMAN THOMAS: Mr. Secretary, I think
3 some of the problem might have been that you were flying at
4 100,000 feet.

5 Edwards Air Force Base was in my district for the
6 entire time I was in Congress. And when pilots got into the
7 X15 and flew above 60,000 feet they got astronaut wings. So
8 I'd suggest if you were at about 50,000 then you could have
9 had a little better picture of what was going on.

10 WITNESS PAULSON: Good point.

11 VICE CHAIRMAN THOMAS: Thank you very much for
12 coming. We really, really appreciate the ability to cross
13 sections with one person in trying to get a better
14 understanding of what happened, in both government and the
15 private sector.

16 WITNESS PAULSON: Thank you.

17 CHAIRMAN ANGELIDES: Thank you.

18 We will take a 15-minute recess, Commission
19 Members. So we've got to move fast.

20 (Whereupon, a brief recess was taken.)

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1 CHAIRMAN ANGELIDES: The meeting of the Financial
2 Crisis Inquiry Commission will come back into order.

3 Welcome, Mr. Secretary. Thank you for joining us
4 today, and we appreciate you joining us midway in two days
5 of hearings about the shadow banking system.

6 Let us start, as we do with all witnesses, and
7 I'm going to ask if you would stand to be sworn for the
8 oath. If you would please stand and raise your right hand.

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

13 SECRETARY GEITHNER: I do.

14 (Witness sworn.)

15 CHAIRMAN ANGELIDES: Good. I know you've been to
16 the Hill a few times, and you know what those microphones
17 and lights mean, but in this instance we appreciate having
18 received your written testimony and we would like to afford
19 you the opportunity, and we would like the benefit of an
20 oral presentation by you this morning. At one minute the
21 yellow light will go on, and when time is up the red light.
22 We would like to ask you to give us a presentation of up to
23 ten minutes, and then we will move to Commissioner
24 questions.

25 Thank you, so much.

1 WITNESS GEITHNER: Thank you, Mr. Chairman. Mr.
2 Vice Chairman, and Members of the Commission:

3 Thanks for the chance to have me up here today.
4 You are engaged in a very important job of sifting through
5 the wreckage of this crisis so that we can better understand
6 what caused it and how to prevent a recurrence, and I
7 welcome a chance to be a part of that effort.

8 The Senate took a very important step yesterday
9 in passing, with overwhelming bipartisan support, reforms to
10 prevent future financial bailouts. This is a necessary but
11 not sufficient step to make our financial system more
12 stable.

13 As the debate now shifts to the design of
14 consumer protection, oversight of derivatives markets, and
15 other issues, the votes ahead are very important.

16 And within the context of this hearing, I want to
17 emphasize a central tragic lesson of this crisis. We cannot
18 create a more stable financial system by carving out certain
19 types of financial institutions or activities from these
20 reforms.

21 If we do, we will only make the system less
22 stable. If we do, we will only allow once again firms in
23 the business of providing credit to escape the necessary
24 protections we need for consumers and businesses against
25 predation, abuse, and excessive risk. We have to create a

1 strong set of rules that no institution can escape.

2 In the aftermath of the Great Depression, the
3 United States put in place broad protections over the
4 financial system that laid the foundation for a more stable
5 banking industry for several decades.

6 But over time, this financial system outgrew
7 those protections. Over time, the constraints imposed by
8 banking regulation encouraged activity to move away from the
9 banking sector in search of weaker regulation and the
10 promise of higher returns.

11 And over time, a large parallel banking system
12 took root outside of the regulatory framework established
13 for banks. In this parallel system, a diverse group of
14 financial institutions were allowed to engage in the
15 business of banking, providing financial services to
16 individuals and companies without being regulated as banks.

17 At its peak, this financial system financed about
18 \$8 trillion in assets, becoming almost as large as the
19 traditional banking system. And much of that system used
20 substantial leverage with relatively thin cushions against
21 the possibility of loss.

22 This parallel financial system, operating with
23 much weaker protections, proved exceptionally vulnerable to
24 a loss of confidence. As the crisis intensified, investors
25 began to pull back and demand more collateral, forcing

1 institutions in this parallel system to sell assets to meet
2 those demands for cash, pushing the price of financial
3 assets down, leading to a vicious cycle of panic.

4 That run--it was a classic run--on our financial
5 system brought us to the brink of collapse and our economy
6 faced the risk, a credible risk, of entering a second Great
7 Depression.

8 Now many people called this parallel system a
9 shadow banking system, but it was not hidden away. It
10 operated in broad daylight, financed by institutional
11 investors with no history--a system with no history, or
12 reasonable expectation of government support in a crisis.
13 Instead, in many ways this parallel system was a pure
14 failure of market discipline.

15 So why did the protections put in place following
16 the Great Depression not protect us against the growth of
17 risk in this parallel system?

18 First, what helped make the growth in this system
19 possible was we entered a long period of relative economic
20 and financial stability during which borrowers and investors
21 took on more and more risk.

22 Trillions of dollars of financial decisions were
23 made in the U.S. and around the world on the expectation
24 that house prices would never fall; that future recessions
25 would be short and shallow; that systemic financial crises

1 in developed markets were a thing of the past; and that the
2 world economy would continue to grow unabated.

3 Those judgments proved tragically optimistic, and
4 ultimately the protections put in place around the
5 traditional banking system did not provide sufficient shock
6 absorbers to withstand a deep recession and a substantial
7 fall in real estate values.

8 But part of the cause lies in our balkanized,
9 fragmented regulatory system designed in a different era
10 that lagged far behind changes in the financial markets.

11 The government system of financial oversight was
12 simply not designed to constrain risk taking in this
13 parallel financial system. Prudential regulations were
14 limited to banks. The Federal Reserve had no legal
15 authority to set and enforce capital requirements on major
16 institutions that operated essentially banking businesses
17 outside of bank holding companies.

18 The Fed also had no legal authority over
19 investment banks, diversified institutions like AIG, or
20 hundreds of nonbank financial finance companies. The SEC as
21 you know had no legal authority to set and enforce capital
22 requirements on a consolidated basis across the full range
23 of activities of investment banks.

24 And more broadly, and this is critical, no
25 regulator or supervisor had the core mission of looking

1 across the financial system and taking action to prevent the
2 diversion of activity away from the protections regulations
3 were designed to provide.

4 The result was a system that applied safety and
5 soundness regulation only to banks was unable to protect the
6 safety and stability of the broader financial system.

7 Now addressing these failures is an essential
8 part of the comprehensive reforms now being considered by
9 Congress. These reforms would require the enforcement of
10 tough constraints on leverage and risk taking across the
11 major institutions that played a critical part in causing
12 this crisis.

13 Financial institutions will no longer be able to
14 escape these limits. Large and complex global financial
15 institutions will be forced to operate with higher capital
16 and more stable funding, reflecting the greater risk they
17 pose to the economy as a whole.

18 These reforms will bring derivatives markets out
19 of the dark. They will provide transparency and disclosure
20 and comprehensive oversight over all derivatives markets and
21 all participants in those markets.

22 And we will bring standardized derivatives into
23 central clearinghouses and trading facilities, reducing the
24 risk that the derivatives markets could again threaten the
25 system.

1 These reforms will provide more stability in
2 funding markets through reform of money market funds to make
3 them less vulnerable to runs, and to make repo markets more
4 resilient.

5 These reforms will help improve disclosure and
6 accounting requirements, reducing opportunities for evasion
7 and giving investors better tools for assessing risks.

8 They will address conflicts in rating agencies
9 and reduce the vulnerability of the system to future
10 mistakes in credit ratings.

11 And they will provide a carefully designed type
12 of bankruptcy process for large financial institutions so
13 that we can break them up with no risk of loss to the
14 taxpayer and less risk of damage to the economy as a whole.

15 Now I know when people look back at this crisis,
16 when they look at the excessive risks that were taken by
17 large institutions, there is a natural inclination to want
18 to move those risky activities elsewhere. To create
19 stability, some argue, we should simply separate banks from
20 risk.

21 But, in important ways, driving risk-taking into
22 areas with less regulation—that's exactly what caused this
23 crisis.

24 The fundamental lesson of the parallel financial
25 system is that we cannot make the economy safe by taking

1 functions that are central to the business of banking,
2 functions that are necessary to help raise capital for
3 businesses, help businesses hedge risks, and move them
4 outside of the banks, outside the reach of strong
5 regulation.

6 Mr. Chairman, let me just close by thanking the
7 Commission for your important work in drawing public
8 attention to what I think was one of the key factors in this
9 crisis, and one of the most important objectives of
10 financial reform.

11 Thank you, very much.

12 CHAIRMAN ANGELIDES: Thank you, Secretary
13 Geithner. We will now begin the questioning.

14 Let me start with just a few questions. And as I
15 said to Former Secretary Paulson today, at least in my
16 instance, while there's been a lot of fascination generally
17 with the bailout and how the financial system was
18 stabilized, I think the questions I want to focus on today
19 is how do we come to the point where it seemed like the only
20 two options were either to allow a collapse of the financial
21 system, or to commit very, very substantial, trillions of
22 dollars of taxpayer money, to save it.

23 And I do want to talk to you in your role as
24 President of the Federal Reserve Board of New York,
25 recognizing that you had direct supervisory

1 responsibilities over bank holding companies, but beyond
2 that in many respects you were the eyes and ears of the
3 Federal Reserve on Wall Street.

4 You were in constant contact with primary
5 dealers. You had a board that did have linkages to the
6 financial community. And that you had played a special role
7 in monitoring systemic risk, and in fact had undertaken some
8 efforts with respect to cleaning up the backlog in trade
9 confirmations in the OTC derivatives market.

10 So one of the things I noted in preparing over
11 the last month for our look at the shadow banking system is
12 that in the period of 2004, 2005, 2006 you actually made a
13 number of speeches about risks that were extant on
14 derivatives, and contagion, shadow banking--I will note you
15 made two different speeches on the same day, May 19th, it
16 must have been a busy day, talking about risk, about
17 concentration of risk posed by CDOs and credit derivatives;
18 and about leverage in the system.

19 And it seems to me you were in a place where you
20 had an extraordinary access to information, not just market
21 data, but what primary dealers were telling you, info on the
22 repo markets. So this is a pretty fundamental question that
23 I have, particularly as we look forward trying to assess the
24 impact.

25 What didn't you know? And this doesn't need to

1 be just ad hominem, but what did you and other key policy
2 makers not know and not have before you to understand the
3 magnitude of what might hit us?

4 WITNESS GEITHNER: Well, Mr. Chairman--

5 CHAIRMAN ANGELIDES: Microphone on.

6 WITNESS GEITHNER: Sure. Let me just start by
7 saying I had spent the previous 15 years in public service
8 dealing with a series of incredibly damaging emerging market
9 financial crises, and the financial crisis in Japan.

10 So when I went to the New York Fed, I had been
11 blessed or scarred by the experience of watching countries
12 manage and mismanage the development of risk in systems, and
13 how to clean up and contain the damage in the aftermath.
14 And when I went to the New York Fed, early in that process
15 beginning in 2004 we began a series of very important
16 initiatives to try to contain, dial back, reduce the growing
17 risk we saw in the system and improve the odds that if
18 conditions changed, if we faced a shock, a recession, that
19 the system was going to be stronger, in a stronger position
20 to withstand that shock.

21 Let me just briefly mention the three most
22 important things we did in that context.

23 The first was to bring a series of experts in
24 markets and risk management, led by Jerry Corrigan, together
25 to do a comprehensive examination of the state of risk

1 management practice in managing exactly the kind of things
2 that have been the subject of this crisis: risk in
3 derivatives, exposure to hedge funds, complex financial
4 products, how liquidity is managed, how stress testing is
5 conducted.

6 And using a model of a process very much like
7 what you are doing, which is a sort of a post-mortem process
8 after the failure of long-term capital management, we
9 brought that group together at my initiative and asked them
10 to do a comprehensive evaluation and to provide
11 recommendations.

12 Then we took those recommendations and we asked
13 the major firms in the world to undertake an assessment of
14 how they were doing against those recommendations.

15 Second, a very important thing we did is to bring
16 financial supervisors of all the major global firms--the
17 SEC, the British FSA, their counterparts in France and
18 Germany and Switzerland in particular, together to conduct a
19 series of what we called horizontal reviews to try to assess
20 limitations and risk management and try to encourage people
21 to fix those problems in risk management early.

22 And those were targeted on very much like the
23 thing I began with, risks in derivatives, in lending to
24 hedge funds, in management of liquidity, in conducting
25 stress testing. And those efforts were designed to assess

1 what was best practice, where there were gaps, and try to
2 bring all the supervisors together around the world to
3 encourage, beginning at that point in the period of '05-'06-
4 '07, to try to get firms to dial back the risks they were
5 taking.

6 And the, finally, just to mention the one thing
7 you mentioned, we began a similar effort to start to clean
8 up the derivatives markets for more standardization,
9 automation. Those were fundamental changes that have paved
10 the way now to what we hope to achieve in these reforms to
11 bring this stuff out of the dark onto clearing houses so we
12 can manage the risk better.

13 Now as you know, those efforts were, in the end,
14 fundamentally inadequate. They did not do enough soon
15 enough. They did not come with enough force and traction.
16 There are a lot of complicated reasons for that that I would
17 be happy to discuss, in part because we were operating
18 within a set of existing capital requirements that did not
19 adequately capture the risk that the system had to the
20 possibility of a deep recession.

21 So I think the simplest way to answer your
22 question about what did we not know, what we did not know
23 was the degree to which the system was reliant on ratings,
24 ratings that did not capture what falling house prices would
25 do to losses across the system.

1 We did not know the extent to which this parallel
2 financial system had built up leverage and exposure to
3 liquidity risk in a level that would, when it came crashing
4 down, would threaten the stability of the rest of the
5 system.

6 We did not know how vulnerable money markets were
7 to runs, how unstable that basic funding structure was. And
8 I could go on.

9 CHAIRMAN ANGELIDES: So overrun by events,
10 inadequate political infrastructure to make the changes
11 necessary, under calibrating the size of the wave?

12 WITNESS GEITHNER: Absolutely. I think that the-
13 -you know, since we were coming out of a period where, as I
14 said in my remarks, we had these two fundamental
15 characteristics of the system. One is, a long period that
16 seemed relatively calm. So even with all the financial
17 shocks from LTCM since, the system had got through them
18 without catastrophic damage.

19 That created a sense, a false sense of
20 complacency about how resilient the system was. And you had
21 this enormous growth in leverage and run risk, liquidity
22 risk, in a large parallel financial system. Those were
23 related. And it was--people could not assess, because they
24 had no experience, with what a shock this large would do,
25 what would happen when you had a run on that system.

1 Now, but you're exactly right, so the oversight
2 system, as I said in my remarks, did not give--did not
3 establish a set of classic constraints on leverage that all
4 financial systems require on what came to be a large part of
5 the American financial system.

6 And people tried, with duct tape and string, like
7 the SEC did in their CSE regime, to take the authority they
8 had and make the best of it, and try to get to a point where
9 they were trying to put in place better constraints, but
10 that effort came too late. It was too weak. It was not
11 grounded in law. And it was fundamentally inadequate.

12 CHAIRMAN ANGELIDES: So let me ask this. That
13 is, given you had spoken on this, and you had actually
14 identified what you saw were levels of risk, and some might
15 say levels of irresponsibility, so you saw those two trains
16 of risk and irresponsibility, you know, going towards each
17 other, towards collision. Do you believe that you or others
18 in leadership sounded the alarm early enough and loud
19 enough?

20 WITNESS GEITHNER: Oh, Mr. Chairman, I will say
21 this always, and I would say it again, absolutely we could
22 have done more.

23 CHAIRMAN ANGELIDES: Okay.

24 WITNESS GEITHNER: Absolutely. And, you know,
25 people ask is this inevitable? Were we really fundamentally

1 powerless as a country to prevent this from building up?

2 And I do not agree with that. I do not believe
3 we were powerless. I think that--it's unfair to say this
4 just from the benefit of hindsight--but I would say that if
5 the Government of the United States had moved more quickly
6 to put in place better design constraints on risk taking
7 that captured where there was risk in the system, then this
8 would have been less severe.

9 And if the Government had moved more quickly to
10 contain the damage, I think the crisis would have been less
11 severe, as well.

12 CHAIRMAN ANGELIDES: So let me talk about that.
13 In the last two days, I've cited a number of market warnings
14 that I won't repeat today from the dramatic expansion of
15 mortgage debt in this country, to the explosion of subprime
16 lending, the efforts of states that were preempted by the
17 OCC to fight unfair and deceptive lending. And, look, I was
18 a person in real estate investment, just on the ground
19 seeing 11, and 12, and 13, and 15 percent annual increases
20 in home prices. So a lot of warning signs out there.

21 So clearly one of the things you've identified is
22 the lack of the structural ability to move on these
23 problems, but do you also think--I want to ask this, and
24 I've really thought about it as we've gone through a set of
25 hearings--do you also think that the system doesn't have

1 enough iconoclasts in it? That the decision making process
2 is unduly controlled, essentially, by people who are of the
3 financial system and close to it and unable to step away
4 from it in a way you need for true risk assessment?

5 WITNESS GEITHNER: I think--

6 CHAIRMAN ANGELIDES: And of course I think there
7 are variations of this, all the way from people maybe on
8 Wall Street who can't see what's happening in Bakersfield,
9 and Sacramento, on the ground to families, to people who
10 just don't have enough distance to make a critical analysis
11 that you would want and expect?

12 WITNESS GEITHNER: I think that is a very good
13 question. And I try always--I've always done this in my
14 jobs, and I definitely tried in the New York Fed to make
15 sure that we brought together people in advisory committees
16 we established that represented a great diversity of views
17 in these things, from the academic community, from the
18 broader business community.

19 And we put in place a series of advisory
20 committees that tried to capture that diversity of interests
21 and perspectives. Because I think what you said is so
22 important. And I think that it's very important for policy
23 makers to make sure that they force themselves to be exposed
24 to a wide diversity of views.

25 Fundamentally I don't think that was the problem.

1 I think the problem was that you did not have a centralized
2 accountability matched with authority anywhere in the
3 government to look across the system, try to identify where
4 we had a problem, and have the capacity to go in and act
5 preemptively to try to put in place measures that might
6 mitigate those risks.

7 Our system was fundamentally solid and
8 balkanized. You had people trawling over parts of the
9 system, and parts of the system that are very risky with
10 nobody looking at it, and nobody responsible, nobody in
11 charge, and that was a tragic failure for the country as a
12 whole.

13 It was an avoidable failure, I believe. It's
14 easy to say that in hindsight, but it was true, as you said,
15 at the time that anybody who was operating in that world
16 could see that you were seeing classic signs of a asset
17 price credit bubble that could prove very catastrophic.

18 And the way I used to say it, Mr. Chairman, was
19 that we had this huge wave of changes in finance, capacity
20 to hedge, other things that helped disperse risk, that
21 looked like that produced a more stable system. They looked
22 like they would reduce the probability of a major financial
23 crisis. But they also--and this was essential to what
24 happened--they also meant that if we were to face a major
25 financial crisis, it could be much more damaging and much

1 harder to manage. Because it was likely to take place and
2 start, as it did, in this parallel system where there was
3 much more leverage and liquidity risk. Derivatives markets
4 complicated it dramatically. And you did not have in place
5 tools there to try to contain the damage earlier. And that
6 is really the story of the crisis.

7 CHAIRMAN ANGELIDES: And many of those,
8 quote/unquote, "signals" I was talking about were not just
9 market data, but looking at leverage ratios, liquidity risk
10 in those firms that were evident.

11 Now two very quick, specific questions, because I
12 want to move on to other Commissioners, about points in
13 time. Because one of the things I think we are trying to do
14 is also try to measure what people saw at different points.

15 So very quickly--and I raised this with Secretary
16 Paulson today--on March 16th there was some engagement, as
17 you know, between the Secretary and Fannie, Freddie, OFAO, I
18 think fairly stated, to life the portfolio caps, keep them
19 in the marketplace as the private market has totally
20 withdrawn.

21 The only reason I mention it is there's a
22 reference--and I don't expect you to know this email, but
23 I'm looking for the bigger picture here--Bob Steele, who's
24 involved in these negotiations essentially to keep Freddie
25 in the game. I think that's how Secretary Paulson would

1 phrase it.

2 It says: I was leaned on very hard by Bill
3 Dudley to harden substantially the guarantee. I do not like
4 that. It's not been part of my conversation with anyone
5 else. I view that as a very significant move, way above my
6 pay grade, to double the size of the U.S. debt in one fell
7 swoop.

8 I think what I'm really driving to is, in March,
9 that Bear weekend, were you worried about what something of
10 the magnitude that ultimately happened in September
11 happening in March?

12 WITNESS GEITHNER: Absolutely. I think we all
13 were. I'm sure Secretary Paulson was. At that time, as
14 Bear Stearns fell off the cliff, we were deeply worried
15 about what that would do to the broader stability of the
16 financial system. And we knew at that point that Fannie and
17 Freddie, like many other parts of the financial system,
18 faced very substantial losses on their, particularly their
19 retained mortgage portfolio. And we worked very hard to
20 encourage the relevant authorities to encourage those firms
21 to go out and raise a lot of capital.

22 As we were doing in other parts of the system, it
23 seemed the straightforward, sensible thing. And that was
24 important because, as we saw, fundamentally, short capital
25 going into a storm like this is catastrophic, and they were

1 short capital.

2 And the problem with these crises is, people tend
3 to wait. If they wait too long, it looks weak, the pricing
4 is expensive, they don't want--their shareholders. So it's
5 the basic classic pattern that was magnified dramatically in
6 the untenable corporate structure Fannie and Freddie had,
7 and we worked, as many people did, very hard to try to
8 encourage people, to encourage them to raise capital early
9 for exactly the reasons that the email reported.

10 CHAIRMAN ANGELIDES: Just kind of yes or no, were
11 you for hardening the guarantee at that point? Did you
12 share Mr. Dudley's view?

13 WITNESS GEITHNER: I often used the argument that
14 you need to make it more credible to the world. They're
15 going to have the financial resources to meet their
16 commitments. You can do that lots of different ways. One
17 is by making sure they raise more capital. The other is to
18 strengthen what was an implicit commitment at that point for
19 the government to stand behind them.

20 And ultimately of course that was--both were
21 necessary, and I was fully supportive of the judgment, of
22 the need to take that step.

23 CHAIRMAN ANGELIDES: All right. Final question
24 for you. And this again goes to depth. Later today we will
25 have a panel of GE Capital, Pimco, State Street,

1 participants in the, quote/unquote "shadow banking system,"
2 but also the repo market.

3 Now it appears from documents that we have that
4 GE was able to keep going with its issuance of commercial
5 paper throughout this crisis, even though of course the
6 general spread over LIBOR increased for all participants.
7 But, you know, at some level the disruption of the credit
8 capacity of GE speaks volumes about the depth of what we
9 were seeing.

10 So on September 29th and 30th, you had six
11 telephone conversations with Mr. Immelt. And just to put
12 that in context, you probably lived--you know, you probably
13 didn't get any sleep these days, but the 27th and 28th was
14 the day that Goldman and Morgan Stanley became bank holding
15 companies, that weekend.

16 On Monday, the 29th, that's the day the Dow
17 dropped 777 points after the House voted down the financial
18 bailout bill.

19 Was Mr. Immelt speaking to you about concerns
20 about disruption and their ability to issue commercial
21 paper?

22 WITNESS GEITHNER: What you've seen, you've
23 described exactly well. At that point, after that famous
24 mutual fund, money market fund broke the buck in the wake of
25 Lehman's failure, you had a broad-based run on money market

1 funds, or the risk of that. And you had a broad-based run
2 on commercial paper markets.

3 And so you faced the prospect of some of the
4 largest companies in the world and the United States, losing
5 the capacity to fund and access those commercial paper
6 markets.

7 So we were involved at that time in designing
8 what ultimately became the Commercial Paper--

9 CHAIRMAN ANGELIDES: CPF.

10 WITNESS GEITHNER: --Financing Facility, which is
11 a backstop for the commercial paper markets, to complement
12 the temporary guarantee for money market funds.

13 So I was involved in a whole range of efforts to
14 help design that facility. And I was exposed to and had
15 conversations with people across the financial markets who
16 depended on commercial paper markets, who were trying to
17 make sure we were aware of what was happening and how
18 perilous it was.

19 You didn't need a phone call to tell you that.
20 All you needed to do was look at what was happening in the
21 price of that stuff and how hard it was. And it was a
22 development that was self-evident and obvious to all of us
23 at the time.

24 CHAIRMAN ANGELIDES: But was Mr. Immelt concerned
25 specifically about that and talk to you about that?

1 WITNESS GEITHNER: I could go back and try to
2 refresh my memory on those specific conversations, but what
3 I'm sure they were about is trying to make sure we were
4 aware of how perilous they thought even a company that
5 strong, how perilous those markets were at that time.

6 But as I said, that was self-evident. It was
7 obvious, conspicuous, and you could see it just looking at
8 your screen.

9 CHAIRMAN ANGELIDES: Right. And I don't expect
10 you to carry our daily planner with you, but if you would
11 check on that, because I think we're trying to get a measure
12 of the intensity and direct concerns by different market
13 participants. If you would check, it's September 29th and
14 30th, and there are six conversations.

15 Thank you. That's all my questions at this
16 point. Mr. Vice Chairman?

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

18 Mr. Secretary, I do really appreciate, one, your
19 willingness to come before us, but, two, the manner in which
20 you have done so. I am very sensitive to structure and
21 protocol, having been around a long time, but our ability to
22 talk to Secretary Paulson, and the value of his having been
23 on Wall Street in the private sector, and then becoming
24 Secretary of the Treasury, followed by your presence which
25 had you at the Federal Reserve just prior to coming to the

1 Secretary of the Treasury--I noted both of you also went to
2 Dartmouth; I don't know what that means to all these Harvard
3 guys around, but I appreciate that.

4 (Laughter.)

5 VICE CHAIRMAN THOMAS: It gives us an opportunity
6 to ask questions which bridge that 2002-2003 to 2009 window
7 in a way I don't think we've ever been able to do that.

8 So when I ask you this question, especially based
9 upon your comments about what you did at the New York Fed in
10 bringing together experts for the state of risk management,
11 then running a global confab with those same subject matter,
12 and most people can't see this, and this is the only thing I
13 have available right now, but basically it's the assets of
14 selected financial sectors.

15 And it shows, the blue, obviously are the
16 deposits of the old-fashioned banks, and then this is the
17 shadow banking above it (indicating). And it is a Federal
18 Reserve Board of Funds Flow Release.

19 So it was around, and people were aware of that.
20 And when you run the numbers, and this is all 2008, you have
21 this commercial banks at about \$7.3 trillion, the so-called
22 shadow banks somewhere between \$7.1, \$7.3, so I mean a 50-50
23 split right there. When you look at the residential
24 mortgage-backed securities, 2008, about \$6.7 trillion. And
25 then you've got over-the-counter derivatives, same time

1 frame, about 2008, gross market value of \$20 trillion,
2 nominally \$684 trillion.

3 And we all knew about the runs on the bank in the
4 '30s and the liquidity problem. Didn't anybody talk about
5 the top-heavy aspect, that somehow what worked to keep
6 conventional banks--and because of those restraints then
7 they developed other approaches, but clearly it was the same
8 thing almost all over again, except much more difficult to
9 perceive because of the muddiness, the ratings, and the
10 rest. That never came up as a subject matter, either when
11 the experts sat around and talked about we're kind of
12 concerned about the weight shift into an area that could
13 have liquidity problems and could be subjected to a run like
14 we had in the '30s?

15 And the global folk didn't talk about it, either?

16 I just don't get it. And I need to understand.
17 Now what we've heard from a lot of other people, players in
18 the market, was that nobody had a model that in the
19 pejorative sense people have said that never thought housing
20 prices were going go down--I think the corrector answer is,
21 no one thought they were going to go down that far.

22 And even given that, you have areas in the
23 government that talk about disasters that no one likes to
24 think about because somebody's got to think about disasters
25 that no one thinks about.

1 I would think that the New York Fed might be
2 involved in that. Looking at those markets, the monitoring
3 job may not have a direct power position, but you're the
4 best person in my opinion to ask in that '03 to '08 period.

5 What happened?

6 WITNESS GEITHNER: Absolutely. Let me just begin
7 by saying financial crises are caused by unwillingness of
8 people to think the unthinkable, and say, well, that seems
9 kind of unlikely so we're not going to worry about that.

10 That is the fundamental mistake that underpins
11 most financial crises. And our system was--that mistake was
12 pervasive across the system.

13 VICE CHAIRMAN THOMAS: Basic, or total?

14 WITNESS GEITHNER: Well, complete, whichever
15 phrase you want to use.

16 VICE CHAIRMAN THOMAS: Yeah, because even the
17 people, the watchers watching the action apparently thought
18 the same thing.

19 WITNESS GEITHNER: No, I wouldn't say that.

20 VICE CHAIRMAN THOMAS: Okay.

21 WITNESS GEITHNER: The initiatives that I
22 described that the Chairman began with, that we at the New
23 York Fed were engaged in, we didn't call it, we didn't
24 really talk it back in '04-'05 about the shadow banking
25 system, but we were deeply focused on exactly this risk.

1 You know, when I explained to people when I first
2 came into that job, I said, well, let's just look at the
3 system today. It's true we have these major banks, but what
4 about the investment banks? Who is watching them?

5 What about AIG? What about the GSEs? What about
6 the hundreds of finance companies that built up, not as
7 banks but doing basic banking?

8 So that basic concern about the vulnerability of
9 the financial system to systemic risk in those institutions
10 was central to the efforts that I described that we
11 initiated.

12 Now you are right to say that those were outside
13 of our--in many ways outside of our formal legal authority,
14 and outside of our mandate in some sense, but we knew they
15 made the core of the system we were responsible for more
16 risky. And we knew we were in the classic position where in
17 effect we were the only fire station in town you could turn
18 to when things fell apart for liquidity.

19 But we had no capacity to constrain risks outside
20 that regulated core. But what none of us anticipated I
21 think was--and I certainly did not understand fully--was
22 what produced that parallel finance system, how vulnerable it was to
23 runs. How you could have had a system where these people
24 were--again, they were operating in public markets, issuing
25 publicly rated debt under the disclosure laws of the United

1 States, funded by institutional investors, that market
2 discipline and all the checks and balances we rely on in
3 that area would have proved so inadequate to contain
4 leverage earlier.

5 Fannie and Freddie you could understand because
6 it was centrally moral hazard, but in the other part it's
7 hard to make that argument in that case.

8 So I guess I would say that set of concerns was
9 central to the efforts we began, but fundamentally what we
10 learned, what we discovered is, and this is an important
11 lesson for us that underpins our reform efforts, is that you
12 can't run a stable system with one part under constraints
13 and leverage and one part without.

14 And these constraints on leverage, capital
15 requirements, were not conservative enough, where they
16 existed, and they were not designed in a way, given the
17 accounting disclosure regime, that allowed us to fully
18 capture the risk in the extreme event.

19 And partly because of the reliance on ratings,
20 partly because we have this long history before relative
21 stability, so it wasn't in the memory, and that left the
22 whole system more vulnerable to the collapse when it came.

23 VICE CHAIRMAN THOMAS: So given those areas that
24 you did have responsibility over, the old-fashioned
25 commercial banks, Bank of America, Morgan Chase, Citibank,

1 the one thing that strikes most people when they talk about
2 it, they're really, really upset about what happened in the
3 residential mortgage area because it affects them directly.

4 What scares them more was the fact that there
5 were no firewalls anywhere. And that what started in an
6 area that you could say wasn't regulated, by definition
7 shadow banking and the rest of it, but it also affected the
8 structure that was designed after the initial failure not to
9 fail again.

10 WITNESS GEITHNER: Exactly.

11 VICE CHAIRMAN THOMAS: Okay, so I got it right,
12 but how come we didn't get it right?

13 WITNESS GEITHNER: Well, again, we came in--
14 another tragic failure of the crisis was that we designed a
15 system with deposit insurance around banks, access to a
16 lender of last resort, basic protections designed to prevent
17 a fire caused by the failure of a single bank to infect and
18 jeopardize the stability of banks.

19 That system, long tested over time, comes with
20 moral hazard risk. Not perfect. Lots of failures, the S&L
21 crisis being a good example. But this other system had none
22 of those protections. No fire breaks. No firewalls.

23 And the Executive Branch of the United States,
24 the largest financial system in the planet, came into the
25 crisis with the President having only emergency authority

1 limited to the act of closing financial markets, or
2 declaring a bank holiday. Actions in a crisis which are
3 largely panic-increasing, not panic-containing.

4 So you're exactly right. We didn't have the
5 tools to prevent the fire from jumping the firebreak and
6 infecting the system, and these reform proposals Congress is
7 debating--I know that's not the subject of your hearing--are
8 designed to provide exactly those tools, to make sure that
9 large, complex institutions like AIG manages itself to the
10 edge of failure, you can put them out of their misery safely
11 and prevent the fire from breaking--from jumping the fire
12 break.

13 VICE CHAIRMAN THOMAS: One last question, which
14 again amazes me in terms of how many people have used it as
15 an answer, in terms of the assets that they held and the
16 potential liquidity, especially in the shadow banking area,
17 they were AAA rated.

18 I mean, at what point, when you look at the kind
19 of residential mortgage product that was bundled, everybody
20 knew, people that you never thought could get in a house,
21 had gotten in a house. So something had happened to the old
22 20-percent-down and all the other arguments that gave you
23 some comfort.

24 Why would anyone think a package of the '08 stuff
25 would have the same AAA rating as the package of the 2000 or

1 1990 rating? Was it because they wanted to believe it did?

2 I mean, how could anybody think that? And
3 especially this group of experts and others?

4 WITNESS GEITHNER: Well when things are going
5 well, people are making money and they tend to think they're
6 smart, not lucky, and they think that it just validates
7 wisdom.

8 VICE CHAIRMAN THOMAS: Mr. Secretary, I just have
9 to tell you that when things are going well and people are
10 making money, no one thinks about making the amount of money
11 that was being made--

12 WITNESS GEITHNER: I agree. I completely agree.

13 VICE CHAIRMAN THOMAS: --on Wall Street. That's
14 not money.

15 WITNESS GEITHNER: I completely agree. And it
16 reinforced again this basic collective sentiment that we had
17 somehow produced a perfectly stable system immune to shocks,
18 things couldn't go bad. And you're right in many ways, what
19 happened to compensation, a whole range of other incentive
20 structures, fed that illusion.

21 VICE CHAIRMAN THOMAS: Thank you.

22 Somewhere I remember reading something about
23 pride going before a fall. Thank you, very much, Mr.
24 Secretary.

25 CHAIRMAN ANGELIDES: Ms. Born.

1 COMMISSIONER BORN: Thank you very much, and
2 thank you, Mr. Secretary, for being willing to join us and
3 help us in our investigation.

4 Your testimony I think demonstrates how there
5 were regulatory weaknesses, regulatory gaps, that tied the
6 hands of the regulators and financial supervisors during the
7 crisis.

8 And I take it that you feel that lack of
9 regulatory powers in some areas was an important aspect of
10 the problem.

11 WITNESS GEITHNER: Oh, absolutely. As I said in
12 my written testimony, this crisis is littered with examples
13 of authority that was not used early enough and forcefully
14 enough.

15 But in the subject of your hearing, and this is
16 true for shadow banking, parallel banking, derivatives
17 markets generally, I would say the oversight failure was a
18 gap, a vast gulf in accountability and legal authority that
19 prevented people, even people who had perfect foresight,
20 from acting preemptively to contain those risks.

21 COMMISSIONER BORN: Let me just ask you briefly
22 first about the over-the-counter derivatives market, an
23 enormous and unregulated market, as of the time of the
24 crisis, where there were tens of thousands of contracts out
25 there creating counterparty credit risk, and virtually no

1 transparency.

2 You said in your testimony: These markets have
3 proved to be a major force of uncertainty and risk during
4 periods of financial disruption.

5 Do you feel that the lack of regulation, the lack
6 of transparency, the enormous size of the market, played a
7 role in exacerbating the financial crisis?

8 WITNESS GEITHNER: I do. I would emphasize two
9 things, though.

10 The first is that--and this is I think
11 fundamental. You had very large institutions writing
12 hundreds and hundreds of billions of dollars of commitments
13 in derivatives without capital to back them up. This was
14 obviously true for AIG, but it was true for a whole industry
15 of monoline insurance companies, and of course it was true
16 for many other financial institutions.

17 So fundamentally what happened is, when they had
18 to meet those commitments they didn't have enough resources
19 to do it. And of course that brought them to the edge of
20 collapse.

21 But I think the other problem was that in this
22 world of millions of bilateral contracts it was like
23 spaghetti, cooked spaghetti together. And when the crisis
24 hit and you had to untangle those and try to figure out what
25 was my exposure to default risk across the system, it was

1 very hard for people to know.

2 And, they reacted as people do in facing fear.
3 They decided, I am going to withdraw and pull back from risk
4 wherever I can. And that in a crisis tends to feed a panic
5 like margin spirals do, and that tends to amplify the
6 crisis.

7 So the inability that those tens of thousands or
8 millions of contracts provided for people to assess quickly
9 what my exposure was to a risk of default by a major
10 institution was a substantial factor exacerbating the panic
11 and made the crisis harder to manage.

12 And of course the paradox is that those were
13 markets designed to help people hedge risk. And that gave
14 people the capacity to hedge risks, but it also gave them
15 much more risk of exposure to panics when things fell apart.

16 COMMISSIONER BORN: So not only--I mean, I
17 believe they are very useful instruments and essential to
18 managing risk, but they also magnified risk greatly in this
19 disruption.

20 WITNESS GEITHNER: I agree with that.

21 COMMISSIONER BORN: Is this why the
22 Administration is proposing regulatory oversight over the
23 market?

24 WITNESS GEITHNER: Yes, absolutely. Again, these
25 markets grew up--grew dramatically in the decade that

1 preceded this crisis. You know this of course very well.

2 The risks were apparent to many earlier, but they
3 grew dramatically over that period of time. And it was a
4 fundamentally--I mean, people were doing this thing by
5 spreadsheet and fax. People did not have electronically
6 accessible records of what their exposure was.

7 There were huge backlogs of transactions not
8 captured by risk management systems. So when we came--when
9 I came to the New York Fed and we started an effort to clean
10 that up and produce it, it put us in the position where we
11 could finally propose reforms that would bring the
12 standardized part of the market onto clearinghouses and make
13 sure that centrally cleared stuff would be traded on
14 exchanges, or on electronic trading platforms, and the reforms
15 also of course as I said give people the authority to make
16 sure that major institutions writing these commitments are
17 forced to hold capital against it; that margins are
18 conservative enough; and that the SEC and the CFTC have the
19 tools they need to better police fraud and manipulation to
20 deter fraud and manipulation earlier.

21 Those are the reforms now working their way
22 through the Congress, and they are a very strong package of
23 reforms.

24 COMMISSIONER BORN: You have essentially
25 indicated that the lack of regulation, or the lower level of

1 regulation in shadow banking made the shadow banking sector
2 more vulnerable to the financial problems that we
3 experienced in 2007 and 2008.

4 And I wanted to ask about kind of the flip side
5 of the coin, which is: Whether the growth and competition
6 of the shadow banking system impacted subtlety or at all on
7 banking regulation?

8 Because this was a less-regulated system. I
9 think the banks did suffer competitively with various
10 aspects of the shadow banking system. You know, they lost
11 deposits to the money market funds. They lost potential
12 commercial loans to commercial paper, and repo. And I can
13 imagine that commercial banks, having felt this competitive
14 pressure, would have wanted to be able to engage in broader
15 activities and with less constraints from banking
16 regulators.

17 We have been told during our investigations that
18 by the time Glass-Steagall was altered by Gramm-Leach-
19 Bliley, there was not a great deal of separation in fact
20 between the activities commercial banks could engage in and
21 investment banks.

22 So I wanted to ask you whether, as a banking
23 regulator, you saw pressures to soften constraints on the
24 commercial banking sector because of the growth of shadow
25 banking?

1 WITNESS GEITHNER: I did not feel those
2 constraints. But what you described was central to
3 everything that was happening. And you gave all the right
4 examples. But let me provide a couple, a few more.

5 We created a system that allowed institutions to
6 in effect choose the regulator. The best examples of that
7 were banks that chose to become thrifts, Countrywide being
8 the best example.

9 A lot of people thought regulatory competition
10 was a virtue. It would produce better regulation. But if
11 you allow people to move risk to where the regulations are
12 weakest and they operate with leverage and risk to the
13 system, that's just a catastrophic choice.

14 So you saw it definitely across banking
15 regulators. And in fact, you know, Countrywide is an
16 example where Countrywide was able to evade the tougher
17 restrictions of a Fed regime and choose the softer regime,
18 restrictions of an OTS regime. That's a good example.

19 And overwhelmingly you saw people pressured,
20 banks and--pressure to follow the market down. What
21 happened in mortgage underwriting is another great example.

22 I think it's true in the early part of that
23 decade, really probably up to 2004, most mortgages were
24 still underwritten by banks and by thrifts.

25 But over time of course most of the mortgages

1 migrated to other parts of the system outside the banking--
2 remote to the banking system for the same basic reason.

3 So again, the mistake is to permit that on a
4 scale that can threaten the system. And again what these
5 reforms do, which is very important, is recognize the basic
6 principle that if you're doing banking we regulate you as
7 banks so we can better protect the system.

8 It doesn't mean everybody has to be exactly the
9 same in their financial structure, but the leverage
10 requirements they operate with, the requirements on funding,
11 should be economically similar so we produce a level of
12 stability that's more tolerable for the country.

13 COMMISSIONER BORN: When you were at the Federal
14 Reserve Bank of New York, you and your staff had the role of
15 overseeing some of the biggest bank holding companies in the
16 world. And those were also institutions that suffered
17 adversely during the financial crisis that we've
18 experienced.

19 I wonder if you would comment on the ability of
20 supervisors to effectively oversee institutions that are
21 that large and that complex? And, whether you felt that you
22 and your staff really had the capabilities to do the kind of
23 job you would have wanted to do?

24 WITNESS GEITHNER: I believe we did. And I think
25 that we have examples where it worked quite well, and

1 examples where it was just fundamentally inadequate.

2 It was absolutely made more difficult by the fact
3 that we were operating in a system where the checks and
4 balances that we all rely on, which are internal controls,
5 good audit control regimes in these firms, risk management
6 systems that look across the entire entity and capture those
7 risks and bring them together so you can look at them, those
8 things were fundamentally weak and inadequate, and we were
9 very vulnerable to that.

10 We were somewhat vulnerable to the fact that
11 under Gramm-Leach-Bliley we rely on functional supervisors
12 to supervise for safety and soundness the underlying bank,
13 or in the case of the SEC in this case it was the broker-
14 dealer. And these firms operated across the world and were
15 able to push risk into other jurisdictions like in many
16 cases in the UK in ways that make it harder to capture it.
17 And we were vulnerable to those limitations of that system
18 as a whole.

19 And of course as we've learned, the capital
20 requirements, and the accounting requirements, and the
21 disclosure requirements did not do a good enough job of
22 giving us a good picture of what capital really was relative
23 to risk.

24 And that is why the big lesson I take from this,
25 among the many lessons, are to make sure that we force the

1 system to run with more conservative requirements on
2 leverage. Because I do not believe you can design a system
3 that depends on a community of regulators always being wise,
4 and tough, and smart, and have foresight, and perfect
5 foresight to come and preemptively and preempt pockets of
6 risk, and bubbles, and leverage. I think it's unlikely.

7 We will do our best. Our successors will do their
8 best. But they will be imperfect. And the best defense
9 against that potential problem is to force the system to run
10 with stronger shock absorbers: reserves, in terms of cash
11 available to absorb losses across the system; and again
12 that's the lesson we're trying to bring about with these
13 reforms, so that not just the institutions run with less
14 leverage, but that markets like repo, or secured funding
15 markets, securities lending markets, et cetera, derivatives
16 markets, where firms come together, also run with much more
17 conservative cushions against the unknowable, against the
18 uncertain, against the likelihood, the possibility that the
19 next shock could be beyond our imagination, beyond our
20 experience, and could be very damaging.

21 I think that's the central lesson we try to take-
22 -I try to take from the crisis.

23 COMMISSIONER BORN: What about the need for a
24 systemic view which is very hard for any of our existing
25 regulators to have because of their siloed jurisdiction?

1 WITNESS GEITHNER: I think that is very
2 important. There are two ways to do it, just conceptually.

3 One is to take all the regulatory
4 responsibilities that are relevant to systemic risk, put
5 them in one place, like maybe the British did in some ways,
6 and have a single point of accountability for measuring and
7 managing all those basic risks.

8 I don't think that system works. I don't think
9 it's feasible. We're proposing a different model, which is
10 to create a council, which brings those firms, those
11 entities together with their functional specialization for
12 market integrity, for resolution like the FDIC for safety
13 and soundness, for the payment system, et cetera, and put
14 them in a place where they have to sit around the table with
15 the Secretary of the Treasury, who because we're the
16 custodians of the taxpayers' money, and fundamentally
17 responsible for the financial security of the country, have
18 to be in a position to be accountable to the Congress for
19 making sure that complement of regulators is running the
20 system sufficiently conservatively, that there are not big
21 gaps, the system is not lagging way behind the growth in
22 these markets.

23 Now that is not going to force perfect foresight,
24 but I think it offers a better chance of at least forcing
25 somebody to be accountable for looking across the system to

1 make sure that we don't recreate again huge gaps,
2 opportunities for evasion, arbitrage, where the rules lag
3 way behind risk in the way they did in this case.

4 COMMISSIONER BORN: Could I have two minutes?

5 CHAIRMAN ANGELIDES: Two minutes.

6 COMMISSIONER BORN: Let me ask you one last
7 thing. There became prevalent a view among economists, a
8 view among some regulators during the last 10 or 20 years,
9 that financial markets were essentially self-regulatory, and
10 government supervision, government regulation of markets,
11 was either unnecessary or actually counterproductive.

12 Do you think that played a role in the regulatory
13 weaknesses and the regulatory gaps that you have described
14 in your testimony?

15 WITNESS GEITHNER: It's hard to know. I find it
16 hard to imagine that anybody who lives in financial systems
17 believes fundamentally they are self-regulating, just
18 because the history of financial systems is a history of
19 recurrent crises, some devastating like this one, and some
20 more mild, but always consequential.

21 And we learn those lessons painfully, of course,
22 but I think the lesson of behavior and experience in history
23 is that if you allow institutions to take deposits that can
24 be withdrawn on demand and make loans that can't be called
25 on demand, then you create a risk of runs. And if you allow

1 them to run with big leverage, that's consequential to the
2 economy as a whole.

3 And so we built up a set of protections, not just
4 to counteract the moral hazard caused by the perception that
5 these firms are important--failure would be consequential--
6 but to make sure that you protect the economy from things
7 getting out of whack.

8 Now our system, like any country, has among its
9 strength, it has a lot of people with diverse perspectives
10 making these decisions in the Congress and in the regulatory
11 community.

12 I think the real problem was that that long
13 period of stability allowed all views to prevail. Some
14 people could say that proves that all these innovations
15 reduce risk; that they prove that the market is working
16 well; that capital requirements are strong. And that long
17 period where risks seemed permanently reduced allowed people
18 to not confront I think what were fundamental
19 vulnerabilities.

20 So that is the way I would try to answer that
21 question.

22 COMMISSIONER BORN: Thank you.

23 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

24 COMMISSIONER HOLTZ-EAKIN: Thank you,
25 Mr. Chairman. Thank you, Mr. Secretary, for coming today.

1 One of the things that is delightful about your
2 testimony is you actually are clear about what you think and
3 don't think of what went on, and that is not in the typical
4 performance by someone at the table. So thank you.

5 Let me ask you a few questions about that. One
6 thing you said is that a root cause of the crisis is uneven
7 regulation, or absence of regulation.

8 Yesterday we learned that under the CSE Program
9 the SEC felt that all of the five major investment banks had
10 adequate capital. They met the Basel II Standards. They
11 had the 10 percent capital that the Fed would have required.
12 They had more than adequate liquidity because they had gone
13 above the Standards the Fed imposed on bank holding
14 companies.

15 What difference would having it be a legal
16 requirement make, given that they were in compliance with
17 the standards?

18 WITNESS GEITHNER: I want to answer that question
19 carefully because I was not--as you know, I was not their
20 supervisor--

21 COMMISSIONER HOLTZ-EAKIN: I know.

22 WITNESS GEITHNER: -- and I have no underlying
23 knowledge of their financial condition, but I think it is
24 very--

25 COMMISSIONER HOLTZ-EAKIN: But you're saying that

1 it's necessary to have legal regulatory authority, and since
2 they were in compliance with the regulations, what does
3 making it legal do?

4 WITNESS GEITHNER: I think it would be actually
5 very hard to justify a judgment that those firms were
6 operating with a level of leverage and a sufficiently
7 conservative funding structure that made them equivalent,
8 certainly three of them, equivalent in terms of stability to
9 those firms that were operating under the constraints of the
10 leverage ratio and the broader bank supervisory regime.

11 I don't think--I would not agree with that
12 judgment. And of course I'm limited by the fact that I
13 don't even know what happened after, after the storm
14 enveloped many of them and had no direct knowledge before
15 that. But I think it is fair to say, looked at in the
16 appropriate way, which is economically, they were allowed to
17 run with more leverage, much more exposure to run risk than
18 was true for a classic bank subject to a leverage ratio and
19 the other requirements that came.

20 COMMISSIONER HOLTZ-EAKIN: Well I guess that
21 leads to my second question, which is the assertion that
22 this was a fundamentally more fragile structure. In the
23 aftermath it appears that regulated banks, commercial banks,
24 and the shadow, whatever you want to call them, failed at
25 comparable rates.

1 WITNESS GEITHNER: I think--

2 COMMISSIONER HOLTZ-EAKIN: So where's the
3 fragility--

4 WITNESS GEITHNER: --I think you're right to
5 point out, we know the banking systems are fundamentally
6 fragile, and most financial crises are classic failures of
7 traditional banking. Banks lending too much for too long
8 without--too cheaply, without being compensated for risks,
9 et cetera--so you're exactly right, and this crisis shows
10 you both examples.

11 But it began and was much more severe, in my
12 view, in this parallel banking system. And I think the
13 crisis would have been much easier to manage if it was
14 simply a classic banking crisis, which are slower moving by
15 design because liquidity risk is more contained. But I
16 think you're right to say on both divides, traditional
17 banking and in parts of the shadow system, you saw people
18 taking too much risk against the possibility, the remote
19 possibility, they thought, of a deep recession, a deep fall
20 in real estate values.

21 I think you're right. And as I said in my
22 remarks, I absolutely believe that the leverage constraints,
23 the capital requirements that were put in place in the
24 traditional banking system were not conservative enough.
25 And I think they were not conservative enough in two

1 respects.

2 One is they didn't give enough weight to the
3 possibility you'd have a huge shock like this. And they
4 also didn't capture the exposures banks had to the pressures
5 that would come when that parallel banking system--didn't
6 collapse, but parts of it collapsed with enormous stress.

7 So I think those were a failure in design of
8 capital requirements around traditional banks as well.

9 COMMISSIONER HOLTZ-EAKIN: Just as a point of
10 clarification, would you agree that you don't really want to
11 call it "shadow" versus "traditional banking" in terms of
12 institutions? There's a set of activities that were located
13 in traditional banking and seen by the regulators that were
14 simply the activities that were the same as in the shadow
15 banking system, right?

16 WITNESS GEITHNER: There were, yes.

17 COMMISSIONER HOLTZ-EAKIN: The banks owned hedge
18 funds.

19 WITNESS GEITHNER: I think that's fair to say.
20 And if you want to try to say what's the one cause that was
21 common to everything--

22 COMMISSIONER HOLTZ-EAKIN: Well I would love to
23 hear that, because you haven't disagreed with any of the
24 causes that have been put up so far. So what don't you
25 believe started the crisis? And which causes are the most

1 important?

2 WITNESS GEITHNER: Well I was going to say I
3 think if you look at a single factor that underpinned the
4 risk management failures, the failures of the capital
5 regime, the ratings failures, et cetera, was the failure to
6 anticipate the possibility that houses prices would fall as
7 much as they did and what effects that would have on
8 stability as a whole.

9 And, you know, that failure is the same failure
10 that caused millions of families to borrow more than the
11 value of their home was likely to be worth, as well as
12 people lending more against the value of their home than was
13 probably prudent in general. I think that would be one.

14 What was not a cause of the crisis?

15 COMMISSIONER HOLTZ-EAKIN: Yes. Which things
16 that people have put forward do you think ought to be
17 crossed off our list? We don't have forever to write this
18 report, so--

19 WITNESS GEITHNER: Well why don't you give me
20 your candidates, and I'll respond.

21 (Laughter.)

22 WITNESS GEITHNER: I mean, I do think--

23 COMMISSIONER HOLTZ-EAKIN: Global capital flows.

24 WITNESS GEITHNER: I'll give--global capital
25 flows? I believe that a long period of very low real

1 interest rates around the world absolutely contributed to
2 the crisis. I think that created this enormous force of
3 money looking for a return. I would say it was a factor.

4 I mean, this is a deeper conversation of course
5 but there are people who believe that at the root of
6 everything was a unifying moral hazard risk, which as I said
7 I think is more complicated than that.

8 I don't believe that the existence of the fire
9 station causes financial crises. So I wouldn't put that
10 high on the list.

11 COMMISSIONER HOLTZ-EAKIN: Okay.

12 WITNESS GEITHNER: But you probably should test
13 me on the others.

14 COMMISSIONER HOLTZ-EAKIN: Let me go to--I'll
15 come back to this. I don't know what order to do this in,
16 but I don't want to lose all my time.

17 Another thing you said in your sort of diagnosis
18 of the problem was the absence of a systemic regulator, and
19 I was instantly going to point out the FSA and the fact that
20 England had a financial crisis, and you've already dismissed
21 them as not your preferred model.

22 But to what extent did we not already have a
23 President's Working Group on Financial Markets that had the
24 capacity to do exactly what you're suggesting: sit down,
25 look at risks, and we got a financial crisis anyway?

1 WITNESS GEITHNER: An excellent question, I
2 agree, and I think that that body did not provide this
3 important function. And you're also right to say that it's
4 just establishing in statute that it's now a Council with a
5 more formal mandate won't necessarily make sure that people
6 use that with that effect.

7 But I think it is an important difference in the
8 sense that the way the reforms are designed now, there
9 really is an explicit mandate with the ability to in effect
10 deter weakening of, let's say, prudential safety and
11 soundness requirements, and to recommend they be higher.

12 And the existing, much more informal structure
13 that is the President's Working Group doesn't come with that
14 mandate or that responsibility. So I think this would help.

15 But again, as you know, I think from what I said,
16 I don't think committees prevent financial crisis. I don't
17 committees solve financial crises. But on the other hand,
18 you do need to invest people with the direct responsibility.
19 You want people to wake up every day with a sense of
20 obligation, not just to look across the system where risks
21 are, but to give them some authority to act in that case.

22 And we did not establish in the Executive Branch
23 of the United States that set of, that obligation or quite
24 that capacity for leverage.

25 COMMISSIONER HOLTZ-EAKIN: I want to go back now

1 to your time as president of the New York Fed. During that
2 period, the Board of Governors came to the conclusion that
3 the risks in subprime housing could be contained, and indeed
4 made a statement to that effect.

5 Did you agree with that?

6 WITNESS GEITHNER: I never made that statement,
7 was not part of making it--

8 COMMISSIONER HOLTZ-EAKIN: Did you agree with it?

9 WITNESS GEITHNER: --and I would not have said it
10 that way. What I said, and I believe I tried to say this,
11 was that I think we faced growing risks across this
12 financial system of exposure to a very dramatic crisis.

13 And part of it of course was what was happening
14 in real estate markets. It was not principally because of
15 what was happening in subprime. It was a much broader
16 phenomenon that produced this mix of leverage across the
17 system. So I tried to cast it, when I talked about it, as
18 facing significant risk but risk from a much broader and I
19 think more dangerous constellation of forces than simply
20 what was happening in subprime.

21 COMMISSIONER HOLTZ-EAKIN: And what would be on
22 that list in that constellation?

23 WITNESS GEITHNER: Well again, to oversimplify,
24 you had people taking huge leverage bets on the possibility
25 on a world which did not envision house prices falling

1 sharply, or growth falling off the cliff.

2 That was the unifying mistake that so many people
3 in risk management, investors, borrowers, made.

4 COMMISSIONER HOLTZ-EAKIN: Were you surprised by
5 the concentration of mortgage exposures on the balance
6 sheets of, for example, the regulated banks? Citi--

7 WITNESS GEITHNER: No. I think that, you know,
8 banks lend money. Banks always hold exposure to real estate
9 risk, as you've seen across the country. You know, the
10 story of community bank failures across the country is deep,
11 concentrated exposure to commercial real estate relative to
12 capital. So no surprise in that.

13 What was surprising was that a huge part of that
14 risk was held in these financing vehicles that came with
15 very high ratings, in these structures that came with very
16 high ratings. And as I said, this is a fatal flaw in the
17 capital requirements, that they were not designed--they were
18 designed in a way that made the system much more vulnerable
19 to those failures and did not protect against those
20 failures.

21 So people everywhere took false comfort from the
22 fact that a huge amount of these exposures to real estate
23 risk were in securities that were rated AAA.

24 COMMISSIONER HOLTZ-EAKIN: Were you surprised by
25 the large amount of hedging that was done through AIG and

1 other monoline insurers through the CDs?

2 WITNESS GEITHNER: Of course I was like up to my
3 eyeballs in the growth in the CDS market and what that meant
4 for the system, but we had no window in, no capacity to
5 assess who had actually written huge commitments relative to
6 their capital.

7 Because, as you know, the things we could see
8 were only in those institutions we could regulate, and as I
9 said even those metrics we used were flawed. But we were
10 not able to see where you had those huge pockets of risk in
11 institutions outside the banking system that wrote those
12 huge commitments in derivatives.

13 COMMISSIONER HOLTZ-EAKIN: When you tasked Mr.
14 Corrigan to assess risk management practices and develop
15 best practice and sent them off to the financial community,
16 how did they do? You never said.

17 WITNESS GEITHNER: They did--well, the
18 institutions did not do well, but the recommendations I
19 think, even if you look back in retrospect at them, were
20 quite good. And what we did not--and as I said, I think the
21 lesson I take from this is that we did not have sufficient
22 traction to use those recommendations to induce enough
23 changes in behaviors earlier largely because we were still
24 operating within the existing capital requirements.

25 And I don't think--I think the only way I can

1 think of preventing that from happening in the future again
2 is to make the simple capital requirements and the leverage
3 ratio and the other ones conservative enough so you can rely
4 on them, not rely on all these other things we tried to do.

5 Remember, all these firms, when you looked at
6 their stated ratios. they gave you some comfort that they
7 held a fair amount of capital against their risks. That was
8 false comfort. The simple lesson I think is just to say
9 you've got to run the system with more conservative shock
10 absorbers.

11 COMMISSIONER HOLTZ-EAKIN: I am in complete
12 concurrence that in the end you need more capital. I don't
13 want it to look like I'm contesting that. I was just trying
14 to get a sense for, given what the perceived best practice
15 might be, what your assessment of their actual practice was,
16 and whether they improved it in response to this.

17 WITNESS GEITHNER: I think some did improve.
18 There's a nice way to do this comparison exactly the way
19 you're doing it. If you look at the Corrigan Report,
20 Counterparty Risk Management Policy Group II Report,
21 excellent title, and you compare it against this thing we
22 organized called the Senior Supervisors Group Report, which
23 is a report on actual practice across those firms that I
24 think was published in the Fall of '08? '07? I'm not sure.
25 And you can see in there a pretty stark comparison and

1 criticism of what was the state of actual practice.

2 And I think we had significant effect in changing
3 practice, but obviously not enough. Those efforts were
4 inadequate.

5 COMMISSIONER HOLTZ-EAKIN: So, before I run out
6 of time, two more questions.

7 Number one, you said in your opening statement
8 that among the things that caused the crisis was the
9 government not moving quickly enough to do things.

10 When should it have moved? And what should it
11 have done? And what did you mean by that?

12 WITNESS GEITHNER: Well again, I'm making things
13 more simple than they obviously could be. But to say that
14 historically, I would say that it did move early enough,
15 effectively enough, to contain the emerging risks across the
16 system.

17 COMMISSIONER HOLTZ-EAKIN: Preemptively.

18 WITNESS GEITHNER: Preemptively, and when things
19 started to fall apart--and I think this is true for
20 governments around the world--did not move quickly enough
21 and forcefully enough to try to contain the damage.

22 I think that the Federal Reserve was
23 exceptionally aggressive, took a huge amount of criticism,
24 did things we hadn't contemplated ever before with the
25 authority Congress gave us, but in the end you can't solve

1 these financial crises with tools that are about liquidity.

2 They require ultimately, as we saw, the full
3 financial force of the government in terms of fiscal policy
4 to support demand, and ultimately capital in the system and
5 broad-based guarantees to contain panics. And I believe
6 that if that had been deployed more quickly--and many of us
7 of course were strong advocates of early action--I think
8 this would have been a less damaging crisis.

9 VICE CHAIRMAN THOMAS: I yield the gentleman two
10 additional minutes.

11 COMMISSIONER HOLTZ-EAKIN: In particular, one of
12 the things that you pointed out is that investment banks
13 don't have access to a lender of last resort--indeed, many
14 of these nonbank.

15 A question that immediately comes up then is:
16 Should the Fed have moved more quickly to provide Discount
17 Window access to people outside bank holding companies? And
18 as you know, there's lots of interest in the decision making
19 that went into that, and I'd love to hear your views.

20 WITNESS GEITHNER: We were extraordinarily
21 reluctant, I think appropriately reluctant to take that
22 exceptional step. It had not been taken since the Great
23 Depression, again, to provide our traditional lending
24 facilities, against collateral, to institutions we were not
25 supervising and regulating--because we knew in doing that

1 you would be creating enormous moral hazard risk for the
2 future.

3 And I think we were appropriately reluctant to
4 take that step until we believed, and we came to believe of
5 course that fateful week in March, that the system was at
6 the edge of collapse.

7 Now those facilities of course are not designed
8 to protect individual firms from their failures. They are
9 designed to protect the system from broad-based runs to
10 prevent solvent institutions from becoming illiquid. And
11 they can only achieve so much, as you've seen.

12 But we were very reluctant until we were at the
13 point where we thought there was a substantial possibility
14 of systemic collapse. And at that point, it was absolutely
15 necessary, and in my judgment essential, that we do it. And
16 I fundamentally believe we did it at the right time.

17 COMMISSIONER HOLTZ-EAKIN: Thank you.

18 Thank you, Mr. Chairman.

19 VICE CHAIRMAN THOMAS: The former Chairman of
20 Bear Stearns yesterday said that you did it 45 minutes too
21 late. If you could do it an hour earlier, do you think the
22 end result would have been significantly different?
23 Different? Or ultimately no difference?

24 WITNESS GEITHNER: I don't. And I've had the
25 chance to testify on this before. Again, these--and I think

1 the history of what happened after this proves this basic
2 point.

3 Again, these facilities allow us to lend against
4 collateral to mitigate--not completely prevent--but to limit
5 the severity of the liquidity run crisis. But they cannot
6 prevent--they can't protect a firm that can't convince its
7 investors it has a franchise that can earn enough money to
8 cover their risk, has enough capital to cover their risks.

9 VICE CHAIRMAN THOMAS: Unless your pockets are
10 deep enough.

11 WITNESS GEITHNER: And we were not prepared--we
12 were not prepared to lend into a run on an institution that
13 had lost the capacity to convince people it was viable.
14 That would have been irresponsible as an act.

15 VICE CHAIRMAN THOMAS: Thank you.

16 CHAIRMAN ANGELIDES: Senator Graham.

17 COMMISSIONER GRAHAM: Thank you, Mr. Chairman.
18 Thank you, Mr. Secretary, for excellent testimony.

19 I would like to put our crisis into a broader
20 perspective. I have seen some foreign ministers of finance
21 and others who have been at least subtly critical that we
22 may be moving too rapidly and therefore not properly
23 integrating our reforms with what will happen on a broader
24 multinational basis.

25 Could you comment as to where do we--is this

1 crisis--if you do a diagnosis, would that result in a
2 sufficiently similar determination of causation to then lead
3 to essentially similar prescriptions being written for a
4 variety of countries?

5 WITNESS GEITHNER: Senator, let me just say two
6 things in response.

7 There are a lot of people--and we debated this--
8 who made the argument a year ago that we should wait until
9 this crisis was definitively passed. We should undertake a
10 much longer reflection of how best to fix it before we began
11 the process of broader reform.

12 And we made the different choice. We decided--
13 and we did this with countries around the world--that we
14 were better able to get consensus quickly on a stronger set
15 of reforms if we were acting when people were deeply aware
16 of the scars of the crisis and the damage; the memory hadn't
17 faded.

18 And, you know, I think we know what we need to
19 know about the core choices involved in reforming the
20 system. And we've done this in close cooperation and in
21 parallel with other major economies. So as early as April
22 of last year when we were laying out our initial set of
23 proposals, we also negotiated with G-20 and with the new
24 Financial Stability Board, a complementary set of proposals
25 that we hoped would be enacted globally.

1 And there are core elements of our reforms that,
2 to be effective have to be done multilaterally. The best
3 example of that is capital requirements globally. And we
4 are in the process of negotiating a new international
5 capital accord to limit leverage and risk taking.

6 But there are some things that are problems that
7 are unique to our market that are going to have to be done a
8 little differently. And our responsibility of course is to
9 make sure we are fixing those things, too.

10 The world I believe generally would very much
11 like to see the United States act to fix the things we got
12 wrong in our country, and are depending on us to do it. And
13 I've never heard any of them suggest to us that we should
14 slow the pace of reform down.

15 They want to make sure that we are doing this in
16 ways that globally would be not too punitive on them. And
17 there's a lot of concern outside of the United States that
18 some of the proposals we've been promoting on capital, for
19 example, are going to be a big burden for other countries.
20 And that is the source of some tension, as it is inevitable
21 it should be, but it's a sign of, I think you should view it
22 as a sign of health that we're trying to--we're being
23 ambitious in what we're trying to achieve.

24 COMMISSIONER GRAHAM: If I could pick up on that
25 issue of capital, I was surprised to learn that under the

1 Basel, I believe it's Basel II, that the value of
2 securitized mortgages is higher for purposes of capital
3 purposes than the underlying mortgages themselves? Is that
4 a correct statement?

5 WITNESS GEITHNER: I do not know whether that
6 exact point is correct. But I would say it this way--one of
7 the things that's important to note. Basel II was not in
8 effect for U.S. banks--it's still not in effect for U.S.
9 banks--and it was essentially irrelevant to the cause of the
10 crisis.

11 All U.S. firms were operating under Basel I
12 design back in 1990 with a set of leverage requirements.
13 And those set of risk weights did not do a good job of
14 capturing a broad set of risks firms were running, and we're
15 involved in a very important process in the United States to
16 try to change those to make them better reflect risk.

17 COMMISSIONER GRAHAM: Well you've sort of
18 anticipated my question. If that statement that I made--and
19 maybe I had the wrong Basel--is correct, and my colleague
20 thinks it is correct, did this indicate that the
21 international financial community was falling victim to the
22 same mistake that we made, which was to put unwarranted
23 value behind a certain set of instruments largely because
24 they had a high credit rating without any requirement that
25 there be some greater due diligence as to just what was the

1 composition of those structured instruments?

2 WITNESS GEITHNER: Absolutely. Absolutely. And
3 the system was riddled with that basic vulnerability. Which
4 is, it was too dependent on ratings that were too vulnerable
5 to mistakes. And firms, as a result, held less capital than
6 they should have.

7 COMMISSIONER GRAHAM: And do you believe that the
8 international financial community is moving to correct those
9 errors?

10 WITNESS GEITHNER: Absolutely. You know, the way
11 our system works is, we don't turn this over to the
12 international community to solve for us. What we do is we
13 figure out what makes sense to the United States, and then
14 we try to build consensus internationally to pull other
15 firms to that level. But we preserve the authority here to
16 be more conservative to differ if we think we need to do it
17 differently.

18 You pointed out one example of a set of basic
19 vulnerabilities in that system, but we were fortunate in
20 many ways because we did have a crude leverage ratio in
21 place for banks and bank holding companies. Many countries
22 did not. And as a result, our firms had--and they were
23 forced to run with more capital--they had less leverage,
24 less vulnerable to crisis than was true for many other
25 countries.

1 And as many people have pointed out, our banks,
2 although they look large because we're a large country,
3 we're much smaller as a share of our economy than was true
4 for all the other major countries. So our banks were, at
5 the peak, even with investment banks now called banks, are
6 about 1 times GDP. The comparable numbers in Switzerland at
7 the peak were almost 8 times GDP. In the UK, almost 5 times
8 GDP. In Continental Europe, 2 to 3 times GDP.

9 So our banks were less leveraged and the whole
10 system as a whole was much smaller as a share of our
11 economy. It's hard to imagine it because our crisis was
12 very severe, but we were in a much better position to
13 withstand the shock than was true for many other countries.

14 COMMISSIONER GRAHAM: Those leverage ratios that
15 you just cited, they're so extreme. Does that indicate that
16 a higher proportion of the financial business in a place
17 like Switzerland is run through traditional banks, as
18 opposed to what we're studying these two days, the shadow
19 system?

20 WITNESS GEITHNER: You're exactly right. Those
21 systems are what we called "universal banking models." And
22 they combine in one entity, legal entity, the whole span of
23 financial activities. And their capital markets, their
24 securities markets, are a less important source of credit
25 than it is in our country.

1 In our country, still roughly half of credit
2 comes through institutions we call banks, and roughly half
3 of credit comes through the securities markets, both simple
4 bond markets as well as the asset-backed securities markets.

5 COMMISSIONER GRAHAM: I am almost out of time.

6 CHAIRMAN ANGELIDES: Would you like a couple of
7 minutes?

8 COMMISSIONER GRAHAM: If I could get a couple of
9 additional minutes to ask a different question. And that
10 is, you've talked a lot about your efforts in New York, and
11 now here, to look over the horizon and try to have a better
12 idea of what's coming at us.

13 To what degree will the reforms that you are
14 advocating increase our capability to be more anticipatory
15 and therefore proactive rather than just reactive?

16 WITNESS GEITHNER: I think they will help. They
17 will help a lot. And of course ideally what you want is a
18 system that is able to move more preemptively, that is more
19 agile, that can stay closer to the frontier of innovation,
20 and we hope to produce that. But there's no guarantee we
21 can. And that's why fundamentally I keep coming back and
22 saying that you need to do your best to design a system that
23 creates that possibility, but you need to prepare for the
24 possibility it won't be perfect and so therefore you want
25 the system to have better cushions against the inevitable

1 uncertainty we all live with.

2 Because we won't know with confidence where the
3 next shock is going to come from. We just need to make sure
4 it's going to be less damaging when it happens.

5 COMMISSIONER GRAHAM: Thank you.

6 CHAIRMAN ANGELIDES: Thank you. Mr. Wallison.

7 COMMISSIONER WALLISON: Thank you, Mr. Chairman.
8 And thank you, Mr. Secretary, for coming to spend some time
9 with us today. This has been very informative.

10 I would like to follow up on what my colleague,
11 Douglas Holtz-Eakin was talking about before because I think
12 these are very important questions. And particularly the
13 question of whether you in what you are proposing for a
14 reform is really attempting to solve the right problem.
15 Because I think you would agree that you don't want to solve
16 the wrong problem. And one of the things we are in is
17 trying to figure out what the problem really was. Okay?

18 Now in the hearings that we have held so far, it
19 seems fairly clear that it did not really matter whether you
20 were a regulated bank, or you were a less regulated
21 investment bank, in terms of what happened to that
22 institution in the financial crisis. Would you agree with
23 that?

24 WITNESS GEITHNER: No, I wouldn't agree with
25 that. I would say that in a--let's think of it this way.

1 Say you had a world where you only had two institutions.
2 You had classic banks that take deposits and make loans, and
3 you had banks that, let's call them "banks" for the minute,
4 for the moment, but they're funded very short, no deposit
5 insurance, money can leave in an instant, and they're able
6 to take on more leverage than banks.

7 COMMISSIONER WALLISON: But their assets are
8 different than banks?

9 WITNESS GEITHNER: Well, in many--

10 COMMISSIONER WALLISON: Banks assets tend to be
11 long term, right? And investment banks tend to have very
12 short-term assets, easily sold, in theory?

13 WITNESS GEITHNER: A little less short than many
14 people thought. A very substantial portion of their assets
15 were quite illiquid in the crisis and they could not sell
16 them, actually, that quickly.

17 COMMISSIONER WALLISON: Right.

18 WITNESS GEITHNER: Which is a fundamental
19 difference. And so the level of--I'm not an economist--but
20 the level of maturity transformation, that risk to run, in
21 many of those other institutions was very, very large, I
22 think in many ways as large as banks.

23 But the difference is that when liquidity dries
24 up in that parallel system, the assets were not liquid
25 enough in a panic to be able to sell them and meet your

1 demand for margin, et cetera, meet your demand for
2 withdrawals. And so that stuff came really crashing down.
3 And that put enormous pressure on the rest.

4 It was only--if we were dealing only with
5 mistakes banks have always made over centuries, it would
6 have been a much more slow moving crisis, because liquidity
7 would have been more stable, because most of it was deposit-
8 funded, and it would have been a much easier crisis to
9 manage.

10 It would have been a serious recession still,
11 because of everything else, but it would have been an easier
12 crisis to manage. So I think it was different consequences.

13 COMMISSIONER WALLISON: Okay. Now I think you
14 raised exactly the point that I was trying to get to, and
15 thank you very much. And the point is:

16 In 2007, as you recall--you were at the Fed at
17 the time--the mortgage-backed securities market simply came
18 to a halt. A completely unprecedented event. And that
19 meant that these investment banks that you're talking about
20 here turned out to have in effect long-term assets when they
21 were intended to be short-term assets.

22 So the question really is: Is the right question
23 the investment banks? Or is it what caused the short-term
24 assets they thought they had to become the long-term assets
25 that made them look a little bit like regulated commercial

1 banks?

2 And so I am going to posit to you the possibility
3 that because of this crash in the mortgage-backed securities
4 market that turned short-term assets into long-term assets,
5 no regulatory system could have survived this.

6 Because we took about \$2 trillion in assets that
7 were on the banks of financial institutions--on the balance
8 sheets of financial institutions all over the world--also
9 particularly in the United States, but all over the world--
10 and we made them illiquid. They couldn't be sold.

11 Isn't that a major effect that no regulatory
12 system could have anticipated? And shouldn't we be thinking
13 about what caused that to happen? Rather than simply
14 imposing more regulation?

15 WITNESS GEITHNER: Well I'm not quite sure where
16 you're going with that, but I think that's an interesting
17 question.

18 I guess, I guess I would try still to look at it
19 this way. If you're going to take on a lot of risk, whether
20 it looks short-term or long-term, whatever it is, whatever
21 you think about your assets, but you know there's risk in
22 those assets, and you're going to fund them with money that
23 can leave in a heartbeat, and you don't hold much capital
24 against the risk of losses in that case, then you're going
25 to have a problem.

1 And that I believe is a problem that is mitigated
2 if you get capital regulation right over institutions that
3 are in the business of making our markets work and helping
4 companies borrow.

5 But I completely agree that there are a whole
6 other set of things that happened in our financial markets
7 that made us more vulnerable to the abrupt loss of
8 confidence in anybody holding a security backed by real
9 estate in the United States. Lots of things contributed to
10 that, too, and that made it worse, but--anyway, I'm not sure
11 where you were going.

12 COMMISSIONER WALLISON: Well all I'm saying is
13 simply this: that is, that we had an abrupt, common shock
14 to the entire system coming from the fact that a very large
15 number, size of assets simply disappeared as saleable assets
16 on the balance sheets of banks, and on the balance sheets of
17 investment banks--

18 WITNESS GEITHNER: Then maybe--

19 COMMISSIONER WALLISON: --and that changed the
20 condition of those institutions very materially from a
21 capital and from a liquidity standpoint, and I'd like your
22 reaction to that.

23 WITNESS GEITHNER: I guess I think that's right,
24 but again that's sort of what happens in any crisis. What
25 happens in any crisis is two propositions are tested.

1 One is the proposition that your funding is
2 stable. And, you know, a lot of people made a lot of
3 judgments on the expectation that liquidity would be
4 seamless, permanent, uninterrupted, never disappear, it
5 would all be there, and cheap, and available. That
6 assumption is tested in a crisis.

7 The other assumption tested is you hold a bunch
8 of assets. And you think you know what you might lose in
9 those assets if you have to sell them, or hold them over
10 time and you lost losses. And it usually takes both those
11 mistakes to cause a crisis. And I think we had both of them
12 at the same time, and they were somewhat related, as you
13 said--

14 COMMISSIONER WALLISON: Yes.

15 WITNESS GEITHNER: --because people ran because
16 they saw the--or at least they couldn't assess what the risk
17 was in the assets.

18 COMMISSIONER WALLISON: But what I'm saying is,
19 this wasn't "any crisis." This was a much larger crisis than
20 anything we've experienced before. And I think the reason
21 is that we're talking about an asset size larger than
22 anything we've ever experienced before--about \$2 trillion in
23 mortgage-backed securities, and related securities scattered
24 throughout the financial world, and suddenly becoming
25 almost, not worthless, but very difficult to sell except

1 into the most distressful circumstances.

2 So isn't that a problem? Rather than whether we
3 had sufficient regulation?

4 WITNESS GEITHNER: No, I don't think so, because
5 again in any--like almost every financial crisis sort of has
6 real estate at the scene of the crime. It doesn't really
7 matter how fancy the products are, what you've called them,
8 CDOs, or asset-backed securities, whatever, the usually have
9 real estate central to the crime. So nothing unique in
10 that.

11 And again, what we do is we protect ourselves
12 from that risk by making sure that the institutions that are
13 necessary to make markets function, to make economies work,
14 hold enough capital to cover their losses and aren't
15 vulnerable to runs.

16 And again, I don't think regulation can solve all
17 problems. Regulation can cause lots of damage. Done
18 poorly, it's damaging. Regulation creates incentives for
19 evasion. But capital limit leverage I think has to be the
20 center of any diagnosis of the problem in the reforms.

21 COMMISSIONER WALLISON: I have a little bit of
22 additional time, so I will go on. That is--

23 CHAIRMAN ANGELIDES: Three minutes from the Vice
24 Chairman.

25 COMMISSIONER WALLISON: Three minutes. Here's

1 the issue. You suggest that capital regulation would be a
2 solution to this problem. But if we are talking about a 70-
3 year flood--that is, we haven't had anything like this since
4 the Depression--are you talking about imposing so much in
5 the way of capital requirements on our banking system, on
6 our investment banking system that they will no longer be
7 able to offer reasonably priced credit to those who need it?

8 WITNESS GEITHNER: No. But you're asking exactly
9 the right question I believe.

10 Just a short story. When I first came to the New
11 York Fed and I was understanding the system in which banks
12 were operating, I asked my colleagues, I said how do we know
13 what's enough capital? How do we choose what's enough
14 capital?

15 And my colleagues used the same example you said,
16 which is to say that we think it's enough to cover a 30-year
17 flood, but not a 100-year flood. Governments make a choice
18 about what level of insurance you force firms to run with
19 against what is the probability of a flood.

20 And I agree that we cannot and should not try to
21 design a system that makes failure impossible, that would
22 cover any--because that would impose excessive costs on
23 businesses and would not be efficient for the country as a
24 whole.

25 But I can say with a lot of confidence that our

1 requirements were too thin, too modest, and it would be
2 better for credit generally, better for the economy, better
3 for the allocation of capital across time, if those
4 requirements were more conservative. But I completely agree
5 with you, you can't design them and should not try to design
6 them to protect against all sorts of shocks, and we have to
7 have a system that allows for failure.

8 We just don't want the failure to be as damaging
9 as it was in this crisis.

10 COMMISSIONER WALLISON: One last question, then.
11 You say in your prepared testimony that the financial
12 system--I think I'm quoting here--"outgrew the protections
13 that were created in the Depression."

14 Now wouldn't it be fair to say that the system
15 grew outside the banking system not to avoid regulation so
16 to speak, but because banks were in fact unable to
17 participate in the securities market which was a very
18 efficient market for financing business, and financing
19 consumers--this is the securitization market. Banks were
20 really effectively prevented from participating in that, in
21 part because of Glass-Steagall, and I'm not advocating
22 Glass-Steagall certainly, but isn't that why we developed
23 this shadow banking system, if we want to call it that?

24 WITNESS GEITHNER: The capital requirements had
25 this paradoxical feature. They were strong enough to

1 encourage a lot of that funding to shift outside to where
2 there was no capital regulation, but they were not strong
3 enough to protect the system when that system came crashing
4 down.

5 But I don't think the premise is quite right in
6 the sense, Mr. Wallison, that banks were allowed to help
7 companies raise debt and equity. And they were allowed to
8 participate actively in these other secured funding markets--
9 -for credit card receivables, for automobile receivables--
10 not just real-estate backed, asset-backed. So they were
11 able to fully participate in that system, and a lot of them
12 did of course in ways that left them in the panic you
13 referred to, exposed to loss.

14 So I don't think I quite agree with that part of
15 your question.

16 COMMISSIONER WALLISON: That's all the time I
17 have, but thank you very much.

18 CHAIRMAN ANGELIDES: Mr. Georgiou.

19 COMMISSIONER GEORGIOU: Mr. Secretary, you said
20 something to the effect that all this stuff started to crash
21 down, and crash down pretty quickly. I guess I would like
22 to explore whether the stuff really deserved to crash down,
23 and was really created in such a way that anybody who was
24 other than right in the center of it and not looking at it
25 ought to have known that it had the strong possibility of

1 crashing down.

2 Yesterday we had testimony from former SEC
3 Chairman Cox who said something to the effect that if honest
4 lending practices had been followed, much of this crisis
5 quite simply would not have occurred; the nearly complete
6 collapse of lending standards by banks and other mortgage
7 originators led to the creation of so much worthless, or
8 near worthless mortgage paper that as of September 2008
9 banks had reported over one-half trillion dollars in losses
10 on U.S. subprime mortgages and related exposure.

11 And the creation of those mortgages was
12 exacerbated by then turning those residential mortgage-
13 backed securities into collateralized debt obligations in a
14 process that at the last hearing I likened to something like
15 medieval alchemy where you took this low-rated tranche, the
16 BBB-rated tranches of the residential mortgage-backed
17 securities--93 percent of the tranches were higher rated.
18 This was the bottom 5 percent of the 7 percent. There was 2
19 percent of equity below.

20 Then you took that tranche, low-rated, from a
21 whole bunch of mortgage-backed securities and created
22 something called the collateralized debt obligation, somehow
23 slicing and dicing that and ending up with a security that
24 had not only AAA, but some 50 percent of it was AAA+ rated,
25 which was super-senior tranches, ostensibly.

1 But of course we now know that all that was
2 essentially fictitious, really, and that when you lost a
3 very modest amount, when these mortgages began not to
4 perform in some modest amount, 3, 5 percent, you impacted
5 all that BBB tranche, and then you essentially rendered the
6 CDOs worthless.

7 And it was exacerbated--I think it's important to
8 note it was exacerbated by the shadow banking system in a
9 couple of ways. We had another \$120 billion of those CDOs
10 that were essentially insured by AIG by selling credit
11 default insurance against it, which they weren't capitalized
12 for, and they were essentially spreading their AAA rating
13 like holy water over these CDOs that didn't deserve to be
14 rated in that way, and another \$60 billion was sold to
15 commercial paper conduits.

16 So you took these fundamentally flawed
17 securitized products and concentrated risk in a number of
18 institutions which ultimately we as taxpayers had to bail
19 out--AIG, Citi, which took a \$25 billion liquidity put on
20 these CDOs off their balance sheet, which is essentially a
21 third of their capital, which nobody seemed to have noticed
22 anything about.

23 And I guess all of this goes to say that we
24 needed to, it seems to me, have people prepared to recognize
25 that the emperor had no clothes; that there needed to have

1 been people who saw that the possibility of this collapse of
2 the securities was much, much higher than anybody gave them
3 credit for. And I wondered if you could speak to that
4 general problem.

5 WITNESS GEITHNER: I think I agree with much of
6 what you said. And I think you're right that you had a
7 dramatic erosion in underwriting standards. So people lent
8 money against a very large fraction of the value of a house
9 inherently exposed to substantial risk of loss if you had
10 the combination of prices falling a lot and a lot of people
11 losing their jobs.

12 And that risk was pervasive across the system.
13 It was in--

14 COMMISSIONER GEORGIU: They don't even have to
15 fall that much. I mean, they don't have to fall a lot.
16 They can just fall a little bit.

17 WITNESS GEITHNER: Right. So relatively modest
18 losses would have eaten deeply into those particular
19 tranches of CDOs. I think you're absolutely right in what
20 you described.

21 But I guess what I would emphasize is that it
22 wasn't just in those complex structures. It was across the
23 system. It was in--I mean, you know, Countrywide would be
24 an example, banks across the country that did lend too much
25 against real estate as a whole.

1 And it was--it was--

2 COMMISSIONER GEORGIU: And they just held the
3 mortgages themselves.

4 WITNESS GEITHNER: They held some of them, and
5 they--

6 COMMISSIONER GEORGIU: Right. But, I agree with
7 you, it wasn't exclusively that, but it was significantly
8 that. And I guess, you know, part of what we've been
9 discussing for the last few days is that a number of the
10 parties who originated these mortgages held--essentially had
11 no consequence if they failed. Not just the mortgages, but
12 the securities themselves.

13 And I don't know that in this regulatory reform
14 that's going on how much there will be remedial--how many
15 remedial measures will be made to address that question.
16 And would the systemic risk council that you propose, or
17 that people have proposed, be able to identify this kind of
18 problem in the future?

19 WITNESS GEITHNER: And you are right to say that
20 these reforms won't solve all these problems definitively.
21 We won't know for sure which ones they do an adequate job of
22 solving, but they do do some very important things.

23 They do get fundamentally at some of the
24 conflicts in rating agencies that helped contribute to the
25 mistakes in ratings. They will force much more disclosure,

1 not just about ratings and their methodologies, but into
2 these basic complex asset-backed securities structures so
3 investors have a better chance of looking deep into them and
4 understanding the risks they're exposed to.

5 They will force firms that write these
6 commitments to hold more capital against those commitments.

7 COMMISSIONER GEORGIOU: And to hold some of the
8 securities themselves, if I understand it.

9 WITNESS GEITHNER: Yes, and to retain an economic
10 interest in those securities. So again, these things are--
11 we are confident these things would be helpful.

12 I think you could say they're necessary. But of
13 course over time people will find their way around them.
14 And if you have another period where you create great
15 incentives for people to take great risks, they will do it
16 again.

17 Our job is to make sure that those mistakes when
18 they happen are not as damaging to the system.

19 COMMISSIONER GEORGIOU: I guess the other thing
20 that we looked at at the last hearing that I'd just like
21 your comment on was this capital arbitrage where
22 institutions like Citi were putting things either off
23 balance sheet or into different elements, putting it in
24 their trading book, that avoided people recognizing,
25 different regulatory entities recognizing that there was

1 ultimately a risk in this particular instance of liquidity
2 puts to \$25 billion, almost a third of their capital, if
3 this one set of CDOs failed.

4 WITNESS GEITHNER: Well again you're exactly
5 right. The system did not capture the economic exposure
6 many firms had to the funding vehicles they used.

7 I mean, the crisis began in July 2007 when a
8 French bank that owned a money market fund closed the gates
9 on withdrawals because that fund had funded a bunch of risk
10 in structured investment vehicles, these off balance sheet
11 fancy vehicles, of German banks that had bought a huge
12 amount of U.S. subprime mortgage risk.

13 So--and without, frankly, the knowledge of the
14 fund or the bank in some basic sense. So, but, you know, it
15 happened across the system. And neither the accounting
16 regime, the disclosure regime, the rating regime, the
17 capital regime, did an adequate job of capturing those risks
18 of exposure. And that is a fixable problem.

19 It won't get fixed perfectly, and you want to
20 make sure it adapts over time better, but that is a--I think
21 that is a problem that we can do a much better job of
22 preventing in the future by again making sure the accounting
23 conventions capture these exposures.

24 Disclosure is better. Ratings less vulnerable to
25 conflict. Capital provides bigger cushions against

1 uncertainty and loss. It won't solve all problems, but it's
2 a good place to start.

3 COMMISSIONER GEORGIU: Very good. Thank you,
4 very much, Mr. Secretary.

5 CHAIRMAN ANGELIDES: Right. Mr. Secretary, very
6 quickly I just want to make an observation, picking up
7 really on the comments of Mr. Wallison and Mr. Georgiou
8 about the regulatory framework.

9 One of the things that struck me when I heard
10 that discussion is so many people who have come before us
11 have talked about how nothing could have been done to avert
12 the crisis, but what's at least clear to me as I read more
13 and more and hear more and more is there's a lot that
14 should never have been done at the outset.

15 And when you were talking about in this
16 discussion what kind of regulation on securitized products
17 or on capital, is it fair to say that we can't also forget
18 to look at the point of origin of problems?

19 In other words, there was a situation here, and
20 I'm not saying it was the whole of the problem, but the fact
21 was the poisonous subprime loans were permitted to enter the
22 system in the first place. And then exotic financial
23 instruments were created that helped carry that poison
24 throughout the system.

25 And so any look back and look forward has to look

1 at the point of entry of the contamination, doesn't it?

2 WITNESS GEITHNER: I agree. But again I would
3 just underscore this is in the character of saying it's
4 worse than you think. I would just emphasize that if you
5 look at losses on prime mortgage loans, on conforming
6 mortgages in this crisis they are very high, too, well
7 outside the expectations of most people in this case because
8 again house prices fell so far, and unemployment rose so
9 much more than people had expected.

10 So it was pervasive. And I do not believe you
11 can prevent all financial crises. I do not believe that you
12 can try to run a system that tries to prevent failures. But
13 the job of government is to make sure that you make those
14 failures less damaging; that they don't cause so much
15 collateral damage to the innocent, they don't have such
16 catastrophic consequences for the economy, and I believe we
17 can do a better job. And I think these reforms provide a
18 very good framework for fixing not just the direct cause of
19 this crisis, but making us much less vulnerable in the
20 future.

21 But crises will happen. Again, what policy
22 should do is make them less damaging.

23 CHAIRMAN ANGELIDES: I mean the only other
24 observation I would have is, would you agree that the
25 problem in prime mortgages may have been exacerbated by the

1 price run-up, which in part may have been fueled by the
2 availability of no down payment, negative amortization, a
3 whole slew of loan products to a whole set of consumers who
4 otherwise wouldn't have been able to enter that market?

5 WITNESS GEITHNER: I do agree with that.

6 CHAIRMAN ANGELIDES: Okay. One other just small
7 item so I don't forget today. And this is just in the way
8 of cleanup. I had earlier asked you about conversations
9 with Mr. Immelt. I want to expand just for a minute.

10 We had talked briefly about the CPFF. And by the
11 way, I assume you've had a lot of conversations with him
12 because he was on your board. But I know that on October
13 7th of 2008 you announced the commercial paper program,
14 October 27th you began buying commercial paper. I believe
15 originally there was some talk about that being only asset-
16 backed and not unsecured? I don't know if it was shifted,
17 but--

18 WITNESS GEITHNER: We started a facility called I
19 think the Asset-Backed--it had some acronym, but it was
20 about asset-backed commercial paper. And then we put in
21 place a broader commercial paper-backed facility.

22 CHAIRMAN ANGELIDES: But when I asked you about
23 the conversations, I asked about September 29th and 30th,
24 and whether there was concern about being able to issue
25 commercial paper by GE.

1 I would like to expand that to just ask you, did
2 conversations occur about being able to enter those programs
3 because of a necessity of those programs to support their
4 issuance, or the market as a whole?

5 WITNESS GEITHNER: Again, to the best of my
6 recollection, Mr. Chairman, those conversations, like I had
7 with a variety of people in the markets both money market
8 funds, institutional investors, and people who were relying
9 on CP markets, they were about making sure we understand how
10 broad the problems were.

11 And people had lots of ideas about how we should--
12 --as they always do--about how we should solve them.

13 CHAIRMAN ANGELIDES: Well you were going to
14 check. Why don't you--I don't expect you, like I said, to
15 carry your daily planner--

16 WITNESS GEITHNER: But your question was, were
17 they about both the asset-backed--

18 CHAIRMAN ANGELIDES: GE's ability to (a) issue in
19 that time period, you know, fear of their own issuance; and
20 (b) their participation in those programs.

21 WITNESS GEITHNER: Okay. I'm happy to go back
22 and check. But again, my recollection is that absolutely,
23 almost certainly they were about making sure we understood
24 how broad the potential financing stress was. And like we
25 heard from across the system, across the economy,

1 encouragements for us to do something about it.

2 CHAIRMAN ANGELIDES: All right. Double-check,
3 and if you can swing back.

4 (Information to be provided.)

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1 CHAIRMAN ANGELIDES: Mr. Hennessey?

2 COMMISSIONER HENNESSEY: Thank you. And thank
3 you for coming today.

4 I am a little concerned about one of the biggest
5 challenges we have here, two of the biggest challenges, are
6 the advantage of hindsight, and the danger of selection
7 bias. We now know what happened when policymakers and
8 supervisors did not know what was going to happen.

9 And as you well know, at any point in time you
10 can find someone who is predicting almost any outcome. And
11 so we have had, you know, people point to specific
12 predictors from the past and say, why weren't those paid
13 attention to.

14 And with respect to Senator Graham, I want to use
15 an analogy from his home state: I can tell you with
16 certainty that devastating hurricanes will hit Florida. But
17 that is different than suggesting that I should know when a
18 specific hurricane is going to hit Miami. And even if I
19 know that houses are being built that are too big on the
20 shores of Florida, that's different than saying I should
21 have known about this hurricane. Or, as some have been
22 suggesting, that I knew that a particular situation was
23 going to occur, and that someone did nothing about it.

24 And since you were running the New York Fed, that
25 argument would apply to you. And I don't buy the argument,

1 but I want to ask you about it, with respect to housing, and
2 then with respect to how the housing problems translated
3 into the financial sector.

4 I think it was generally known for years, if not
5 decades, that U.S. policy subsidizes housing. I know a lot
6 of my economist friends would say "over-subsidizes" housing
7 relative to other forms of capital investment.

8 I know that I did not know until the Fall of 2007
9 that there were specific severe problems in an element of
10 the housing finance market.

11 Can you comment on the argument that policymakers
12 should have seen well before the Summer or Fall of 2007
13 those housing problems? Do you believe that is a valid
14 argument?

15 WITNESS GEITHNER: I basically agree with where
16 you begin. And I say--I usually say exactly the same thing
17 to you, which is be wary of the benefits of hindsight. And,
18 and be skeptical of the capacity for foresight. I
19 completely agree with that.

20 So I can only tell you what I thought at the
21 time. Which is, that I was very worried about the
22 possibility that this whole set of forces you saw in the
23 long period of rising house prices, huge increases in
24 leverage, the growth in these risky funding structures
25 outside the banks, I was very worried that those risks would

1 be substantial for the system. And, that we did not know
2 what the possibility was of a big shock, where it would come
3 from, how it would happen, how damaging it would be. But we
4 thought--I thought there was a risk it would be quite
5 damaging and harder to manage than previous financial crises
6 for the reasons I said before.

7 But I would not claim, in having said that, that
8 I thought at the time, or I spent time--I went a lot of time
9 with people in these markets of course, and I did not find
10 people at the time who were particularly compelling about
11 exactly putting these things together and seeing how exactly
12 what was happening in no-doc loans, NINJA loans, et cetera,
13 was actually producing huge exposures that looked AAA or
14 super-senior.

15 So that's a complicated answer to your question.
16 But in general I agree with you that, be wary of the
17 benefits of hindsight. But I think on these basic--the
18 reason I think it's important to come back to the simple
19 risks and leverage is that leverage is hard to capture. But
20 you could observe at that time that there was leverage in
21 the system that made us vulnerable to a shock when it was
22 going to happen. But nobody had the capacity to predict the
23 timing, nature, magnitude of that shock.

24 And again, the lesson I would take from that is
25 to say that design a system that recognizes that limitation.

1 Don't design a system that tries to depend on people sitting
2 in these jobs, like you had, or everybody else had, and
3 saying we're going to hope those people in Washington step
4 in preemptively with perfect wisdom in the future and
5 deprive people of taking, borrowing too much.

6 I think that would not be a good way to run a
7 system. Run a system that rests on--that has some more
8 skepticism in it about the capacity of individuals to act
9 preemptively. And I think that is what these reforms try to
10 do.

11 COMMISSIONER HENNESSEY: Thank you. The second
12 part of that same sort of question, and I could characterize
13 it as were you generally surprised by the Bear event? And
14 then subsequent events?

15 And what I mean, more specifically, is by the
16 Fall of 2007 everyone knew that there were severe problems
17 in subprime financing, but then taking that to specific
18 failures of specific institutions, some have been suggesting
19 that you and others should have seen that was going to
20 happen, or some are even implying that people did see that
21 that was going to happen and didn't do something about it.

22 WITNESS GEITHNER: Well as I tried to explain, we
23 did a lot of things, starting in 2004, which were designed
24 to make the system more resilient and reduce the risk that,
25 whatever happened, it would be less damaging.

1 And as I said, I think those steps--I think they
2 were--had the right objectives. They were very effective in
3 many areas.

4 Think, for example, of what happened to how
5 little effect hedge fund failures had on the system as a
6 whole. A lot of examples of things that those results that
7 were helpful for the system.

8 But absolutely did not do enough soon enough to
9 make the system strong enough to withstand that. But our--
10 for us, in my view, this crisis started in the middle of
11 2007. And as you know, the Fed moved very aggressively,
12 doing things we had never done before. No road map. Way
13 ahead of other countries, to help to put some foam on the
14 runway and to sort of contain the risks that would escalate
15 and contaminate other institutions.

16 But ultimately of course you don't solve these
17 problems by simply using liquidity. You have to solve them
18 with more force.

19 COMMISSIONER HENNESSEY: Good. I want to praise
20 you for the work that you did, and have been doing, on
21 dealing with the resolution issues, having to do with credit
22 derivatives. And I strongly support the arguments you're
23 making about in effect hardening the system so that, even if
24 all of the oversight, and all of the supervision fails, that
25 the system is more robust to withstand that shock.

1 We heard from Bear. They said, look, we were
2 profitable. We were solvent. Just an irrational run
3 occurred.

4 After Bear there was the Emergency Liquidity
5 Facility at the Fed which, as I understand it, has since
6 expired. So let's imagine that another profitable, solvent
7 firm faces an irrational run. Isn't there the same risk?
8 Isn't the system not hard enough in that particular area
9 where the same thing could happen?

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

12 COMMISSIONER HENNESSEY: Thank you.

13 WITNESS GEITHNER: I would not characterize what
14 happened in that case as a run on a solvent institution.
15 But if we don't reform the system, absolutely we're still
16 living with that vulnerability today.

17 You know, we're still living with the same system
18 that produced this crisis. And without the full set of
19 protections, preventative and better tools for crises, we'll
20 be living with a more vulnerable system.

21 Because the actions we were forced to take do add
22 to moral hazard. And again, if you did nothing, you sat
23 here and did nothing, did not pass reforms, the system would
24 be less--more vulnerable, less stable than in the past.

25 But absolutely, even solvent firms are vulnerable

1 to runs. And you saw a lot of institutions that were very,
2 very strong financially come under extraordinary pressure
3 because the world went into panic.

4 And again, I think the best defense against that
5 is to make sure that the entire system, firms and these
6 funding markets, derivative markets, et cetera, are run with
7 thicker cushions against loss. That will make everything
8 less fragile when somebody makes huge mistakes.

9 But also make sure that when things fall apart,
10 when people make mistakes, you can put them out of their
11 misery without the taxpayer being exposed to loss, and you
12 can draw a firebreak around them so that the fire doesn't
13 jump to the rest of the system.

14 That is the basic, simple theory that underpins
15 these reforms. And I think those are achievable reforms.
16 They won't be designed to prevent people from making
17 mistakes. We just want the mistakes to be less damaging.

18 COMMISSIONER HENNESSEY: So that's the resolution
19 authority, and then a whole set of requirements to reduce
20 the probability that any one particular firm gets itself
21 into a situation where investors will lose confidence.

22 WITNESS GEITHNER: Yes.

23 COMMISSIONER HENNESSEY: But as we saw with
24 Wachovia, and WaMu, even insured institutions can face runs.
25 I presume that even if say the pending legislation becomes

1 law, even if you have the resolution authority and those
2 other strengthening things, you are still at a greater risk
3 for one of these non-insured firms of an irrational
4 liquidity run just because that facility doesn't exist.

5 You could still have a firm that claims, or
6 believes that it's solvent and profitable saying, look,
7 there's an irrational run; I'm running out of liquidity.

8 WITNESS GEITHNER: I think that's right. I think
9 the question you have to ask is: Is that desirable? And
10 will that induce more conservative behavior?

11 You know, in the absence of expectation there's a
12 safety net that should induce caution. Of course it didn't
13 work that way for large parts of the system coming into the
14 crisis.

15 So again, I think the lesson we try to take is to
16 say there's a function called banking which is about helping
17 companies raise capital, helping people borrow to finance
18 things they need. You want that system to be stable in
19 crises. Otherwise, economies can't function well. And that
20 requires this mix of constraints on risk-taking, and better
21 fire fighting capacities when things fall apart.

22 And you can't make the system stable if that set
23 of protections only exists on fundamentally half the system.

24 COMMISSIONER HENNESSEY: Thank you.

25 CHAIRMAN ANGELIDES: Ms. Murren.

1 COMMISSIONER MURREN: Thank you.

2 Thank you, Mr. Secretary, for being here to talk
3 to us about this. I would like to follow up on a nuts-and-
4 bolts question that actually came up in our last hearings,
5 which were on Citi. And we had had the opportunity to
6 question former Chairman Greenspan, and in this instance we
7 were able to take a look at the 2005 Operations Review of
8 the Bank Supervisor Group at the Federal Reserve Bank of New
9 York.

10 And this one is dated May 9th to May 27th of
11 2005. I would like to enter that into the record.

12 This is an internal peer review report, and it is
13 conducted by examiners from other Federal Reserve Banks.
14 And it is my understanding that each Reserve Bank is
15 reviewed every four years.

16 And, that in this particular report there was
17 commentary made that related to the Citigroup team, that was
18 that the team's time and energy is absorbed by hot topic
19 supervisory issues which include compliance, governance,
20 information requests, and that that keeps the team from
21 fully completing its continuous supervision objectives.

22 The result is that there are insufficient
23 resources to conduct continuous supervision activities in a
24 consistent manner. And we recommend that management review
25 the sufficiency of staff across the LCVO portfolio.

1 And then there's also another report, which is
2 the same year I think on the same topic, which is titled "A
3 Draft Closeout Report," which also mentions not having
4 sufficient staff to sustain continuous supervision
5 activities which may result in late reaction to address
6 emerging risk areas.

7 I am curious about, when you look back on this
8 and, you know, recognizing the benefits of hindsight, do you
9 agree with the findings of this report that there were
10 insufficient resources allocated specifically to Citigroup,
11 and also perhaps to other large, complex banking
12 organizations?

13 WITNESS GEITHNER: Here's how I think about this.
14 Again, colored a little bit by hindsight.

15 I was very concerned in looking at our mix of
16 responsibilities in those bank holding companies about the
17 burden imposed by a range of what you might call compliance
18 obligations--consumer protection, CRA, Bank Secrecy Act--
19 very important policy instruments, policy requirements that
20 we were charged with enforcing through regulation, and the
21 burden those imposed relative to the resources we had to
22 also do what you might call a much more difficult task, also
23 an important task, of judging whether a firm had a risk
24 management capacity to manage his risk adequately, whether
25 the safety and soundness obligations we faced were

1 adequately met, whether liquidity was managed carefully
2 enough, et cetera; whether the firm had, for example
3 adequate stress testing regimes to capture what might happen
4 if all those securities it held turned to mud.

5 And I felt--and again, this lesson helped shape
6 what we've proposed on financial reform, because we've
7 proposed to take the Fed out of the business of consumer
8 protection and have it focus in its supervisory
9 responsibilities on a narrower range of safety and soundness
10 requirements. And I still believe that is right and
11 appropriate, in part because again it helps make sure that
12 these people are focused on a more single mission, which is
13 safety and soundness, which as we've discovered is so
14 important to the system as a whole.

15 COMMISSIONER MURREN: I guess the question then
16 would also be, have we had an opportunity to be able to
17 address that? Or have you?

18 If you look, also a similar Operations Review,
19 and this one is dated December of '09, there are still
20 references here to the timeliness of supervisory products
21 being a concern, and that it is in fact a repeat finding
22 from the 2005 Operations Review.

23 And there are further citations that relate to
24 supervisory ratings not being updated on an ongoing basis to
25 reflect the evolving risk profile and financial condition of

1 the organization.

2 Do you feel like the responsiveness of the
3 supervisors at the Federal Reserve Bank in New York was
4 swift enough to the circumstances? Do you think they should
5 have been more aggressive in their ratings and their
6 supervision and reporting of this condition of Citigroup?

7 WITNESS GEITHNER: I believe that these are the
8 most capable, most talented public servants I have ever
9 worked with. But I absolutely agree--and I've said this,
10 and I'll say it many times--that I do not think we did
11 enough as an institution with the authority we had to help
12 contain the risks that ultimately emerged in that
13 institution.

14 And I think a lot about what we could have done
15 differently in that context. And maybe part of it is about
16 resources, but I think it's a more fundamental problem,
17 which is I think that the system, again we were operating
18 with a set of rules that did not compel firms to hold enough
19 capital against the risks they were taking. They did not
20 capture them. And that is why I believe it is so important
21 in this reform processes that we rely not so much on the
22 discretion of supervisors to force more than the framework
23 forces, try to get the rules better. And so that firms can
24 live with a set of measurable objective rules and you're not
25 forced with the risk that these very capable people, because

1 of other preoccupations, other burdens, were insufficient
2 leverage and traction--you don't want the system to rely on
3 their ability to force firms to be more conservative than
4 the rules require.

5 You've got to make sure the rules adapt and force
6 more conservatism themselves.

7 COMMISSIONER MURREN: Do you think that there
8 should have been more examination of the off balance sheet
9 entities of Citigroup, specifically the underlying assets?
10 Is that something you think that would be beneficial as we
11 go forward?

12 WITNESS GEITHNER: Absolutely. And again, a
13 fundamental lesson of these reforms--and a lot of this has
14 happened with the evolution of accounting already in
15 capital--is that you need to make sure that these either
16 come on balance sheet, or if they're going to stay off
17 balance sheet that you force people to hold capital against
18 the risk in those exposures. Absolutely. A lot of progress
19 has been made in that area.

20 I would give just one cautionary note, though.
21 Those particular sets of risks themselves did not in the end
22 prove that large, in that particular case. It was--but it
23 was a problem across the system, and it made it much harder
24 for people to really understand what fundamentally might be
25 the ultimate measure of losses in a lot of institutions that

1 took too much risk to the real estate losses they had.

2 COMMISSIONER MURREN: Thank you. And I think I
3 need to enter these two reports that I cited into the
4 record. Do you need information on that?

5 CHAIRMAN ANGELIDES: I noted it was the 2005
6 Operations Report and the 2009 Operations Report. Correct?

7 COMMISSIONER MURREN: Yes.

8 CHAIRMAN ANGELIDES: Can I just very quickly,
9 though, we're going to keep you on schedule here. This is
10 remarkable. But I just want to press one last point.

11 In our interviews with Federal Reserve Bank of
12 New York staff, we were told that they did not look at the
13 credit quality of assets held by any of Citi's off balance
14 sheet entities. And actually in the end, as we understand
15 it, what happened at Citi is they had been reporting a \$13
16 billion subprime exposure. And as you know, in kind of a,
17 I'm sure you're quite aware, in a matter of weeks leading up
18 to Mr. Prince's resignation, that was revised upward to \$55
19 billion.

20 And they actually took that twenty-five back onto
21 their balance sheet, even though they weren't legally
22 required to as a liquidity put. So I think we could at
23 least say it was material.

24 The other thing that was pointed out to us is the
25 Examiners at the OCC complained about the provisions of

1 Gramm-Leach-Bliley, saying that it prevented them from
2 obtaining the information about nonbank affiliates and kept
3 them blind to some of the asset quality problems that
4 eventually came back on the balance sheet.

5 It sounds to me like there was a little hole
6 here. You had these off balance sheet entities, vehicles,
7 and no one is really looking at them. And so they did pose
8 a risk, or at least certainly a potential risk.

9 WITNESS GEITHNER: Absolutely they presented a
10 risk, and I didn't mean to claim otherwise. And I agree
11 they were material in the sense of--and, you know, this
12 system, this system of a whole bunch of different regulators
13 looking at pieces of the entity. The Fed is supposed to be
14 looking at the whole thing.

15 Accounting regime, rating dependence, capital
16 that didn't capture the risk, internal checks and balances
17 that failed to capture those risks, that system absolutely
18 did not work.

19 CHAIRMAN ANGELIDES: Right. And by the way, I
20 should add, the SEC told us they were aware of those. They
21 really fell, it seems to us, at least my reading of it, into
22 a black hole of sorts.

23 WITNESS GEITHNER: Right. And I think--

24 CHAIRMAN ANGELIDES: Or a gray hole.

25 WITNESS GEITHNER: In many ways, the problem with

1 the hole, or the shadow was that it looked like it was
2 called AAA, or Super Senior, and people didn't say, well,
3 how big a cushion of loss absorption is underpinning that?
4 And so that's why all of a sudden stuff that looked like it
5 was risk free had a lot of embedded losses.

6 CHAIRMAN ANGELIDES: And of course then there
7 were CDOs composed out of BBB tranches.

8 With that, I want to thank you--I'll let you
9 close us up--thank you very much, on behalf of all the
10 Commissioners, for coming here today, for your time, for
11 your answers to our questions.

12 Mr. Vice Chairman?

13 VICE CHAIRMAN THOMAS: Mr. Secretary, we are
14 going to be sending you a list of causes, those that had
15 been mentioned and those that weren't, and we really
16 appreciate you helping us. But probably more fundamental
17 than that, as one of the major architects of the financial
18 regulatory reform that's currently being examined by
19 Congress, would you provide a 30-second, or a one-minute pep
20 talk to the Commission as we're going forward attempting to
21 find the causes of the financial crisis, while you and
22 others have already decided what it was?

23 (Laughter.)

24 VICE CHAIRMAN THOMAS: And you can take a minute.

25 WITNESS GEITHNER: You are doing such a terrific

1 job--

2 (Laughter.)

3 WITNESS GEITHNER: --of exposing the full range
4 of fundamental causes, that you are helping the cause of
5 reform. Because we can match very closely the causes you've
6 exposed with the core of the reforms that the Senate is now
7 considering, and you are giving great energy and urgency to
8 the task.

9 But don't stop now. Even if the Senate enacts
10 this stuff in the next two weeks, don't stop your exercise,
11 because that's just the first stage. We are still going to
12 have to not just deal with the GSEs and the housing finance
13 markets, we are still going to have to design these set of
14 constraints on capital liquidity, disclosure, et cetera.

15 We have a huge amount of work ahead of us in that
16 process, and the process that you are undertaking, as well
17 as the other bodies in the Hill and internationally, will be
18 central to that process.

19 So when Congress, as we hope they will, enacts
20 these reforms, it will be the beginning of the process of
21 reform, not the end. And the work you have ahead of you
22 will be so important to exercise, but--I'm not quite sure
23 you wanted this, Mr. Thomas--but please encourage our
24 leaders in the Senate to act on reform so we can get on with
25 the business--

1 VICE CHAIRMAN THOMAS: I'm trying to explain to
2 them the institution, and the fact that the committees have
3 jurisdictions which don't necessarily cover everything that
4 needs to be done. And I hope people notice there are
5 deadlines that are created by the leadership in Congress,
6 but the follow-ship sometimes doesn't get there.

7 WITNESS GEITHNER: I am learning that myself,
8 too. But I think we're close now, and I hope they move
9 quickly.

10 VICE CHAIRMAN THOMAS: I think we are.

11 WITNESS GEITHNER: And remember, there will still
12 be an enormous amount of work that we have to shape, and the
13 process of inquiry you've laid out will be enormously
14 important to that work.

15 VICE CHAIRMAN THOMAS: And final word, we've got
16 to quit talking about it as history. It's here still.

17 WITNESS GEITHNER: The vulnerability, absolutely.
18 We are living with the system today that caused the worst
19 financial crisis since the Great Depression, and it is worse
20 than that. Because we had to do things no one should ever
21 have to do that create the risk of moral hazard. And if we
22 don't act to fix those problems, we will be more vulnerable.

23 So my compliments to what you are trying to do,
24 and keep at it. Don't stop just because we're going to get
25 the bill done.

1 VICE CHAIRMAN THOMAS: That was pretty good.

2 CHAIRMAN ANGELIDES: Thank you, very much. We
3 got out of that question and answer unscathed, and we will
4 take, Commissioners, a 15-minute break. We will recommence
5 at 2:35, or actually we'll do it at 2:30. We will take a
6 12-minute break.

7 Thank you very much, Mr. Secretary.

8 (Whereupon, at 2:18 p.m., the hearing was
9 recessed, to reconvene at 2:30 p.m., this same day.)

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1 AFTERNOON SESSION

2 (2:33 p.m.)

3 CHAIRMAN ANGELIDES: The meeting of the Financial
4 Crisis Inquiry Commission will come back into order.

5 We are on our final session of day two on our
6 hearing on the shadow banking system. I want to welcome our
7 witnesses who are with us today.

8 Gentlemen, as you know, we have been undertaking
9 an examination of the growth and development of what has
10 been termed the "shadow banking system," looking at how that
11 system developed, the risks it posed, what happened to that
12 system in 2007-08, and the consequences for our financial
13 system and our economy.

14 I would like to start off today by asking you all
15 to stand so we can do what we customarily do for every
16 witness who comes before us, and that is to stand and raise
17 your right hand, and I will administer the oath to you as
18 witnesses.

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

23 MR. McCULLEY: I do.

24 MR. NEAL: I do.

25 MR. BARBER: I do.

1 MR. MEIER: I do.

2 (Witnesses sworn.)

3 CHAIRMAN ANGELIDES: Terrific. We are grateful
4 for the written testimony that you have provided to us, and
5 we are going to ask each of you to give an opening statement
6 of no more than five minutes--both an opportunity for you to
7 speak to us, and for us to hear your views.

8 And so we will go, without political prejudice,
9 from left to right here, and we will start with you, Mr.
10 McCulley. If you would, start off.

11 WITNESS McCULLEY: Thank you, Chairman Angelides-
12 -

13 CHAIRMAN ANGELIDES: Okay, and I should add one
14 other things, gentlemen. You will see that there will be a
15 yellow light that comes on with one minute to go, and the
16 red light is when time is up. Thank you, Mr. McCulley.

17 WITNESS McCULLEY: Chairman Angelides, Vice
18 Chairman Thomas, and the Honorable Members of the
19 Commission:

20 My name is Paul McCulley, and I am a managing
21 director and portfolio manager with PIMCO. On behalf of my
22 colleagues at PIMCO, I thank you for the invitation to
23 appear before this distinguished Commission.

24 PIMCO is an investment management firm founded in
25 1971 based in Newport Beach, California. As an investment

1 manager, PIMCO is hired to invest money on behalf of clients
2 in accordance with contractual guidelines they establish
3 with us.

4 Our objective is to protect and enhance our
5 client's assets, their pensions, savings, and investments,
6 and thereby help them achieve their investment goals over
7 time.

8 We do not conduct investment banking or
9 proprietary trading activities, and we are not a broker-
10 dealer.

11 Let me turn now to the substantive issue that
12 you've asked me to speak about today, which is the role of
13 the shadow banking system in the financial crisis of 2007
14 and 2009.

15 Let me give you a definition. Shadow banks are
16 levered financial intermediaries engaged in liquidity,
17 maturity, and credit quality transformation but operating
18 without public safety nets. Notably, FDIC insurance and
19 access to the Fed's Discount Window.

20 Shadow banking, that phrase, is not a pejorative
21 phrase, but merely a descriptive phrase of how the shadow
22 banking system works.

23 Let me turn now to the fundamental role of banks.
24 Banking is fundamentally defined as the business of
25 transforming savings into investment in our economy while

1 simultaneously acting as the Nation's payment system.

2 Traditionally we think in terms of this activity
3 in the context of conventional banks, which issue deposits
4 and then turn them into loans. The system therefore
5 necessarily requires faith on the part of depositors that
6 their money is safe.

7 In the wake of repeated bank runs in the early
8 20th Century, Congress enacted legislation creating the
9 Federal Reserve in 1913, and the FDIC in 1933. As Professor
10 Gordon observed earlier before this Commission, FDIC insured
11 deposits issued by banks with access to the Fed's Discount
12 Window are informationally insensitive.

13 That is, holders of such deposits do not have to
14 do any due diligence or gathering of information to feel
15 comfortable holding such deposits because they are viewed by
16 the public as being backed by the full faith and credit of
17 our government.

18 Since the creation of the Federal Reserve and the
19 FDIC, conventional banking has inherently been a joint
20 venture between the private sector and the public sector.

21 Deposits are made informationally insensitive to
22 the public by the safety nets from the government, allowing
23 conventional bankers to redeploy those deposits into longer
24 dated, riskier loans and securities earning a net interest
25 profit.

1 Given the fact that the conventional banking
2 system is indeed a joint venture between the private sector
3 and the public sector, conventional banking has been
4 regulated.

5 In recent decades, the shadow banking system
6 developed to provide many of the same lending and
7 intermediary functions of conventional banks, also sharing
8 their same profit motive.

9 Today, many Americans have financed their homes,
10 car loans, and student loans via institutions that are part
11 of the shadow banking system.

12 One of the distinctions between conventional
13 banks and shadow banks is that, while conventional banks are
14 subject to extensive regulatory framework, shadow banks
15 typically are not.

16 In order to serve a similar function as
17 conventional banks, shadow banks needed to create an asset
18 that was perceived by the public as just as good as a bank
19 deposit. This in turn meant creating a informationally
20 insensitive asset.

21 The shadow banking system effectively did that.
22 But, unlike the conventional banking system, the shadow
23 banking system was and is inherently vulnerable to runs if
24 their liabilities suddenly become informationally sensitive.

25 CHAIRMAN ANGELIDES: How much time do you need to

1 wrap up?

2 WITNESS McCULLEY: One minute, sir?

3 CHAIRMAN ANGELIDES: Okay. I will grant one
4 minute, yes.

5 WITNESS McCULLEY: Indeed, a run on the shadow
6 banking system was, as was discussed throughout these
7 hearings, one of the defining characteristics of the most
8 recent financial crisis.

9 Short-dated liability holders of the shadow banks
10 discovered that actually the assets they were holding were
11 not just as good as deposits, but were informationally
12 sensitive.

13 And when they became informationally sensitive,
14 you had a run. Call it the Great Run. Extraordinary
15 actions by government, and governments around the world were
16 required to stop it, as Secretary Geithner explained.

17 Let me conclude. There are many lessons to be
18 learned from the crisis. For me, the most important is that
19 the shadow banking system is indeed a banking system engaged
20 in the same type of activity as banks.

21 Thus, I believe that the key guidepost for reform
22 of our financial structure is simple. What an institution
23 does, not what it is called, should determine how it is
24 regulated.

25 I look forward to your questions, and I thank

1 you.

2 CHAIRMAN ANGELIDES: Thank you, Mr. McCulley.

3 Mr. Neal?

4 WITNESS NEAL: Thank you.

5 Chairman Angelides, Vice Chairman Thomas, and
6 Members of the Commission:

7 I appreciate the opportunity to appear before you
8 here today. My name is Mike Neal. I am the Chairman and
9 CEO of G.E. Capital and a Vice Chairman of General Electric
10 Company.

11 We at G.E. and G.E. Capital hope that our
12 participation on this panel today is helpful as you pursue
13 your important mission of analyzing the causes of the
14 financial crisis.

15 I grew up in Georgia. I graduated from Georgia
16 Tech and started with G.E. 31 years ago. I actually started
17 out on the industrial side of the company. I moved into
18 financial services back in the mid-1980s, and I've had a
19 series of operating roles since that time. I became
20 President and Chief Operating Officer of G.E. Capital back
21 in the 1990s. I became the CEO of G.E. Commercial Finance
22 in the early 2000s, and then the CEO of G.E. Capital a few
23 years ago.

24 I am proud to lead a company that has focused on
25 lending to Main Street businesses and consumers. Our

1 lending supports more than 170,000 small businesses in their
2 daily operations.

3 Our business relationships include household
4 names like Lowe's, GAP, EBay, JC Penny's, Rooms To Go, and
5 Wal-Mart. G.E. Capital is a market leader in mid-market
6 commercial lending, equipment lending, leasing, middle-
7 market corporate finance, aircraft financing, health care
8 financing, franchise financing, fleet leasing, dealer
9 financing, energy financing. If you flew in here today on
10 U.S. Air, you probably flew in on one of our aircraft.

11 We concentrate on extending straightforward
12 commercial loans and capital to largely middle-market
13 customers. We underwrite these loans to hold, not to sell.
14 We match-fund our debt, a policy that allows us to manage
15 risk associated with the funding for specific assets.

16 Our leverage is quite low. We did not and do not
17 originate CDOs or SIVs. We did not and do not sell credit
18 default insurance. We did not and do not trade derivatives.
19 And what we do use with derivatives, what some people might
20 call the old-fashioned way, we hedge responsibly against
21 interest rate, exchange rate, and other fluctuations in our
22 liabilities.

23 Our business is focused on Main Street. And when
24 small business and their customers succeed, so do we.

25 The turmoil in the markets over the past two-and-

1 a-half years has been unlike anything I have ever
2 experienced during my 30 years at G.E. Many Americans have
3 lost their savings, their jobs, their homes, and confidence
4 in our financial system and its institutions has been
5 shaken.

6 We think it is good for policymakers to think
7 about regulatory reforms. Yet, even with the market turmoil
8 of the past two-and-a-half years, we have continued to lend
9 to Main Street throughout this period. We will continue to
10 do so.

11 We extended \$96 billion of new credit in the
12 fourth quarter of 2008. As the crisis unfolded, we
13 maintained our focus on lending to Main Street, while
14 strengthening our credit risk management and shrinking our
15 balance sheet.

16 G.E. Capital was able to meet its short and long
17 term funding needs throughout the financial crisis. G.E.
18 raised more than \$15 billion of capital through an equity
19 offering, and managed through the challenges of the past
20 three years without seeking extraordinary assistance through
21 the Federal Government's TARP Capital Purchase Program.

22 Of course G.E. Capital did participate in CPFF
23 and TLGP Programs, which were very important and meaningful
24 for us. My colleague, Mike Barber, will speak to those
25 programs in just a minute.

1 G.E. is, first and foremost, an industrial
2 company. G.E. Capital's focus on middle-market commercial
3 lending is consistent with our parent's company focus. We
4 will continue to maintain a straightforward and focused
5 portfolio and emphasize risk management, capital allocation,
6 and cost.

7 Before, during, and after the crisis, G.E.
8 Capital has avoided riskier structured finance businesses,
9 reduced balance sheet and risk, and strengthened capital
10 ratios, while enhancing its liquidity.

11 These actions have made us a much stronger
12 company. We have fully appreciated that our middle-market
13 customers are critical to turning around the economy and
14 stand ready to continue working with them in the years
15 ahead.

16 I hope you will find Mark Barber's discussion of
17 our commercial operations helpful, and I welcome your
18 questions.

19 CHAIRMAN ANGELIDES: Thank you, Mr. Neal. Mr.
20 Barber?

21 WITNESS BARBER: Chairman Angelides, Vice
22 Chairman Thomas, and Members of the Commission:

23 Thank you for the opportunity to appear here
24 today. My name is Mark Barber, and I am Deputy Treasurer of
25 General Electric Company, and G.E. Capital, with

1 responsibility for short-term funding and investment.

2 I joined G.E. Capital in 1989 as Assistant
3 Treasurer for Short-Term Funding, after 10 years with Ford
4 Motor Company's Financial Services Unit. And during my more
5 than 20 years at G.E., my work has related to the company's
6 short-term funding and investment activities.

7 I manage G.E. Capital's commercial paper program.
8 It is one of the company's overall funding and liquidity--it
9 is part of the company's overall funding and liquidity
10 operation.

11 I will provide a brief overview of G.E. Capital's
12 commercial paper funding program and government programs
13 established during the financial crisis.

14 Unlike many of the structured financial products
15 that have come under scrutiny in the wake of the crisis,
16 unsecured commercial paper is not a new or complicated
17 product. G.E. Capital has issued commercial paper since
18 1952. Today, G.E. Capital continues to issue commercial
19 paper to meet its liquidity and funding needs. This is a
20 market that is long known for its depth, efficient pricing,
21 informed investors, and transparency.

22 G.E. Capital, unlike most other commercial paper
23 issuers, prices and sells commercial paper directly to
24 investors without going through dealers. We determine each
25 day how much cash we want to raise based on a number of

1 factors, including the amount of the company's maturing
2 commercial paper, and its current and projected liquidity
3 profile.

4 We set pricing daily based on our borrowing needs
5 and market factors, and then present to potential investors
6 our pricing scale for newly issued commercial paper.

7 Our primary commercial paper purchasers are
8 institutional investors, including investment managers,
9 money market mutual funds, state and local governments,
10 corporations, and a variety of other institutions.

11 G.E. Capital maintains strong relationships with
12 commercial paper investors, many of which have been
13 purchasing commercial paper directly from us for years.

14 As the credit markets began to experience stress
15 in 2007, G.E. monitored changing market conditions to ensure
16 stable and prudent short-term funding. To this end, G.E.
17 periodically reviewed its key drivers of liquidity, debt
18 issuance and maturities, backup credit lines, asset
19 origination and income, access to securitization and
20 syndication platforms, and other liquidity sources.

21 In 2008, many financial institutions faced a
22 stagnating debt market, a weakening secondary market, and
23 growing investor concerns over safety and security.

24 The bankruptcy filing of Lehman Brothers on
25 September 15th placed significant pressure on money market

1 funds, a number of which held Lehman-issued commercial
2 paper.

3 In particular, the reserve primary fund was
4 forced to write down \$785 million in holdings of Lehman-
5 issued commercial paper, and subsequently announced that it
6 had, quote/unquote, "broken the buck" on September 16th.

7 The fund experienced massive demands for investor
8 liquidations that it could not fully honor. Investors began
9 to question the vulnerability of other prime funds, and as a
10 result began a more widespread withdrawal from prime
11 institutional money market funds.

12 In October of 2008, the government took steps to
13 restore investor confidence in the short-term funding
14 market. These steps included the creation of the Federal
15 Reserve's Commercial Paper Funding Facility, or the CPFF,
16 and the FDIC's Temporary Liquidity Guarantee Program, or
17 TLGP.

18 G.E. Capital participated in both the CPFF and
19 the TLGP. G.E. is proud of the way we've managed our
20 business through this crisis. We kept the company safe and
21 secure and, with the support of our investors, continued to
22 fund our operations every day, despite volatile and stressed
23 markets.

24 We also respect the important role federal
25 officials played to reassure investors and navigate the

1 market uncertainty. Going forward, G.E. Capital will
2 maintain its conservative business model. We all hope never
3 to experience anything like the events of the Fall of 2008
4 again.

5 Our continued aim is to maintain and improve
6 shareholder value through smart, safe, and secure lending
7 and funding practices.

8 I hope my testimony today has been useful to the
9 Commission, and I look forward to answering your questions.
10 Thank you.

11 CHAIRMAN ANGELIDES: Thank you very much, Mr.
12 Barber. Mr. Meier? MAI-ER or MAY-ER?

13 WITNESS MEIER: It's "My-er" actually.

14 CHAIRMAN ANGELIDES: Mr. Meier.

15 WITNESS MEIER: Thank you.

16 Chairman Angelides, Vice Chairman Thomas, and
17 Members of the Commission:

18 Thank you for the opportunity to appear before
19 you today. My name is Steven Meier. I am the Chief
20 Investment Officer for Global Cash Management at State
21 Street Global Advisors, which is the investment management
22 arm of State Street Corporation.

23 I have more than 26 years experience in financial
24 services, with a focus on traditional money markets, fixed
25 income, global cash, and financing.

1 The events of 2007 and 2008 were unprecedented,
2 and their consequences were devastating. Millions of people
3 saw the values of their homes and savings decline, business
4 fail, and our economy entered into a severe recession.

5 On behalf of State Street, I would like to
6 express our gratitude to the American people and our leaders
7 for their resolve and determination throughout this
8 difficult period in our Nation's history.

9 Although many are still suffering, the commitment
10 of America's people and institutions has put us on a path to
11 recovery.

12 My understanding is that the Commission is
13 primarily interested in three short-term lending activities:
14 repurchase agreements, commercial paper, and securities
15 lending. I would be happy to answer questions on each of
16 these topics as appropriate.

17 It is important with respect to all these
18 instruments that institutions properly assess and manage
19 risk. At State Street Global Advisors we have a dedicated
20 credit team tasked with evaluating counterparty and issuer
21 risk.

22 This group considers a range of factors in
23 assessing potential client counterparties, and thoroughly
24 investigates the quality of the underlying collateral.

25 In the commercial paper market, particular

1 emphasis is placed on vetting issuers and examining the
2 liquidity support providers.

3 This rigorous credit analysis helps protect our
4 clients and allowed State Street Global Advisors to focus on
5 solid investments during difficult market conditions.

6 None of the money market funds advised by State
7 Street Global Advisors risked breaking the buck, and the
8 other cash products underlying our securities lending
9 program have not experienced material credit losses.

10 The credit and asset-backed markets, however,
11 have experienced extreme illiquidity and credit spread
12 widening, and the market price for those products have not
13 always reflected the quality of the underlying assets.

14 Neither State Street nor our cash funds had
15 material exposure to Bear Stearns immediately prior to its
16 sale, and while some of our clients did have collateralized
17 securities lending and repurchase agreement exposure to
18 Lehman Brothers and its affiliates, our clients did not
19 incur any investment losses as a result of such exposure.

20 I have thought long and hard about the lessons
21 learned from the financial crisis. I would like to
22 highlight three points in particular.

23 First, credit quality alone may not be sufficient
24 to protect against price degradation when there is limited
25 market liquidity.

1 Second, the secondary market liquidity mechanism
2 has proven less reliable in a severely distressed market,
3 which has implications for portfolio construction.

4 And third, I believe the industry has
5 increasingly recognized the need for substantial additional
6 committed resources and infrastructure to manage money
7 market assets.

8 Let me also say that I do not believe the blame
9 for this crisis can be attributed to any single event,
10 entity, product, or decision. In my view, the financial
11 crisis flowed from a confluence of factors, many of which
12 the Commission is investigating.

13 In particular, I would point to excessive
14 leverage and inadequate capital requirements which
15 ultimately contributed to a lack of liquidity and frozen
16 credit markets.

17 Thank you again for the opportunity to be here
18 today. I will be pleased to answer any of the Commission's
19 questions.

20 CHAIRMAN ANGELIDES: Thank you very much,
21 gentlemen.

22 So we will now start our questioning. Let me
23 just start with a very few before we go to the Vice Chair,
24 and let me start with you, Mr. McCulley.

25 I was struck by something in your testimony, both

1 written and verbal, about the vulnerability to the system
2 still today. Let me ask you just the fundamental question,
3 because you really end on the note that institutions ought
4 to be treated and regulated for what they do, not how
5 they're legally defined.

6 And so does that argue for more sweeping deposit
7 insurance? Or how do you really, truly--how could you have
8 mitigated historically, or today, the possibility of a run?

9 WITNESS McCULLEY: As Secretary Geithner was
10 testifying earlier, there were large nonbank levered
11 institutions that were systemically important but weren't
12 regulated at the consolidated level with respect to capital,
13 or liquidity buffers, or activities that they could engage
14 in.

15 They escaped, if you will, the regulatory
16 umbrella of the conventional banking system. And the
17 crisis, the run, originated in the shadow banking system and
18 moved over into the conventional banking system.

19 And as the case with Lehman's failure, we could
20 not have a orderly bankruptcy because we did not have a
21 resolution authority to unwind that firm in a orderly way.
22 And we found out that a disorderly bankruptcy created huge
23 collateral damage, not just for the financial system, but
24 for the real economy.

25 And, quite frankly, we still don't have such a

1 resolution authority. So my most important message with
2 respect to your question is that we need the ability in our
3 country to have orderly failure, because disorderly failure
4 of a systemically important institution is simply too
5 painful for our economy.

6 CHAIRMAN ANGELIDES: Would the presence of a
7 resolution authority in and of itself have mitigated the
8 possibilities of runs on Bear and on Lehman and on other
9 nonbank institutions?

10 WITNESS McCULLEY: By itself I don't think that
11 resolution authority is the solution. I think we need a
12 whole mosaic of regulatory arrangements to make our system
13 less vulnerable to runs.

14 And I would point out that runs happen on
15 institutions, and then spread throughout the system, because
16 you have important institutions that have inadequate
17 capital, and perhaps dodgy assets, and when that is
18 recognized by the investment public they naturally withdraw.

19 So actually having bigger buffers of capital in
20 Systemically important institutions, regardless of what their legal
21 structure is, I think is an important safeguard. People do
22 not initiate a run on a bank that is sound.

23 Now after you get a run, you can see a cascading
24 effect. But the original run involves fundamental problems
25 with an institution.

1 CHAIRMAN ANGELIDES: All right. In March of
2 2008, in one of Mr. Thomas's and my home state papers,
3 actually the hometown paper of Ms. Born, the San Francisco
4 Chronicle, you said, quote, "People had levered half the
5 distance to the moon in dodgy assets."

6 So I guess this is a way of saying you thought
7 they were over-levered and in very risky assets. But let me
8 ask you a question. At what point was there knowledge by
9 repo lenders, at what point did that become relevant to repo
10 lenders?

11 Take me through late 2007-2008 and the
12 recognition by repo lenders, other short-term lenders, as to
13 this fundamental problem. Why wasn't that evident before
14 that time?

15 WITNESS McCULLEY: I think it was evident. And
16 it became quite evident in the summer of 2007 when you saw
17 the funding for the shadow banking system become more dear
18 and less available. And actually it was in the asset-
19 backed commercial paper market before it was demonstrated in
20 the repo market.

21 And if you had to pick a day when I think the
22 recognition really hit, was August 9th of 2007 when Bank
23 Paribas froze redemption in three of its off-balance sheet
24 vehicles. And that was the ringing of the bell I think to
25 the short-term funding markets that the assets that they

1 were owning, whether it's asset-backed commercial paper or
2 repo, had become informationally sensitive. And when it
3 comes informationally sensitive, you will have a pulling
4 back.

5 So actually for us involved in the market, and I
6 think for the market at large, you really have to go back to
7 the summer of 2007.

8 CHAIRMAN ANGELIDES: But it was event driven, but
9 up until that time you relied on--the information you relied
10 on was, what, credit ratings, an assumption that the
11 collateral was sufficient, that there weren't underlying
12 problems in the collateral itself?

13 WITNESS McCULLEY: I think as a general--

14 CHAIRMAN ANGELIDES: Really, kind of going to
15 your, the lender's level of due diligence?

16 WITNESS McCULLEY: I think that's a very
17 important point.

18 CHAIRMAN ANGELIDES: Because actually, let me
19 just add something else you said because I think it's
20 important. You actually spoke about how the later stages of
21 the bubble were driven by mortgage originators: They
22 originate to distribute outfits who were turning
23 underwriting standards into a very, very sad joke. That was
24 the marginal source of finance for the marginal buyer-
25 speculator.

1 You then go on to say: Getting a handle on this
2 phenomenon, which clearly the Fed did not, required more
3 than macro data. It required good, old-fashioned
4 shoe leather research.

5 So I would ask, of the funders as they saw what
6 was entering the system, the collateral that was backing the
7 asset-backed commercial paper, the nature of the assets in
8 the institutions who were doing the loan, kind of what level
9 of due diligence, what level of recognition did you have
10 before August 9, 2007?

11 WITNESS McCULLEY: Clearly the industry at large
12 was not doing adequate due diligence, and was outsourcing
13 it, if you will, way too much to the rating agencies, and
14 also to the conventions of the tri-party repo system where
15 your lesser quality assets were repoed.

16 From the standpoint of what we were doing at
17 PIMCO, and this was long before 2007, we have never used
18 asset-backed commercial paper in our routine liquidity
19 management. We simply haven't used the product.

20 We were unique I think in the industry of not
21 using asset-backed commercial paper--

22 CHAIRMAN ANGELIDES: Because you felt you
23 couldn't understand it? You didn't really know what was
24 behind it?

25 WITNESS McCULLEY: The key reason is that asset-

1 backed commercial paper was issued by off--in the main, by
2 off-balance sheet vehicles, conduits, and SIVs. And if I
3 couldn't do the due diligence on what the SIV was holding on
4 the asset side, then I did not want on behalf of our clients
5 to own the liabilities.

6 I did not want to own the liability of what I did
7 not know on the other side, so we didn't. I would also note
8 that we at PIMCO were not participants in the tri-party repo
9 market where the lesser quality assets were funded by the
10 shadow banking system.

11 We were engaged in the bilateral repo market on
12 Treasury and agency collateral. So when I look back at how
13 we ran our business for our clients, we simply were not
14 involved in those two arenas.

15 CHAIRMAN ANGELIDES: All right.

16 Mr. Neal, just as a follow up, did you hear the
17 prior session with Mr. Geithner at all?

18 WITNESS NEAL: Just small pieces of it.

19 VICE CHAIRMAN THOMAS: Microphone on.

20 CHAIRMAN ANGELIDES: Yes, microphone.

21 WITNESS NEAL: Sorry.

22 CHAIRMAN ANGELIDES: Well I had asked him, and
23 you might shed light on this, I had asked him--because one
24 of the things I know that our staff talked to the G.E. folks
25 about is your continued ability to issue commercial paper

1 even during the depths and the difficulty of the crisis, and
2 apparently we've received information that shows you
3 continued to do it all the way through as, I believe, with
4 fairly consistent spreads below LIBOR. I was looking at our
5 Director, who did not know me--

6 (Laughter.)

7 CHAIRMAN ANGELIDES: But is that an accurate
8 statement?

9 STAFF DIRECTOR: Yes.

10 CHAIRMAN ANGELIDES: Yes. Even though she didn't
11 acknowledge me, she did hear me. But I was curious about a
12 couple of things. I asked Mr. Geithner about, you know,
13 some critical days: September 29th, September 30th, when
14 that's in the wake of the official announcement by AIG that
15 it had signed a definitive agreement to obtain an \$85
16 billion line of credit. It's over the weekend when Goldman
17 and Morgan Stanley become bank holding companies.

18 On Monday, September 29th, the Dow dropped 777
19 points after the House of Representatives voted down the
20 financial bailout bill.

21 So this is a pretty critical time. And what I
22 was trying to get a handle on is, in those conversations, or
23 other conversations, was G.E. expressing a deep concern
24 about your ability to continue to issue commercial paper?

25 So that was one set of questions. Mr. Neal? Mr.

1 Barber? Either one of you?

2 WITNESS NEAL: I'll start with that, if that's
3 okay. In the early days--well, early days, late summer--you
4 know, we actually benefitted I think from a flight to
5 quality in some cases in our CP program.

6 Now we're not naive to what was going on in the
7 market, particularly as you moved more into September, but
8 we were able to sell our quota every day, what we were
9 trying to raise. I think you've seen the data on that.

10 The markets were choppy. We were concerned about
11 the markets and the direction of the markets and where they
12 might ultimately end up. But having said that, we were
13 doing okay.

14 I would say it got more difficult after the
15 reserve fund, after Lehman. Having said that, we were still
16 issuing, and issuing successfully, through that period.

17 I think a lot is to the strength of G.E., a AAA-
18 rated player, at least at that time. We were downgraded in
19 the first quarter, but I would answer your question that
20 way.

21 CHAIRMAN ANGELIDES: Yes, but to get to the
22 extent of the crisis, did G.E., Mr. Immelt, yourself, other
23 representatives, urge for example the Federal Reserve to
24 initiate the CPFF program and other support programs because
25 you were concerned about the ability to continue to issue?

1 WITNESS NEAL: We had a number of people--and
2 Mark might be better to talk to that than me--that were in
3 contact with different members of government. I never had a
4 conversation with Mr. Geithner, or Secretary Paulson, about
5 something like that.

6 WITNESS BARBER: Mr. Chairman, just to echo Mr.
7 Neal's comments, in the period up to Lehman Brothers we were
8 funding normally in the markets and benefitting from,
9 through in fact the asset-backed commercial paper challenges
10 that Mr. McCulley has described, a bit of a flight to
11 quality, as investors pulled back from some of those
12 structures and came to recognize names like G.E.

13 And after Lehman Brothers and the Reserve Fund,
14 it is true that we had regular dialogue with the Federal
15 Reserve Bank of New York, their team there, that had I think
16 a meaningful outreach process to many members of the market,
17 many issuers and investors on both sides. Their job was to
18 find out what was going on and how the markets were
19 performing. And we of course shared our experience with
20 them as we went through that crisis. So there was regular
21 dialogue.

22 And through there, they were aware of the
23 withdrawal of liquidity from some of the funds and the
24 challenges it would have created across the whole market.
25 And we simply shared with them our experience in issuing

1 every day.

2 CHAIRMAN ANGELIDES: One more question on this
3 line, and then I want to stop and move on. You were pretty
4 big participants in both the TLGB program, which was the
5 FDIC backstop long term debt. I think you borrowed I think
6 at one point about eighty? Does that sound about right?
7 \$80 billion?

8 WITNESS BARBER: Yes.

9 CHAIRMAN ANGELIDES: I think you've paid it down,
10 though. You still have about \$59 billion outstanding. \$21
11 billion has been repaid. You were a big participant in the
12 CPFF program, even though I believe you are no longer in
13 that program? Is that accurate, or not?

14 WITNESS BARBER: That is correct, sir. The
15 program is shut down, and you may know that the program took
16 in three-month commercial paper, issued into it, and
17 whatever we put into the program we paid down on our first
18 roll, as the market began to heal and to improve.

19 CHAIRMAN ANGELIDES: So I guess my only question
20 is: Did you participate in those programs because you
21 needed to, or because they offered favorable pricing that
22 allowed you to be competitive with others in the market?

23 WITNESS BARBER: Sure. I'm glad you asked the
24 question. What I would say to you is that in the period
25 after the reserve fund, G.E. Capital honored requests for

1 liquidity from many of our investors who needed to move to
2 cash.

3 And in the two or three week period following
4 that, those requests were significant and we did our best to
5 provide that liquidity to the market. In fact, that was the
6 basis for our communication to our investors, and publicly,
7 when we announced that we were going to apply for the CPFF,
8 that we would use this as a process to provide liquidity.

9 CHAIRMAN ANGELIDES: To meet your own liquidity
10 needs, which were a function of--

11 WITNESS BARBER: --investors liquidity, very much
12 like what the asset-backed commercial paper program was
13 doing for the Fed. So funding ourselves through, and
14 helpful to investors in providing liquidity to them, and it
15 was very useful that way.

16 But after the first issuance into it, we matured
17 out everything and ended in probably February I think it
18 was.

19 CHAIRMAN ANGELIDES: All right. Thank you, very
20 much. Mr. Thomas?

21 VICE CHAIRMAN THOMAS: I am interested in a
22 couple of different directions, and I am pleased to have you
23 in front of us.

24 One, because although it's partially useful,
25 pathology isn't all that much fun in talking to folks that

1 used to be there. You have come out the other end and
2 you're still here.

3 So you might have a slightly different look at
4 tomorrow than you had yesterday, based upon having survived.

5 I am trying to understand--let me ask it this
6 way, and I am really just asking any of you who want to
7 respond, to respond.

8 You're sitting at the table. You are in some
9 kind of a general category like shadow banking, or non-
10 traditional banking, however you want to phrase it. Do you
11 folks look at each other as competitors? What's the
12 business relationship that you feel toward each other? Does
13 that make sense? Are you in such discrete areas of
14 involvement that none of you are in direct competition? Do
15 you seek out a niche that doesn't put you in direct
16 competition with others, notwithstanding the fact you're
17 supplying a service and you're using a similar financing
18 mechanism which isn't in the traditional system?

19 WITNESS MEIER: Mr. Vice Chairman, if I can
20 address that, I would say that we are also a fiduciary and
21 an investment manager. We don't take proprietary risks. So
22 in that respect, we are a competitor of PIMCO.

23 We also have significant business dealings with
24 PIMCO at the State Street Corporation level, as providing
25 clearing and custody operations for them.

1 I should also mention that we are a significant--

2

3 VICE CHAIRMAN THOMAS: Are you trying to put them
4 out of business by being better at what you do?

5 WITNESS MEIER: They're very good at what they
6 do, but I think we're very formidable as well. So I think
7 it's more of a friendly competitive rivalry.

8 In terms of our relationship with G.E. and G.E.
9 Capital Corp. in particular, we are a significant investor
10 of their assets, both commercial paper and medium-term
11 notes.

12 VICE CHAIRMAN THOMAS: One of the things that
13 amazes me is that this particular niche isn't a niche
14 anymore. And that you grew to equal the commercial banking
15 side in volume, living off of finding your daily bread every
16 day, versus the more traditional model.

17 I'm trying to determine whether you feel in the
18 way in which you get your assets a certain camaraderie,
19 commonness of function, that you now look at the person next
20 to you slightly differently than you did a couple of years
21 ago in terms of whether or not you can sustain the model
22 that you have, what you've been through?

23 I really do--and I'll make it specific to you,
24 Mr. McCulley--I really do believe there can be runs on banks
25 that are sound. Because it would be based on inaccuracies,

1 rumors that have no truth to them, but that doesn't mean
2 that you can't produce a run. And that was one of the
3 reasons they created that backstop of FDIC and the rest to
4 give a comfort level, and obviously that isn't available to
5 you.

6 Do you believe that you can do a better job on
7 the margins on return on capital than the commercial banks?

8 WITNESS McCULLEY: First and foremost, PIMCO is
9 not a shadow bank.

10 VICE CHAIRMAN THOMAS: No, I understand.

11 WITNESS McCULLEY: PIMCO is an investment
12 manager.

13 VICE CHAIRMAN THOMAS: None of you are the "bank"
14 part of the "shadow banking." And I don't want to dwell on
15 the specificity of the definition. I'm trying to take a
16 group of people who stay alive in a particular type of
17 market.

18 WITNESS McCULLEY: I think all of us as
19 participants in the money markets have deeper appreciation
20 than we had a few years ago at just how vulnerable the
21 system can be to a loss of confidence.

22 And I think collectively in our industry that we
23 recognize the need for levered institutions that don't have
24 access to our lender of last resort, or deposit insurance,
25 to have robust capital buffers, as well as liquidity buffers

1 such as backup lines of credit with conventional banks.

2 From the standpoint--

3 VICE CHAIRMAN THOMAS: And we also don't want any
4 dodgy assets.

5 WITNESS McCULLEY: Well, and--

6 VICE CHAIRMAN THOMAS: So would you define for me
7 how you avoid dodgy assets?

8 WITNESS McCULLEY: First and foremost is, as an
9 investment manager you do your homework. You have a
10 fiduciary duty to your clients to invest in quality assets.

11 VICE CHAIRMAN THOMAS: So I have nothing but AAA.

12 WITNESS McCULLEY: No, that's not necessarily the
13 case. Doing your homework is not outsourcing your credit
14 research to the rating agencies, but actually doing it
15 yourself. It's due diligence on companies, due diligence on
16 industries, and actually, if I might, I will tell you
17 something that we did at PIMCO back in 2005 and 2006.

18 We started in '05 when we believed that there
19 were serious signs of bubbles in the property market. We
20 sent out credit analyst to 20 different cities to do some
21 old-fashioned shoe leather research. Literally, 20 cities
22 around the country, getting on the ground, speaking with
23 real estate brokers, mortgage brokers, and players in the
24 real estate market in each local area in order to determine
25 just what was going on in the markets, including this

1 degradation, the outright degradation of underwriting
2 standards.

3 So we literally got on the ground and observed
4 it. And when our group came back, they reported what they
5 saw and we adjusted our risk accordingly.

6 VICE CHAIRMAN THOMAS: So you got out of the
7 mortgage--

8 WITNESS McCULLEY: We severely limited our
9 participation in the private-label mortgage securitization.

10 VICE CHAIRMAN THOMAS: Well especially if you're
11 in Orange County and you could observe not only your
12 neighbors but yourself in terms of what happened in the real
13 estate market.

14 In terms of G.E.'s role, size, perspective, did
15 you ever think what happened could happen? I mean, there
16 was always a possibility, wasn't there, that what you
17 thought were assets that you had to rely on for your daily
18 bread in turning them over that somebody might just say no?
19 And of course if they never had, you don't anticipate that,
20 right?

21 WITNESS NEAL: I think, you know, from my
22 perspective I never anticipated that things could be as bad--
23 --it hadn't happened in my lifetime--as we saw in the Fall
24 and Winter of 2008, principally from a funding standpoint.

25 Our assets have actually held up pretty well

1 through the recession. Just under--just to make a point,
2 G.E. Capital is different than State Street and PIMCO. What
3 we do is we have 8000 sales people that call on CFOs, and we
4 originate, we finance, we lease, it's what we do.

5 People like PIMCO and State Street support us by,
6 you know, working with us on the debt side.

7 VICE CHAIRMAN THOMAS: And you have a foot
8 through the door because of the first two letters of your
9 name.

10 WITNESS NEAL: We are highly rated. And we are
11 highly profitable. We have run what we think is a pretty
12 wonderful business for a long period of time, and so we are
13 attractive.

14 I think, as I mentioned earlier, there was a
15 flight to quality, at least for awhile, with us through
16 that. But the--

17 VICE CHAIRMAN THOMAS: So you had no worries at
18 all during this period?

19 WITNESS NEAL: Oh, tons of worries. Every, you
20 know, our customers--

21 VICE CHAIRMAN THOMAS: What was number one?

22 WITNESS NEAL: Just where were things going. You
23 know, for me, I start with Bear, go through the GSEs, Ed,
24 Lehman, watch the buck doesn't get broken. It's only
25 happened twice, very often. The investment banks become

1 bank holding companies. WaMu, the run on Wachovia.

2 VICE CHAIRMAN THOMAS: You used to know what
3 quality was and you couldn't quite define it anymore?

4 WITNESS NEAL: It was just a remarkable time,
5 from that standpoint. So you wonder. You worry about
6 everything, just like I'm sure all of you did during that
7 period of time. And, you know, what's the ultimate impact
8 on the economy? What's the ultimate impact on our business?

9 So we became I think both prudent and
10 conservative as we worked to manage our way through that
11 successfully. But we were concerned. I was concerned. But
12 we were successful as we went through that in funding
13 ourselves.

14 VICE CHAIRMAN THOMAS: Do you still think there's
15 a clear separation between the two financial structures? I
16 mean, as people talked about moving toward the Gramm-Leach-
17 Bliley removal of Glass-Steagall, that commercial banks were
18 moving more in the direction of your profile, it sounds to
19 me like you want to move more in the direction of some kind
20 of a support window that would allow you in difficult times,
21 if you followed certain rules. What comes out the other
22 side, from your perspective, that either advantages you or
23 disadvantages you in terms of your current business model?

24 WITNESS NEAL: I would say that what we do,
25 commercial banks typically don't do a lot of. We just have

1 a different business model. We tend to be in middle market,
2 and smaller businesses. We finance--we're a collateral
3 lender, in many ways.

4 When you think of commercial banks and Glass-
5 Steagall, that was more of a move into investment banking,
6 trading, proprietary trading. These are things that we
7 don't do.

8 I think the way to think about G.E. Capital is
9 just as an old-fashioned finance company. We happen to be a
10 big one. And we happen to be pretty successful. We're
11 global at it, and the business has been a strong contributor
12 to G.E.'s profits for quite a long period of time.

13 But that's the niche that we're in. We've become
14 what we think are experts on collateral classes, on customer
15 groups; whether that's franchise financing. If you drove
16 through D.C., a lot of the franchises you see, we may be the
17 finance company in that; aircraft, we're the biggest in
18 that; trucking. It's just things that banks don't do a lot
19 of.

20 VICE CHAIRMAN THOMAS: Yes, diesel engines on
21 railroads, and that sort of thing?

22 WITNESS NEAL: That sort of thing, yes.

23 VICE CHAIRMAN THOMAS: Mr. Meier, looking at what
24 the legislation is and where it looks like it's going, what
25 do you see that you'll have to change in terms of your

1 business model?

2 WITNESS MEIER: In terms of our business model
3 I'm concerned about the impact of legislation on the
4 availability of credit to consumers. Also I'm concerned
5 about the impact on our growth potential as a Nation, in
6 terms of slowing down that ability to lend.

7 I think when you look at our business--

8 VICE CHAIRMAN THOMAS: Well, but if you saw what
9 happened when we didn't slow down the lending, that ought to
10 at least temper you a little bit, shouldn't it?

11 WITNESS MEIER: Perhaps, Mr. Vice Chairman, but--

12

13 VICE CHAIRMAN THOMAS: It's tough to get out of
14 the hole we're in.

15 WITNESS MEIER: Yes. I think when you look at
16 our business and our assets and our management and the types
17 of assets we buy, potentially it may temper your view in
18 terms of the nature of the problem.

19 For example, as this point we've got about \$575
20 billion in assets under our management at our peak, well
21 over \$700 billion in cash. At our peak, over 80 percent of
22 those assets were invested in regulated banks.

23 We are a big buyer of time deposits, certificates
24 of deposit, commercial paper holdings; ninety percent plus
25 are dominated by bank holding company issuance.

1 Our repurchase agreement counterparties, now if
2 you include Goldman Sachs and Morgan Stanley, is 100 percent
3 financing for banks. The asset-backed commercial paper
4 conduits that we purchase are typically issued by banks.

5 We don't simply look at the assets, although we
6 do do due diligence. We know the sponsors, the entity. But
7 we also look through to the liquidity support providers.
8 And we wouldn't buy any asset-backed commercial paper
9 conduit unless we're 100 percent sure that they are fully
10 supported by a bank institution.

11 So the shadow banking system has got various
12 definitions, but from our perspective, Mr. Vice Chairman, we
13 agree that we prefer, given the risk tolerance of our
14 clients, to invest in highly regulated entities such as
15 banks.

16 VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman,
17 my time is up and I want to hear from others, but I just
18 want to reference the discussion about where we are.

19 Today the Dow went down 998 and a half points earlier. It
20 has recovered up to about -465. And that's the world we are
21 still in, obviously with worry about Greece.

22 Thank you, Mr. Chairman.

23 CHAIRMAN ANGELIDES: Just before we go to Ms.
24 Born, a very quick question for Mr. Neal and Mr. Barber.

25 Just a quick reaction. You are in the old-

1 fashioned finance business. You actually lend to businesses
2 that are creating products, employment. Just any visceral
3 reaction to--I assume you don't have on your books, you
4 don't carry as assets subprime CDOs, CDO-squared, other
5 structure products?

6 WITNESS NEAL: No. No, we don't.

7 CHAIRMAN ANGELIDES: Any judgment on their
8 utility to the financial system and larger economy,
9 synthetic CDOs, CDO-squared?

10 WITNESS NEAL: "Synthetic" is a bad word, I
11 think, Mr. Chairman. But, no, we don't do that.

12 CHAIRMAN ANGELIDES: Synthetic is a bad word, or
13 the devices are not particularly good?

14 WITNESS NEAL: I think, you know, I run a finance
15 company. We are just not in those businesses. I think
16 there certainly are products like that that I think weren't
17 understood well in some cases, maybe not rated well in some
18 cases. But it's not a line of business that we're in.
19 We've been quite disciplined about that.

20 We do a number of things, but in most cases it's
21 financing, leasing, lending, and middle to small--now we do
22 it in 50 countries around the world, but we stayed to that.
23 We don't have a broker-dealer. We're not a--we don't
24 originate to sell. We originate for our own balance sheet.
25 And that's a business that we've grown quite a bit over the

1 last 30 years, and it's attractive.

2 Now we went through a tough cycle, as did
3 everybody else, in the last two years. But we are coming
4 out of it now. I would say the good news is things are
5 better, at least in terms of our operations. So we do feel
6 better about it. But I'm not an expert on those products.

7 CHAIRMAN ANGELIDES: Ms. Born.

8 COMMISSIONER BORN: Thank you, very much.

9 And thank you all for being willing to appear
10 before us and help us with our investigation. I think my
11 first questions I want to direct to Mr. Neal and Mr. Barber
12 about G.E. Capital, which I do consider to be part of the
13 shadow banking system, although not part of the investment
14 banking system. Because I think you do borrow money, and
15 lend it the way banks do, but you're on a different model
16 than the investment banks. You're not regulated as a
17 commercial bank, although I understand you do have a thrift
18 subsidiary in your affiliates.

19 I understand that you are the biggest, the
20 world's biggest issuer of commercial paper? Is that right?

21 WITNESS BARBER: We, worldwide, are the largest
22 issuer of commercial paper. In the United States we are
23 probably in the top five, but I don't believe we're the
24 largest issuer now. But we are a large issuer, yes, ma'am.

25 COMMISSIONER BORN: Well let me ask you about

1 what kind of problems were experienced in the commercial
2 paper market during 2008, for example, as first of all Bear
3 Stearns failed and was acquired by JPMorgan, and then later
4 in September we had Lehman Brothers and the GSEs and AIG get
5 into trouble.

6 I noticed, I'm sure there was a lot of turmoil in
7 the markets during that period of time. Mr. Barber, would
8 you like to respond to that?

9 WITNESS BARBER: Sure. Commissioner, you've
10 referenced an extended period of time. The period of 2007
11 when I think the marketplace, particularly asset-backed
12 commercial paper began to experience some challenges, as I
13 mentioned earlier we, as we have at different points, stress
14 in the money market in past years actually benefitted a
15 little bit as our investor base for G.E. and G.E. Capital
16 Paper, we had a little bit of a flight to quality back to
17 us; investors that may not have worked with us for awhile
18 came back.

19 So we saw continued good demand. And I would
20 also quickly add that we're an issuer of commercial paper in
21 the U.S., and also in other markets around the world. So
22 similar experience there.

23 And one of the advantages that we had, which I
24 mentioned in my opening remarks, is that we deal directly
25 with end investors. So we don't work through an

1 intermediary. The relationship we have with the portfolio
2 managers and the credit teams, and the leadership teams at
3 organizations like State Street Global Advisors, and PIMCO,
4 and many others, really helps us better understand the
5 portfolio strategies and plans that they have.

6 They have their views on G.E. and G.E. Capital,
7 and it's our opportunity to express to them our company's
8 performance, our funding plans, our liquidity models. So
9 that direct relationship is very important to us. It's part
10 of our DNA, and it is one of the things that really helped
11 us through the entire period that you're talking about.

12 I think that in the period following--in the
13 commercial paper market--following the events that we've
14 talked about, Lehman, and Reserve, and so forth, you began
15 to see some conditions that we had never seen before.

16 And in the range of 45 percent of our funding
17 would have come at that point in time from the money market
18 fund industry, which tells you that we also had 55 percent
19 or so of our funding that came from sources different from
20 those.

21 So well diversified investor base. But when you
22 began to see withdrawals of liquidity from some of the
23 portfolios, their natural reaction would have been to
24 protect their cash, to hold cash, and therefore reduce
25 demand for longer dated paper.

1 One of the important metrics that we have around
2 G.E. Capital's program is that we keep what we think is a
3 fairly long and modest average remaining term on the
4 program. It means it's well extended. It's well placed out
5 in the longer maturity ranges. And the money market funds
6 and other invest--

7 COMMISSIONER BORN: What would the longer
8 maturity ranges be? What's your average range?

9 WITNESS BARBER: You may know that commercial
10 paper can be issued, a 3A paper at least can be issued all
11 the way out to nine months.

12 COMMISSIONER BORN: Right.

13 WITNESS BARBER: And our average remaining term
14 at that period of time was somewhere in the 55 to 60 day
15 range, maybe a little bit more, which I think, I don't know
16 for sure, is generally on the longer end of how paper
17 programs are managed.

18 So we had what we thought was a long and
19 conservative goal in the reality with our program. And so
20 when we went into that period, we saw less demand for long-
21 term paper, but we still found many buyers. Again, this was
22 not just money funds that we'd sell to.

23 And as I mentioned also, we saw requests for
24 redemption of our paper early to meet liquidity demands,
25 which we did our best to honor.

1 So communication with our investors about their
2 plans and what they were seeing, opportunity to talk with
3 them about our own funding and liquidity plans and the
4 success we were having in marketing our own debt, and just
5 understanding where the liquidity pressures were coming.
6 All that helped us really navigate through the period.

7 It was very important, we thought, that some of
8 the actions that the government was taking to support
9 liquidity in not just our market but others, that those
10 steps were helpful in terms of bringing liquidity and
11 stability back to markets that had never seen anything like
12 this.

13 So I think the steps that they took--"they"
14 meaning the Fed and the CPFF, the asset-backed support
15 program which of course we weren't a part of but
16 accomplished pretty much the same thing, then ultimately the
17 TLGP were very, very useful.

18 COMMISSIONER BORN: And I suppose the support to
19 the money market funds had an impact, as well?

20 WITNESS BARBER: I forgot that. I think probably
21 my colleagues to the left and right can speak more to that
22 than I can, but I think you're correct.

23 COMMISSIONER BORN: Right. So since you weren't
24 in the asset-backed commercial paper market, you did not
25 feel that contraction that occurred in 2007 with respect to

1 that market?

2 WITNESS BARBER: We didn't feel that contraction
3 there. I would quickly add that we do have a small asset-
4 backed commercial paper program called Edison Asset
5 Securitization, which we're no longer originating assets in
6 there, so it's in a declining mode. It's a very small
7 program. So we didn't see any pressure there.

8 COMMISSIONER BORN: You did reduce I think your
9 issuance of commercial paper by 2009, compared to 2007, for
10 example. The statistics I have, and I'm not vouching for
11 their accuracy, was you had about \$106 billion of commercial
12 paper outstanding in 2007. And it was down to about \$50
13 billion in 2009. Is that right?

14 WITNESS BARBER: Your numbers are very close,
15 yes.

16 COMMISSIONER BORN: So you brought it down during
17 that period by about half. And I wondered why that
18 happened? Was it because of market conditions? Because you
19 didn't have the need for that much funding because you were
20 contracting your operations? Why was that?

21 WITNESS BARBER: Sure. As a member of the
22 corporate treasury team supporting the assets that are
23 underwritten that Mike has described to you, we are always
24 evaluating conditions in the marketplace to know how we can
25 support those assets, the pricing of our debt, the strengths

1 of the market.

2 So in that evaluation, as we were going through
3 the September and October period, a decision was made that
4 it would be prudent for us to reduce our reliance on the
5 commercial paper market, and we did.

6 We communicated that to the marketplace. We took
7 action to produce the numbers along the lines that you're
8 speaking of. And today, commercial paper as a percentage of
9 our total debt is a little less than 10 percent, about 9.1
10 percent of total debt, which we think is very conservative
11 and well managed, manageable. And that number is about \$46
12 billion today, worldwide; 80 percent of it in the United
13 States, the other 20 percent in markets outside the U.S. So
14 significantly less reliance on commercial paper.

15 COMMISSIONER BORN: I assume that you both feel
16 that you have survived this crisis rather better than, for
17 example, the big investment bank holding companies did,
18 which either had to become bank holding companies or were
19 acquired or went bankrupt.

20 What do you attribute that to, Mr. Neal?

21 WITNESS NEAL: Well I would say some of it is
22 just our model.

23 COMMISSIONER BORN: What aspects of your model
24 have protected you from this turmoil?

25 WITNESS NEAL: I would say we originate assets to

1 hold. We only originate assets to hold. And what I mean by
2 that is, if we did a transaction that was for 10 years, we
3 look at the risk in it as a 10-year risk.

4 Others, particularly in this period of time when
5 originate-to-sell or distribute became such a popular line
6 of business, your risk, the way you think about it is very
7 different. You may have it in your warehouse for 60 days.
8 And so the underwriting becomes: Can I sell it? Not will I
9 hold it to maturity.

10 And because of that, our portfolio, our losses,
11 which we're not immune to this cycle, but our losses have
12 performed well below the Fed cases. And so the business
13 itself is less impacted because of that.

14 I would say another thing is that we, again we
15 match-fund everything. And when we borrow, if we have a
16 transaction in Australia and we can't raise Aussie dollar, we
17 might raise that here and then swap into that. If we have a
18 five-year transaction and five-year money is not the right
19 way to raise capital that day, we may raise something else,
20 but we swap into that.

21 We do not--we do everything we can to only take
22 credit risk in these transactions that we have. So I think
23 that's a piece of it.

24 We were AAA. We were downgraded to AA, but
25 stable. Everybody--there's no one left. I mean, the whole

1 industry was in the first quarter of last year, but we were
2 able to get through this.

3 I think G.E. is an enormous source of strength
4 for us. When things got difficult, when we got concerned
5 with these markets, we cut our dividend. This is the
6 dividend from G.E. Capital back to G.E. It was 40 percent.
7 We brought it down to 10. We eventually brought it down to
8 zero just to keep capital in the company.

9 We adopted a program which we called "Safe and
10 Secure" at that moment in time. G.E. raised equity and put
11 equity into G.E. Capital--not the government, G.E. did that.
12 So a huge source of strength for our company in that regard.

13 We became very conservative at that period of
14 time. We took our commercial paper down. Today in the mid-
15 40. It's less than 10 percent of our stack. We raised
16 cash. Today we have over \$60 billion in cash on the balance
17 sheet. We have \$52 billion in backup bank lines. So today
18 we have 2-1/2 times coverage on the CP program. It's
19 expensive, but it is very safe, from that standpoint.

20 So when we saw what was coming--and of course the
21 company itself, the stock took a beating during this period
22 of time, although it's coming back nicely now; but we
23 adopted, we thought, the right strategy with our investors
24 to make the company very safe, and we have.

25 COMMISSIONER BORN: So part of it was a different

1 business model than the investment banks. For example, in
2 terms of both the kind of assets you had, the fact that you
3 were lending to hold and not to sell; your ability to call
4 on your parent and its rating for equity suffusions, or
5 other kinds of support.

6 I wanted to ask you about the thrift and the kind
7 of supervision that is being given by the Office of Thrift
8 Supervision, which I understand became G.E.'s consolidated
9 supervisor under the requirements, so that you would meet
10 the requirements of the EU which requires that in order to
11 do business in the EU any financial institution has to have
12 a consolidated supervision in its home country, or become
13 subject to EU regulation.

14 WITNESS NEAL: Um-hmm.

15 COMMISSIONER BORN: Does the Office of Thrift
16 Supervision impose capital requirements, and liquidity
17 requirements on G.E. as a whole, the entire holding company?
18 Or is it just imposing those on the thrift? Or something in
19 between? Some of the affiliated companies and not others?

20 WITNESS NEAL: To answer your question, the
21 Office of Thrift Supervision, you're very accurate in terms
22 of how--we had them as a result of the thrift, and then the
23 FSA gave them equivalency and they became our consolidated--
24 our regulator at that time.

25 They live with us. They are in the building.

1 They have offices. They do look at capital. They do look
2 at risk. And from a G.E. Capital perspective, they report
3 out. They talk to us on a regular basis. I meet with them
4 regularly. My CFO meets with them sometimes twice quarterly
5 in that regard.

6 So we are regulated. Not the same as a bank
7 holding company, but we are regulated by the OTS.

8 COMMISSIONER BORN: So they regulate all--

9 CHAIRMAN ANGELIDES: Would you like additional
10 time?

11 COMMISSIONER BORN: Maybe two minutes?

12 CHAIRMAN ANGELIDES: Sure. Absolutely.

13 COMMISSIONER BORN: So they regulate all of G.E.
14 Capital?

15 WITNESS NEAL: Um-hmm.

16 COMMISSIONER BORN: But do they go up to the
17 parent, G.E., or not?

18 WITNESS NEAL: They do, but most of their focus
19 is on the--

20 COMMISSIONER BORN: Financial operations, which
21 are clearly in G.E. Capital.

22 WITNESS NEAL: But you should also know,
23 Commissioner, that we are regulated all over the world. We
24 are regulated--we own banks. We're regulated in every
25 country we're in.

1 I read sometimes that we're not regulated. We
2 are. We feel regulated in that regard. We're regulated by
3 the Banque de France. We're regulated in Central Europe.
4 The first person I see when I travel to Japan is the Bank
5 Governor in Japan, because we're a large Japanese company,
6 as well. But we do have the OTS. And quite frankly that
7 was the only avenue available to us when that happened, and
8 they are with us, and they do regulate us.

9 COMMISSIONER BORN: How many people do they have
10 stationed at G.E. Capital? How many examiners?

11 WITNESS NEAL: Eight to ten.

12 COMMISSIONER BORN: Before this program, the
13 Consolidated Supervisory Entity Program of OTS was adopted
14 for you, did you have any regulation other than direct
15 regulation of the thrift affiliate?

16 WITNESS NEAL: We had that, and we had the Bank
17 of New York.

18 COMMISSIONER BORN: You had the Federal Reserve
19 Bank of New York you mean?

20 WITNESS NEAL: New York State Bank.

21 COMMISSIONER BORN: New York State Bank was your
22 banking regulator, state banking regulator?

23 WITNESS NEAL: That's right.

24 COMMISSIONER BORN: Thank you.

25 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

1 COMMISSIONER HOLTZ-EAKIN: Thank you,
2 Mr. Chairman, and thank you gentlemen for spending this time
3 with us.

4 Let me just pick up there on one last little
5 detail, which is sort of whether you view your supervision
6 by OTS in particular a stress test of the type that the Fed
7 would run under its Supervisory Capital Program, whether you
8 feel this is a comparable supervisory regime or not?

9 WITNESS NEAL: We think so. We spent a lot of
10 time in 2009 trying to--we stressed ourselves, and then had
11 an all-day investor meeting, 184 pages, on March 19th where
12 we took our whole business through our best--we had a lot of
13 help with this--the Fed stress cases. The OTS is involved
14 with us.

15 We think that we have stressed the business, and
16 the business has been stressed with the help of the OTS in a
17 way that is comparable.

18 COMMISSIONER HOLTZ-EAKIN: So you actually used
19 the Fed's stress--

20 WITNESS NEAL: As best we could. We got a lot of
21 advice on--obviously we weren't one of the 19 banks, but
22 our investors were asking for that so we did. It helped a
23 lot as we tried to make G.E. Capital one of the more
24 transparent companies out there. And I think that worked
25 for us, largely. And, frankly, we have performed below

1 base case since that time, and the business is better.

2 COMMISSIONER HOLTZ-EAKIN: Can I ask you one more
3 question about just sort of the business model, which is:
4 Do you have loans into commercial real estate, residential
5 real estate?

6 WITNESS NEAL: We do. We have--we have both
7 commercial and residential.

8 COMMISSIONER HOLTZ-EAKIN: Residential real
9 estate mortgages?

10 WITNESS NEAL: Yes. We owned a company. We
11 bought it in 2004, a company called WMC, which was in the
12 residential--it was in Burbank, California. We bought it.
13 We were in the business for about three years. We never got
14 very comfortable with it, and in about 2006 became
15 uncomfortable with the business model and exited the
16 business in early 2007. But we do have residential real
17 estate in other parts of the world.

18 We have a pretty good mortgage company in the UK.
19 We have a large residential mortgage company in France. And
20 we also have a residential mortgage company in Australia.

21 Our banks that we--not in this country.

22 COMMISSIONER HOLTZ-EAKIN: But you own abroad.

23 WITNESS NEAL: --own abroad, Bank of Budapest in
24 Hungary, Czech Agribanca in the Czech Republic, they all have
25 mortgages as part of their normal product suite.

1 COMMISSIONER HOLTZ-EAKIN: So has your mortgage
2 losses looked like the industry as a whole, like the great
3 losses in the U.S.? Or have you done better than everyone
4 else?

5 WITNESS NEAL: We have done pretty well around
6 the world. The UK business was loss-making last year, but
7 not big, and turning the corner. It was a forty, is that
8 right, \$40 million roughly profit in the first quarter.

9 The French platform is largely prime and has
10 performed well. The UK business is not originate to
11 distribute. It's originate for our own balance sheet, so we
12 have--

13 COMMISSIONER HOLTZ-EAKIN: Do you have originate
14 to distribute entities? I thought you were exclusively
15 originate to hold for balance sheet?

16 WITNESS NEAL: In terms of the mortgage business,
17 I would say for the most part. There is probably some
18 originate to distribute in the Australian platform, but
19 we're winding that down.

20 Honestly, we are less interested in mortgages
21 globally and are not trying to grow those businesses at this
22 point.

23 COMMISSIONER HOLTZ-EAKIN: How about commercial
24 real estate?

25 WITNESS NEAL: Commercial real estate we have--

1 we're a large commercial real estate player. We operate in
2 about 28 countries around the world. We have about an \$80
3 billion book of commercial real estate.

4 Of that book, about 60 percent of it is a debt
5 book. And about 40 percent of it--these are rough numbers--
6 is an equity book. And again, originated for our own
7 holding.

8 COMMISSIONER HOLTZ-EAKIN: And how is that book
9 performing, that book in particular?

10 WITNESS NEAL: It's been hard. The values of
11 commercial real estate--and I would say that was maybe one
12 of our misses, that the book is too big, particularly the
13 owned book.

14 When we used to think about a cycle in real
15 estate, we would think of it being down 20, 25 percent.
16 These assets in many cases have fallen 40, in that regard,
17 and as a result of that we've had to put a lot of reserves
18 into that business.

19 The business was quite profitable back in 2007,
20 and last year, I don't know the exact number, but over a
21 billion dollars in losses in that regard, much of it
22 accounting in terms of reserves, but we are a large player
23 around the world.

24 COMMISSIONER HOLTZ-EAKIN: Thank you.

25 I wanted to pick up just a couple of details on

1 some of the other business models here. You don't hold any
2 of the asset-backed commercial paper, you said. Don't you
3 give up some yield in the process? You said you never
4 touched that?

5 WITNESS McCULLEY: Right. And in fact that was a
6 conscious decision that we made on behalf of our clients.

7 COMMISSIONER HOLTZ-EAKIN: How do you hold onto
8 your clients if you're giving up yield?

9 WITNESS McCULLEY: Our investment portfolios away
10 from our money market products have cushions of cash, but
11 the value added in the overall portfolio tends to come from
12 other holdings in the portfolio besides cash, and in
13 investing the cash buffers in the portfolios, you give up
14 historically some incremental yield, a handful of basis
15 points, to being in conventional commercial paper versus
16 asset commercial paper. And we made the judgment as a firm
17 that that was the prudent thing to do for our clients, to
18 give up that handful of basis points, because we could not
19 get comfortable looking through the balance sheet of the
20 conduits and get comfortable with the assets they were
21 holding.

22 So it was a conscious decision to give up a few
23 basis points in the interest of preservation of capital for
24 our clients.

25 COMMISSIONER HOLTZ-EAKIN: Thank you.

1 Mr. Meier, you said that you invest in commercial
2 banks, regulated banks. Do you have any exposure to
3 investment banks?

4 WITNESS MEIER: We have exposure to what were
5 investment banks back in the day. I guess if you consider--

6
7 COMMISSIONER HOLTZ-EAKIN: Not any more, yes.

8 WITNESS MEIER: --Goldman Sachs banks, but, yes,
9 we do.

10 COMMISSIONER HOLTZ-EAKIN: So one of the things
11 I'm curious about is I think it's true that both of you were
12 involved in repo agreements with Bear Stearns, is that
13 correct?

14 WITNESS MEIER: Yes.

15 COMMISSIONER HOLTZ-EAKIN: Mr. McCulley?

16 WITNESS McCULLEY: Historically, yes, we were
17 involved in repo.

18 COMMISSIONER HOLTZ-EAKIN: So when you looked at
19 the collateral--and I gather you would have used only their
20 Treasuries and agency securities?

21 WITNESS McCULLEY: Right, and bilateral.

22 COMMISSIONER HOLTZ-EAKIN: And bilateral repo.
23 What collateral would you use?

24 WITNESS MEIER: It was dominated by traditional
25 collateral, Treasuries, bills, bonds, notes, agency

1 debentures, and agency NBS. But we did have some
2 alternative collateral.

3 We also settled 100 percent of those transactions
4 on a tri-party basis.

5 COMMISSIONER HOLTZ-EAKIN: Okay. So what I'm
6 interested in is, as we move to the Fall of 2007 and start
7 to move toward March of 2008, obviously the crucial period,
8 how were you evaluating the collateral?

9 We heard testimony yesterday that in repo you
10 evaluated it on the basis of the counterparty, not the
11 collateral; and that Bear's problem was as a counterparty.

12 I was curious how you, first Mr. McCulley, viewed
13 what you were holding from Bear, and whether you were
14 evaluating the collateral, which you looked through and
15 understand; or whether you were looking at Bear itself?

16 WITNESS McCULLEY: I think you do both. First,
17 you want to know that you are adequately over-collateralized
18 so that you're really lending against the collateral with
19 the haircut.

20 But also you look to the counterparty. Because
21 if the counterparty fails to deliver on the repo, you by law
22 have the collateral. The collateral is greater than the
23 amount of money that you lent, and you can go sell the
24 collateral outside of the bankruptcy process. That's part
25 of the legal structure for repo.

1 But actually, that is not something that you
2 normally want to do. You secure yourself, and you can sell
3 the collateral, but that quite frankly is a very serious
4 headache. And so therefore you would prefer not to deal
5 with counterparties where you think there is a significant
6 possibility that you may actually be forced to liquidate the
7 collateral in order to be made whole. So you actually look
8 at both.

9 COMMISSIONER HOLTZ-EAKIN: Mr. Meier?

10 WITNESS MEIER: I would agree with Mr. McCulley.
11 We certainly look at both. I would say the counterparties
12 are a first line of defense, and we don't want to go through
13 that uncomfortable process of having to liquidate
14 collateral, irrespective of whether it's over-collateralized
15 or not.

16 It is something that creates concern among our
17 investors. The headline risk associated with that would be
18 considerable. So again, when there was a deterioration in
19 terms of Bear Stearns as a counterparty, we would opt not to
20 roll transactions with them, even though it's traditional
21 collateral that typically benefit from a flight to quality,
22 and it was over-collateralized.

23 COMMISSIONER HOLTZ-EAKIN: I want to ask a
24 further question about both the collateral and the
25 counterparty, which is: We have heard conflicting reports

1 on Bear Stearns's problems. Their officials told us that
2 they were always solvent, and that they were in the end
3 victims of a run founded on rumors that were not true. And
4 we have had other officials, notably former Secretary
5 Paulson, say that they were insolvent.

6 So in your evaluation of them as a counterparty,
7 what did you see when you get to March of 2008? Mr.
8 McCulley?

9 WITNESS McCULLEY: For a levered financial
10 institution, if the marketplace comes to the conclusion,
11 rightly or wrongly--

12 COMMISSIONER HOLTZ-EAKIN: I'm not interested in
13 the marketplace conclusion. I want--

14 WITNESS McCULLEY: --that they're insolvent, then
15 they are insolvent.

16 COMMISSIONER HOLTZ-EAKIN: So your conclusion?

17 WITNESS McCULLEY: If Bear was liquidated, it
18 would have been insolvent. It was solvent only if it was a
19 going concern, and it was only a going concern because it
20 was merged into JPMorgan. That's the essence of the name of
21 the game in financial services.

22 If you have to prove your solvency, then in fact
23 you're not solvent.

24 COMMISSIONER HOLTZ-EAKIN: Mr. Meier?

25 WITNESS MEIER: I would suggest when we looked at

1 Bear Stearns, our analysis was as follows: First of all, I
2 think that the senior management from Bear Stearns have a
3 much better determination of whether they were solvent or
4 not.

5 From our perspective, though, their problems
6 really began in the early part of 2007. They had well
7 documented, well covered in the financial press, problems
8 with some of their hedge funds. They had a very
9 concentrated business model. And they were a significant
10 participant in the mortgage market, in the subprime mortgage
11 market, and private label securitization as well.

12 They had a significant fixed-income business, not
13 much diversification beyond that. Their assets and their
14 focus had really been in the U.S., so they didn't really
15 have global diversification.

16 They were a leveraged entity, and we knew what
17 our behavior was; that over the course of time, other
18 investors would start to certainly roll down their exposure
19 to Bear Stearns, which meant that the potential for a quick
20 run was significant.

21 They also had issues, problems with their
22 management team and leadership that were covered in the
23 markets as well, and in the press. So we became
24 increasingly concerned about them as a counterparty and
25 ultimately reached the determination that, given the risk

1 aversion, the risk appetite of our clients, it was more
2 prudent to simply no longer roll over purchase agreements
3 with Bear Stearns.

4 COMMISSIONER HOLTZ-EAKIN: And so who else did
5 you pull back from, and when? Lehman? Mr. McCulley?

6 WITNESS McCULLEY: During that period after the
7 Summer of 2007 when you got the run on the asset-backed
8 commercial paper market, we as an industry, and we as PIMCO
9 on behalf of our clients became ever more circumspect with
10 respect to counterparty exposure. And we had concerns, and
11 where we did have concerns we reduced exposure, yes.

12 COMMISSIONER HOLTZ-EAKIN: Were you exposed to
13 Lehman when they went under?

14 WITNESS McCULLEY: Our clients owned Lehman
15 Brothers bonds in their portfolios at the time, yes.

16 COMMISSIONER HOLTZ-EAKIN: Under your advice?

17 WITNESS McCULLEY: We collectively made the
18 decision to invest in Lehman Brothers bonds, their unsecured
19 debentures, and in retrospect that was a decision we wish we
20 hadn't of made.

21 COMMISSIONER HOLTZ-EAKIN: And what was different
22 about them versus Bear Stearns that gave you the confidence
23 to make those investments?

24 WITNESS McCULLEY: As a practical matter, they
25 were both operating in a similar business model.

1 COMMISSIONER HOLTZ-EAKIN: Yep.

2 WITNESS McCULLEY: Bear was smaller and, as Mr.
3 Meier noted, had a more concentrated business in the
4 mortgage arena, and also was not globally diversified. So
5 conceptually Lehman had a better business than Bear did, but
6 as a practical matter we found out that diversification
7 globally did not matter and that their concentration in
8 mortgage risk was very, very large.

9 So actually the big difference between those two
10 firms is that one the Federal Reserve could find sufficient
11 collateral in order to facilitate a loan to do the merger
12 with JPMorgan, and in the case of Lehman Brothers they
13 couldn't find sufficient collateral to lend against.

14 COMMISSIONER HOLTZ-EAKIN: Could I get--

15 CHAIRMAN ANGELIDES: Three minutes.

16 COMMISSIONER HOLTZ-EAKIN: Did you expect them to
17 find a partner and get assistance?

18 WITNESS McCULLEY: That was the general market
19 expectation.

20 COMMISSIONER HOLTZ-EAKIN: Mr. Meier, same
21 question, in the interest of completeness.

22 WITNESS MEIER: When I think of our exposure to
23 Lehman Brothers--and we did have exposure on a fully
24 collateralized basis for repurchase agreements with Lehman
25 Brothers--when we looked at them as a counterparty, it was a

1 different analysis.

2 Lehman Brothers as a business had been very
3 focused on the short end of the curve. They were a
4 recognized leader in providing services and products to the
5 money market area. And when I say that, it would include
6 out to say five years.

7 They had a more diversified revenue source. They
8 had significant growth in their equity business, for
9 example. They were a global firm with growing operations
10 outside the States. So a more diversified business model.

11 I think also we had a relatively high degree of
12 confidence in their management because they had been through
13 liquidity crises in the past, and that they had--they were
14 able to survive in difficult markets.

15 I would also say our analysis shifted pretty
16 dramatically post-Bear Stearns, and that the Bear Stearns
17 sale to JPMorgan was orchestrated by the Fed. Immediately
18 thereafter, the Fed announced the Primary Dealer Credit
19 Facility, which I think was a tremendous benefit to Lehman
20 Brothers. And our expectation at the time, our assessment
21 at the time was that would provide them with time to
22 recapitalize themselves, seek other partnerships, and
23 potentially sell the firm. And our expectation is that
24 would occur over the course of time.

25 COMMISSIONER HOLTZ-EAKIN: I want to go back to

1 the haircuts on collateral. What haircuts did you apply to
2 agency securities in your repo with Bear?

3 WITNESS McCULLEY: Well convention on Treasury
4 and agency collateral is 102 percent. And then for
5 alternative collateral, haircuts go up but we were not
6 engaged in repo with Bear in alternative assets. So it
7 would be conventional 102.

8 COMMISSIONER HOLTZ-EAKIN: And that didn't change
9 even right up to the very last transactions you did with
10 them?

11 WITNESS McCULLEY: For Treasury and agency
12 collateral, and agencies were implicitly and then explicitly
13 backed by Uncle Sam, that was convention. And we applied
14 conventional haircuts if we chose to do business with them.
15 Because, remember, you never want--you really don't want to
16 get in the situation where you have to liquidate the
17 collateral so--

18 COMMISSIONER HOLTZ-EAKIN: I understand, but--

19 WITNESS McCULLEY: --it's that two-pronged issue.

20 COMMISSIONER HOLTZ-EAKIN: --you've told us that
21 you did great due diligence on looking at what was actually
22 inside things. So you sent people to 20 cities. You
23 decided there wasn't a decent mortgage in America, and you
24 applied no haircuts to agency securities?

25 WITNESS McCULLEY: No, 102 percent.

1 COMMISSIONER HOLTZ-EAKIN: But you didn't
2 increase them in light of the growing evidence of bad
3 mortgage origination, which in the end was going to be on
4 the books of Fannie Mae and Freddie Mac?

5 WITNESS McCULLEY: We fully expected that our
6 government, if push comes to shove, would wrap its arms
7 around Freddie and Fannie, and that's precisely what
8 happened.

9 COMMISSIONER HOLTZ-EAKIN: Thank you.

10 CHAIRMAN ANGELIDES: Just one little follow-up
11 from me before I go to you, Senator, because, before I
12 forget it, which is, I think it was you, Mr. Meier, and
13 maybe you, Mr. McCulley, or maybe both of you cited media
14 reports.

15 When the folks from Bear were here yesterday they
16 cited the extent to which rumors helped drive the liquidity
17 squeeze. I believe in the course of interviews with our
18 staff, folks indicated that sometimes folks in your position
19 may just decide not to have an institution as a counterparty
20 to avoid the heartburn of explaining to clients why you have
21 that institution that has negative media around it as a
22 counterparty.

23 To what extent--I assume you do more thorough due
24 diligence than picking up the newspaper, but to what extent
25 does it factor in? Just stories that may or may not have

1 full veracity?

2 WITNESS MEIER: If I can address that,
3 Mr. Chairman, of course we don't make credit decisions based
4 on what's covered in the popular press. We do all of our
5 own head work around our counterparties and the issuers with
6 whom we buy paper from, but it is a source of information
7 out there and it does affect perception in the marketplace,
8 and it does, candidly, expose certain investment vehicles to
9 headline risk and flight risk.

10 CHAIRMAN ANGELIDES: I think what I'm really
11 asking, sometimes you just decide in the range of vehicles
12 available to you, you know, why screw around with this one
13 and have to explain it to your clients when there's other
14 good choices. Reasonable? Rational? Or no?

15 WITNESS McCULLEY: Prudent risk management means
16 that you're on top of all of your counterparty relationships
17 all the time. And that means doing your head work and your
18 shoe leather work. And if you see that your counterparty is
19 deteriorating, then logically you should pare your
20 exposures, ask for additional collateral, et cetera. But
21 you also do read the newspapers, because in highly levered
22 financial institutions sometimes perception can become
23 reality.

24 In fact, that's what a run is about. So you do
25 have to be attuned to the perception of the market while

1 you're also focused like a laser beam in your own credit
2 work.

3 CHAIRMAN ANGELIDES: All right. Senator Graham?

4 COMMISSIONER GRAHAM: Thank you, Mr. Chairman,
5 and thanks to each of the gentlemen for their very
6 insightful testimony.

7 Our Commission was established to answer the
8 question what went wrong, what was the cause of the financial
9 crisis we're in. Do you consider that the segment of the
10 financial industry that you occupy was responsible for any of
11 the crisis that we are now living through?

12 WITNESS McCULLEY: The underlying culprit in the
13 crisis you have to trace back to the systemic degradation of
14 underwriting standards in mortgages. That is where the--

15 COMMISSIONER GRAHAM: In residential mortgages?

16 WITNESS McCULLEY: Residential, and also on the
17 commercial side, but in an immediate sense the residential
18 came first. So as Secretary Geithner was discussing earlier
19 today, there are a number of vectors you have to look at
20 from the standpoint of the crime, but systemic degradation
21 of underwriting standards for mortgages is where the smoking
22 gun is.

23 COMMISSIONER GRAHAM: And you don't have any of
24 those bullets in your pocket?

25 WITNESS McCULLEY: I didn't underwrite any loans

1 where the borrower didn't put any money down, and didn't
2 have to show his W-2, and didn't have to pay the full
3 interest rate. We're not in the mortgage underwriting
4 business.

5 WITNESS NEAL: Senator, I would just add, I don't
6 know if the so-called shadow banking system versus the
7 banking system was the major--I think what happened is we
8 had for awhile more liquidity in the marketplace than
9 anything I've ever seen.

10 And that created a lot--you know, it was pretty
11 remarkable. And also, Senator, there was a general view, if
12 you go back to 2007, as crazy as it seems now, that that
13 liquidity was going to be here for awhile. The consultants
14 were talking about it, new forms of capital from around the
15 world, China, India, sovereign wealth. And so I think there
16 was a general view, and it was wrong, that the world was
17 going to be very liquid for at least awhile.

18 So I think that's a piece of it. I think that
19 allowed people to maybe get over-levered in some of these
20 spaces. And, you know, if you have high leverage and you
21 have the potential for volatile assets, you are on very thin
22 ice in that regard.

23 I would agree with Paul that, you know, this
24 originate-to-sell changed things. It's not just mortgages.
25 It happened in leveraged loans. It happened in other

1 markets. But I think that it changes the way the business
2 operates.

3 If you are putting an asset, whether it's a
4 mortgage or an LBO, if you're originating that to have it on
5 your balance sheet for the term, then you will look at it
6 for the term. You have to live with it. You have to live
7 with the consequences of that decision.

8 If you're originating that transaction only to
9 put it into a security and sell it, particularly if you're
10 not going to stay in the security, it becomes a fee-based
11 business. It's really just how much can I originate,
12 because you get paid monthly based on what you sell. It
13 goes out, you take what they call in the industry a skim--
14 another bad word I think--but that's how it works.

15 And I think a lot of the underwriting problems
16 really happened from the standpoint that this underwrite-to-
17 distribute model became very large. And I think that
18 created--so you have high leverage. You have high
19 liquidity. The liquidity didn't last.

20 You have the issue I think where people were a
21 little bit lulled to sleep just from the standpoint that
22 they thought it was--you know, when you see 2 percent cap
23 rates, things are expensive. But if you think it's going to
24 be that way for 10 years, you know, maybe not so expensive.

25 So I think that's why people maybe didn't make

1 some of the bold actions that they might have made
2 otherwise. And then I think the underwriting--and it varied
3 a lot--but the underwriting standards of some firms, some
4 institutions, depending on what they were doing, wasn't that
5 good.

6 That's how you get into these no-doc--I mean,
7 why--Senator, if you owned your own bank, you wouldn't let
8 anybody bring in a transaction to you where you don't know
9 if they have a job or not, or there's no documents. You
10 just wouldn't do it.

11 But maybe if you think you're just going to sell
12 it and take a fee, and then people sort of say, well,
13 there's so much liquidity, asset values will continue to
14 rise so it really doesn't matter. And of course when you're
15 wrong, you're very wrong on this.

16 So I think--I mean, that's how I would think
17 about it.

18 COMMISSIONER GRAHAM: Any other comments on the
19 possible contributions of this aspect of the industry
20 towards the crisis?

21 WITNESS MEIER: Well, Senator, if I can address
22 that, please. I would suggest, with the benefit of
23 hindsight, things are a lot clearer than they were back in
24 say 2006 and 2007.

25 Clearly there was an excessive amount of leverage

1 and too much liquidity in the marketplace. I think Mr.
2 McCulley and Mr. Neal are correct in that there was a
3 thinking on the part of some market participants, the
4 philosophy of originate-to-securitize and get the risks off
5 your book.

6 There also was just a significant flow of asset-
7 backed securitizations coming down the pike, and I think
8 many investors didn't do their homework. They didn't do
9 their analysis. And I think that's where they got into
10 trouble.

11 In terms of, you know--

12 COMMISSIONER GRAHAM: Excuse me. Is that
13 because, was there a lower level of due diligence during
14 this period than had been the norm let's say over the
15 preceding 5 or 10 years?

16 WITNESS MEIER: Senator, I really can't say
17 whether there was or there wasn't. I know from our
18 perspective that we never let down our guard in terms of the
19 due diligence and the analysis we did.

20 We had concerns about the subprime mortgage
21 market, the Alt-A market for the same reasons as have been
22 articulated here through other committee discussions.

23 You know, we saw a decline in average FICO
24 scores, the average credit quality of the borrowers, higher
25 loan-to-value ratios. We saw all sorts of unusual mortgages

1 coming down the pike such as IOs, and Option Arms.

2 We saw concentrations of paper being distributed
3 or sold into the marketplace in real estate markets that had
4 significant appreciation.

5 COMMISSIONER GRAHAM: Yesterday we had people
6 with very impressive resumes who said that they could not
7 see this storm coming over the horizon. You just listed a
8 half-dozen data points that you were monitoring which caused
9 you to see something was coming over the horizon.

10 What is that caused you to be as sensitive to
11 what was happening when other people were not?

12 WITNESS MEIER: That's a great question, Senator.
13 I think it had probably more to do with the types of assets
14 we manage. The risk tolerance of our underlying clients.
15 The fact that we manage most of the assets in our cash
16 business to a book value construct. So there's a very small
17 margin of error.

18 So for us it came down to the question of
19 suitability, and exposing our clients into assets that could
20 potentially have a lot of either ratings volatility, spread
21 volatility, and price volatility which just seemed
22 inappropriate and unsuitable.

23 COMMISSIONER GRAHAM: Well, in fact I have no
24 time--

25 CHAIRMAN ANGELIDES: Would you like some,

1 Senator?

2 COMMISSIONER GRAHAM: Two minutes?

3 CHAIRMAN ANGELIDES: You can have two minutes.

4 COMMISSIONER GRAHAM: From the conversation that
5 I had before this session started, I gathered that some of
6 the reasons that people are here in the audience is because
7 of what's happening a few hundred yards away from here in
8 the Senate.

9 [Cell phone rings.]

10 COMMISSIONER GRAHAM: Excuse me, let me turn this
11 off.

12 How would your industry be affected by the
13 financial reform legislation that's currently being
14 considered?

15 WITNESS McCULLEY: Well we're actually in
16 different industries. The bookends of the table are in the
17 same industry, and in the middle is in a different industry.

18 COMMISSIONER GRAHAM: I used--

19 WITNESS McCULLEY: But for all of us at the
20 table--and I'm hesitant to speak for all of us; people will
21 speak for themselves--I think we all have a interest in a
22 financial system that has built in safeguards against a
23 repeat of what happened during the crisis.

24 I think we all--not just as members of the
25 financial services arena, but as citizens--have a tremendous

1 interest in Washington putting in the appropriate regulatory
2 structures--and that includes such things as capital
3 requirements, resolution authority, lots of things that go
4 under that mosaic--but I think that we as an industry
5 benefit if our industry is properly regulated and policed.

6 So I think we will end up, I trust we end up in a
7 better place for the financial services industry because I
8 want, and my firm wants, and our clients want us to be
9 participating in a sound industry that doesn't have fringe
10 elements that are disrupting the normal functioning of the
11 market, or tainting the integrity of the market.

12 WITNESS NEAL: Senator, I would say, first of all
13 I would say that we applaud what you are doing here and the
14 good work that you are doing, because we think this work
15 needs to be done.

16 From my perspective, the whole idea of regulatory
17 reform is much needed. I think the concept of systemic
18 regulation to me makes sense. It makes sense to our
19 company. The ability to resolve companies in a way that
20 doesn't threaten the system I think makes a lot of sense.

21 We think the idea of having more and better
22 capital inside of financial institutions will make them
23 safer, will make the industry safer. Having enough
24 liquidity at hand to deal with unforeseen issues that might
25 come up from time to time we think makes a lot of sense.

1 Having cash to really give you the extended time
2 you need as you may need to make choices about reducing a
3 balance sheet, or generating cash in some other way I think
4 makes sense.

5 The whole idea I think of match-funding your
6 assets and liabilities, something some people do, some
7 people don't, you know, borrowing short, lend long works
8 until it doesn't. But I think the idea of having match-
9 funding, matching that from a duration standpoint, makes a
10 lot of sense.

11 To me the whole idea of having different types of
12 underwriting, the idea that you have underwriting--I would
13 tell you that I think many people that underwrite to hold on
14 their own balance sheet have done better in this process
15 than the securities have done where that didn't happen.

16 So the idea that this work that you're doing ends
17 up in a different way of thinking about this from a
18 regulatory standpoint, from a resolution standpoint, I think
19 we think it's a good thing.

20 WITNESS MEIER: I would add to that--

21 CHAIRMAN ANGELIDES: Go ahead and just answer,
22 one minute to answer, and then we'll move on.

23 WITNESS MEIER: Sure. I would concur with
24 everything that's been said. I would also add to that, I
25 think it's certainly in the best interests of the American

1 people--and Secretary Geithner referred to this earlier as a
2 100-year storm; we want to make sure this isn't an every 10-
3 year storm.

4 So I do think that regulatory reform will be
5 important in terms of protecting the American people, our
6 interests and our position in the world.

7 COMMISSIONER GRAHAM: Thank you.

8 CHAIRMAN ANGELIDES: Thank you.

9 Mr. Wallison?

10 COMMISSIONER WALLISON: Thank you, Mr. Chairman.

11 Let me start with you, Mr. McCulley. You said
12 that we should have a regulatory system in which
13 systemically important firms are regulated. I think that
14 was sort of the point you were making at the outset. And
15 I'm wondering how we can tell whether a firm is systemically
16 important. How would you tell whether a firm is
17 systemically important?

18 WITNESS McCULLEY: There's not a precise--

19 COMMISSIONER WALLISON: I know.

20 WITNESS McCULLEY: --definition.

21 COMMISSIONER WALLISON: I'm not asking for a
22 definition. I'd like to just know how you, if you were say
23 the chairman of the Federal Reserve and had an opportunity
24 to say which firms you are going to regulate, which may come
25 out of the current regulatory bill that's before Congress,

1 how would you decide whether to regulate a firm as
2 systemically important?

3 WITNESS McCULLEY: I think this question has been
4 grappled with repeatedly. You think in terms of the stress
5 tests involved 19 firms, so obviously those 19 were deemed
6 systemically important. And in one of the proposals in the
7 legislative process now is to deem anybody who has greater
8 than \$50 billion worth of footings to be systemically
9 important.

10 So it's not an easy thing to do. It's an important
11 thing to do.

12 CHAIRMAN ANGELIDES: Did you say "footings"?

13 WITNESS McCULLEY: Size of balance sheet, I'm
14 sorry. I'm using jargon.

15 CHAIRMAN ANGELIDES: Thank you.

16 WITNESS McCULLEY: Um--

17 CHAIRMAN ANGELIDES: I've heard more complex
18 jargon.

19 (Laughter.)

20 WITNESS McCULLEY: The important thing is that
21 you have a resolution mechanism for these institutions so as
22 that if they fail they can fail in a orderly fashion.
23 That's more important than defining whether it's 46 or 73
24 firms. Whatever you define it is that you can have a
25 orderly funeral for them if they die, as opposed to a
26 debacle like we had post-Lehman.

1 COMMISSIONER WALLISON: Okay. Now you said that
2 PIMCO is not a member of the shadow banking system. Why do
3 you think it's not?

4 WITNESS McCULLEY: PIMCO is an investment
5 manager.

6 COMMISSIONER WALLISON: Yes, and so are hedge
7 funds. Hedge funds are thought to be members of the shadow
8 banking system. So in what way is PIMCO different from a
9 hedge fund?

10 WITNESS McCULLEY: PIMCO does not manage money
11 for PIMCO. PIMCO manages money for clients. Some of our
12 clients--it's a small portion of our business--run levered
13 mandates. When they hire us to be the investment manager,
14 they explicitly in their investment management contract
15 request that we lever their portfolio.

16 So some of our clients would be--could be
17 characterized as shadow banks, because they're levered
18 without access to a lender of last resort. But PIMCO itself
19 as the investment manager is not a shadow bank.

20 COMMISSIONER WALLISON: But a hedge fund is
21 simply a fund manager, is it not? I mean, yes, they're
22 managing their own money, but they are making investments
23 with their own money.

24 WITNESS McCULLEY: The hedge fund itself could be
25 deemed a shadow bank.

1 COMMISSIONER WALLISON: That's right.

2 WITNESS McCULLEY: The manager of the hedge fund-

3 -

4 COMMISSIONER WALLISON: --is not.

5 WITNESS McCULLEY: --is not.

6 COMMISSIONER WALLISON: Right.

7 WITNESS McCULLEY: Now frequently it's the case

8 with hedge funds that the manager is investing his own

9 money--

10 COMMISSIONER WALLISON: Um-hmm.

11 WITNESS McCULLEY: --whereas, we are a third-

12 party manager.

13 COMMISSIONER WALLISON: But you have a fund that

14 you are investing, is that right?

15 WITNESS McCULLEY: I'm not sure I'm following the

16 question.

17 COMMISSIONER WALLISON: When your customers give

18 you money to invest for them, do they not give you the

19 opportunity to take this money, put it into an account of

20 some kind, and manage it for them?

21 WITNESS McCULLEY: Yes, they do. And some of

22 those clients indeed want that account to be managed on a

23 levered basis. So that account would have the

24 characteristics of a shadow bank; that's correct.

25 COMMISSIONER WALLISON: Now you said before--I'm

1 obviously going to run out of time with all the things I'd
2 like to ask about--but you said before that financing
3 sources like Bear would be better off if they were
4 implicitly backed by the government. Would that be helpful,
5 to give them access for example to, not a financing source
6 but a financing user like Bear, would that be helpful in
7 making sure that we didn't have the kind of crisis that we
8 had before? Would you suggest that anyone that is making
9 use of financing sources be regulated or have access to the
10 Discount Window, the Fed's Discount Window?

11 WITNESS McCULLEY: Unambiguously, if you are
12 going to have access to the Fed's Discount Window, you
13 should be regulated.

14 COMMISSIONER WALLISON: Yes.

15 WITNESS McCULLEY: It is simply not tenable for
16 the Fed to be lending to someone that they have no
17 regulatory control on. That's a self-evident truth, it
18 seems to me.

19 After the merger of Bear into JPMorgan, the
20 Federal Reserve created the Primary Dealer Credit Facility,
21 which they did under Section 13.3 of the Federal Reserve
22 Act, opening effectively the Discount Window to the primary
23 dealers.

24 That was not an easy decision for the Federal
25 Reserve to make. Because essentially they opened a facility

1 to lend to people they weren't regulating. So I don't think
2 that's an appropriate approach. If you're going to have
3 access to the Federal Reserve's balance sheet, then it seems
4 to me it's axiomatic that you should be regulated.

5 And that was an emergency thing, and actually
6 they had to evoke 13.3 to do it. Again, going forward, the
7 key issue it seems to me is we need to have a mechanism so
8 as that a systemically important institution can fail in a
9 orderly fashion. Orderly bankruptcies should not be the
10 tender for a large fire. However, if they're disorderly,
11 they become the tender for a fire that almost engulfed our
12 financial system and gave us a nasty recession.

13 So I put the most emphasis on orderly unwinding.

14 COMMISSIONER WALLISON: And what is the
15 difference between a disorderly and an orderly unwinding, in
16 your view?

17 WITNESS McCULLEY: Actually I think Secretary
18 Geithner did a excellent job of articulating that this
19 afternoon. A orderly unwinding, to use his analogy, is when
20 a house can burn down but doesn't in the process burn down
21 the neighborhood.

22 COMMISSIONER WALLISON: But that means, does it
23 not, that creditors of that institution, or I don't know how
24 we analogize it to a house, but the creditors of that
25 institution are paid off?

1 WITNESS McCULLEY: That's correct.

2 CHAIRMAN ANGELIDES: Would you like additional,
3 what, two minutes?

4 COMMISSIONER WALLISON: Yes. Just to get this
5 question in.

6 WITNESS McCULLEY: That's correct.

7 COMMISSIONER WALLISON: Creditors would have to
8 be paid off?

9 WITNESS McCULLEY: No, no. An orderly resolution
10 could involve, and should involve haircuts for creditors.
11 And in fact one proposal that's being discussed for an
12 orderly resolution is actually another section of the
13 Bankruptcy Code specifically so as that you can have an
14 orderly resolution, in which case unsecured creditors simply
15 take a haircut and take the loss, as opposed to unsecured
16 creditors in a bailout getting par on the dollar and the
17 taxpayer being on the hook. I don't want that to happen.

18 COMMISSIONER WALLISON: I don't think anyone
19 wants it to happen. But the thing I'm trying to get at is,
20 if you tell creditors that they are going to take a loss,
21 say we decide that they're going to take a 20 percent loss,
22 wouldn't that signal to other creditors in the market that
23 they have to run from whatever their investments are because
24 they are not going to be paid out fully? Isn't that the
25 definition of a disorderly workout, or bailout, or whatever

1 you want to call it?

2 WITNESS McCULLEY: Commissioner, we're talking
3 about changing the regime so as that you know ahead of time
4 that you're not going to be bailed out; that if the
5 institution gets into trouble, it will go into an orderly
6 unwinding process and you will lose money. So it's changing
7 the regime which allows you to return to market discipline.

8 If I know as an investor that I'm not going to be
9 bailed out and that I am going to take a haircut in the
10 event that the financial institution goes under, then I will
11 either charge a higher interest rate or not lend to them at
12 all.

13 So returning market discipline to the system is a
14 key part of regulatory reform.

15 COMMISSIONER WALLISON: Why wouldn't bankruptcy
16 do the same thing?

17 WITNESS McCULLEY: In fact I'm suggesting that it
18 would. But you would need to have a new section of the
19 Bankruptcy Code to make a special case so as that you have
20 an orderly unwinding.

21 Remember, Lehman Brothers went through bankruptcy
22 and that was disorderly. So therefore if you want to go the
23 Bankruptcy Code, you would need legislation that created a
24 separate section for systemically important financial
25 institutions.

1 COMMISSIONER WALLISON: I've run out of time.

2 Thanks very much.

3 CHAIRMAN ANGELIDES: All right. Mr. Georgiou, go
4 ahead.

5 COMMISSIONER GEORGIOU: Mr. Neal and Mr. Barber,
6 I wondered if you could tell me, you've shrunk the size of
7 your borrowings, and I take it comparably your assets,
8 considerably over the last two years. Was that--can you say
9 whether you did it to de-lever your borrowings, or because
10 the demand for your services and your loans were, your
11 financings, were less? I mean, which?

12 WITNESS NEAL: It's a great question, and it's
13 complicated, the answer. We actually started back in early
14 two thousand--we go through a strategic plan just like all
15 of G.E. does each year, and we went through a fairly
16 rigorous capital allocation approach in terms of, you know,
17 what businesses were strategic, what product lines, what
18 geographies, what areas had we performed well over time, and
19 really what was the best part of the company. We do that
20 each year, because even in the year where we may be growing
21 we still have businesses that we want to grow faster,
22 businesses that we might want to exit.

23 I would say, as we rolled into this very
24 difficult environment in 2009 and part of 2008, a number of
25 things happened. One is, we accelerated that plan in order

1 to generate cash, or have the balance sheet be stronger.

2 I would say, secondly, because of the recession--
3 a big piece of what we do is finance capital equipment--
4 there was less being sold. So that put some pressure just
5 on our new volumes, even in businesses that we find highly
6 attractive from that perspective.

7 But the view is, our view is, my view is, from a
8 G.E. Capital perspective, we were probably a little too big
9 from just a good portfolio management inside of a company
10 like G.E. So we're reducing the size of the company between
11 now and the end of 2012 by about 25 percent.

12 COMMISSIONER GEORGIOU: From your height? Or
13 from your current--

14 WITNESS NEAL: From the height, in terms of our
15 size. We'll have the business down to a balance sheet of
16 about \$440 billion by the end of 2012, largely exiting
17 businesses not in the U.S., but in other parts of the world.

18 COMMISSIONER GEORGIOU: But of that, you finance,
19 what was it, 20 percent through commercial paper? Is that
20 right, or no?

21 WITNESS NEAL: Well today the debt stack in the
22 company, we have about--and Mark may correct me here--but we
23 have about \$500 billion of total debt. About \$350 billion
24 of that is long-term debt.

25 COMMISSIONER GEORGIOU: Right.

1 WITNESS NEAL: Less than fifty, about forty-six I
2 think today is commercial paper, of different tenors. It's
3 not all short.

4 Then we have about \$100 billion of other types of
5 financing. We do have deposits both in this country in the
6 banks--

7 COMMISSIONER GEORGIU: I understand, yes. So I
8 guess, Mr. Barber, when you said you shrunk the commercial
9 paper by half, that's really--that wasn't, your business
10 wasn't going down by half? It was just that particular
11 means of funding? Is that correct?

12 WITNESS BARBER: Yes, sir.

13 COMMISSIONER GEORGIU: Okay.

14 WITNESS BARBER: There's a shift that would have
15 occurred in our funding mix, and Mike is absolutely right
16 about his numbers and how the debt stack shapes up right
17 now. So there's less reliance on commercial paper, an
18 increased cash portfolio that we have. So there's less
19 commercial paper that we are rationing and turning over in
20 the market. That's balanced out by increases in some of our
21 other forms of funding, whether it's long-term debt, or
22 deposits that we take around the world, and so forth.

23 COMMISSIONER GEORGIU: Thanks.

24 Mr. McCulley, I guess I understand you don't like
25 tri-party repo? Is that right? You prefer bi-party?

1 WITNESS McCULLEY: Historically that is correct,
2 that we have not been comfortable with the tri-party.

3 COMMISSIONER GEORGIU: And why is that?

4 WITNESS McCULLEY: Because there was not full
5 transparency to us on the marking of collateral in the
6 tri-party system. And the tri-party system has lower quality
7 instruments in it.

8 The tri-party system is being seriously evaluated
9 and strengthened in efforts led by the New York Fed, and it
10 is quite possible that going forward we may be involved in
11 the tri-party repo arrangements because we think the
12 architecture is going to be made much more robust.

13 But historically we did not think the
14 architecture was sufficiently robust.

15 COMMISSIONER GEORGIU: So you only engaged in
16 transactions where you actually knew exactly what the
17 collateral was and you were dealing with the party that held
18 it?

19 WITNESS McCULLEY: Yes. We were engaged in
20 bilateral, where actually the counterparty to repo actually
21 wired the collateral to the custodian bank of our client.
22 It would not be held by a third-party bank.

23 COMMISSIONER GEORGIU: Right. And I take it,
24 Mr. Meier, you did engage more in tri-party repo? Is that
25 right?

1 WITNESS MEIER: Yes, Commissioner. I would say
2 at our peak, with about \$175 billion worth of repurchase
3 agreements outstanding, about 98 percent settled on a
4 tri-party basis.

5 COMMISSIONER GEORGIU: Um-hmm.

6 WITNESS MEIER: And I would also have to say
7 that, you know, 50 percent of those assets and our current
8 assets are what would be considered traditional collateral.
9 So Treasuries, agency, agency mortgage-backed securities.

10 The tri-party settlement system is really just a
11 mechanism for obtaining possession and control of the
12 collateral. It happens to occur at our dealer or bank
13 counterparty's clearing bank for operational efficiencies.

14 COMMISSIONER GEORGIU: Okay. And, Mr. Meier, to
15 stick with you for just a sec, you said something to the
16 effect that asset prices--you discussed asset prices getting
17 below fundamentals. Was this an asset class other than
18 mortgages, outside of mortgages?

19 WITNESS MEIER: Pretty much everything,
20 Commissioner. In the height of the panic, credit spreads
21 widened on everything, including say General Electric Credit
22 Corp paper, which we certainly had a very high degree of
23 confidence in them as an issuer as a counterparty.

24 COMMISSIONER GEORGIU: And how did that cause
25 contagion, in your view?

1 WITNESS MEIER: Wow. I think it added to a
2 downward spiral in terms of the capital commitment and the
3 unwillingness on the part of banks and dealers to make
4 markets in the secondary market.

5 When I think back to how this crisis really
6 began, it was a slow and steady deterioration in the
7 subprime market. Come August of 2007, there was a
8 recognition, I'd say an acute recognition, that potentially
9 some of the asset-backed commercial paper conduits could
10 have exposure to those areas.

11 As a result, investors in general--without even
12 looking into the underlying assets--decided I don't want to
13 be in any asset-backed commercial paper, I don't want to
14 invest in a fund that may have those positions.

15 COMMISSIONER GEORGIU: Regardless of whether
16 they were--what the asset was backed by?

17 WITNESS MEIER: That's exactly right,
18 Commissioner. So I think the lesson I learned from that was
19 that informed transparency is critical. Our clients knew
20 what we owned, but they didn't actually have the information
21 that we had in terms of doing our due diligence in looking
22 at everything.

23 So the problem was, when we buy asset-backed
24 commercial paper, we actually look through to the underlying
25 bank that supports that. We only buy fully supported

1 conduits, which means they have 102 percent of bank lines
2 behind them.

3 So the issue is, when investors en mass pulled
4 out of a \$1.2 trillion market, the asset-backed commercial
5 paper conduit market, those liquidity providers that were
6 supposed to provide liquidity contingent upon an inability
7 to roll commercial paper realized that they may be called to
8 provide funding.

9 So they started hoarding cash. And a lot of
10 those institutions were banks. And in the process of
11 hoarding cash and derisking their portfolio, they stopped
12 making normal secondary markets.

13 So what started out as a liquidity crisis quickly
14 moved into a credit crisis, and then ultimately an economic
15 crisis on a global scale.

16 COMMISSIONER GEORGIOU: Could I have one more
17 minute for follow-up?

18 CHAIRMAN ANGELIDES: Absolutely.

19 COMMISSIONER GEORGIOU: If I understand that, you
20 had 102 percent fully backed with, what, lines of credit
21 from banking institutions?

22 WITNESS MEIER: Liquidity lines from banking
23 institutions.

24 COMMISSIONER GEORGIOU: But of course they didn't
25 have the liquidity to honor those obligations, so they had

1 to delever. They had to start selling their assets to do
2 that.

3 WITNESS MEIER: That's exactly right. And I
4 should also state, Commissioner, that we didn't approve all
5 asset-backed commercial paper conduits for purchase in our
6 funds. Again, we did a detailed credit analysis. We
7 probably had about 25 percent of the universe of available
8 conduits approved, and we had relatively small positions in
9 them.

10 COMMISSIONER GEORGIU: Mr. McCulley, did you--
11 could you comment on that process of contagion? I mean, did
12 you see the same thing going on with regard to all this
13 asset-backed paper?

14 WITNESS McCULLEY: Yes. It was very obvious in
15 the Summer of 2007 that a run on the asset-backed commercial
16 paper was underway. I think in the last four months of 2007
17 some \$400 billion was not rolled.

18 So it was very evident that the users of asset-
19 backed commercial paper, the buyers went on a buyer strike
20 and simply weren't rolling. And then it kicked off a whole
21 chain of reaction that you and Mr. Meier were detailing.

22 COMMISSIONER GEORGIU: And that started when?

23 WITNESS McCULLEY: In the Summer of 2007,
24 particularly August of 2007.

25 COMMISSIONER GEORGIU: Thank you very much.

1 CHAIRMAN ANGELIDES: Can I say, post-BMP? Pre-
2 BMP? Post? Or pre? Do you remember which came first?

3 WITNESS MEIER: Post.

4 WITNESS McCULLEY: Post, I think.

5 WITNESS MEIER: It was right afterwards.

6 WITNESS McCULLEY: It was in and around that
7 time. That would be August 9th of 2007, which is, when I'm
8 asked to define what was the single day that was the Minsky
9 moment, it was that day, August 9th.

10 CHAIRMAN ANGELIDES: I was wondering when you
11 were going to get that phrase in. All right.

12 (Laughter.)

13 CHAIRMAN ANGELIDES: Mr. Hennessey.

14 COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.
15 I am going to direct this to Mr. McCulley, but I hope the
16 rest of you will jump in as well.

17 One of my takeaways from both Secretary Paulson
18 and Secretary Geithner was, don't spend all your time
19 thinking about solvency; spend more time thinking about
20 liquidity and the liquidity problems that occurred.

21 I am going to present some somewhat jumbled
22 thoughts and I want to ask if you can help me sort them out.
23 And it's sort of a similar line to what Peter was getting
24 at.

25 First of all, I have a similar question to him,

1 which is: I have believed that a big part of the problem
2 was having a disorderly resolution regime, and have said and
3 believe that we need an orderly resolution regime.

4 And then someone asked me: What do you mean by
5 that? And I kind of wave my hands and say, well, it has to
6 be orderly.

7 So to the extent that any of you have seen good
8 explanations or good analyses--you were referring to some
9 that might be out there--I would love to be better educated
10 on smart people who have actually thought about the details
11 of what a new section of the Bankruptcy Code means, or what
12 was actually missing. Because I don't actually understand
13 the mechanics of that well enough.

14 Okay, now on to my area of confusion. I sort of
15 think of this as on the solvency side we were dealing with
16 it--sorry, on solvency issues we were dealing with this on
17 the asset side. We used TARP to put a bunch of taxpayer
18 money in. I kind of get that.

19 On the liquidity issues we were basically dealing
20 with it by guaranteeing liabilities. So the Fed was doing
21 it by opening up their Discount Window to institutions
22 they'd never done it before. We guaranteed money market
23 mutual funds for awhile. And then made some changes in the
24 FDIC, right, increasing the limit from \$100,000 to \$250,000
25 for individuals, and then if you've got, what, a transaction

1 account and a small business you're guaranteed for good.

2 I understand why those made sense during the
3 crisis. I understand why I think they worked, basically, to
4 at least slow down the liquidity runs. The FDIC is now
5 saying they're going to continue their policies at least
6 through the end of the year, and quite possibly longer.

7 And what scares me is that we are then
8 substituting regulatory discipline for market discipline, at
9 least in those areas. And so, Mr. McCulley, coming back to
10 your original concept of parity between traditional
11 commercial banking and shadow banking, commercial banks have
12 deposits. The shadow banks don't. They have something
13 else.

14 Setting aside the supervision aspects, how do you
15 deal with the guarantees of liability issue? How do you
16 create the parallel, or do you create the parallel to
17 deposit insurance? And how do you think about market
18 discipline versus regulatory discipline with liquidity runs
19 and shadow banking?

20 Does my question--I think you can see the area
21 I'm sort of circling around.

22 WITNESS McCULLEY: Yes, I do. And I think all of
23 us in the industry and here in Washington are grappling with
24 that question. And I come back to what I said in my opening
25 comments.

1 The essence of banking is to create an asset for
2 the public, which is the liability of the bank, that is
3 informationally insensitive. If you have the FDIC label on
4 it, it is informationally insensitive because it has the
5 full faith and credit.

6 And the shadow banking system actually with
7 commercial paper and repo became informationally sensitive.

8 COMMISSIONER HENNESSEY: Right. But even in the
9 commercial banking world, it is partially sensitive because,
10 at least before--

11 WITNESS McCULLEY: Right.

12 COMMISSIONER HENNESSEY: --we did guarantees, it
13 was only partially guaranteed.

14 WITNESS McCULLEY: And that remains the case on
15 term deposits. Obviously on transaction deposits--

16 COMMISSIONER HENNESSEY: So it's not all or
17 nothing.

18 WITNESS McCULLEY: It's not all or nothing. It's
19 a two-tiered structure. And the bottom line is, if you
20 require a nonbank intermediary to have sufficient capital,
21 then the theory is that the senior lenders to that
22 institution, including in the commercial paper market, or
23 more importantly in the repo market, will look at that
24 balance sheet and say it's a fortress balance sheet,
25 therefore I am comfortable being a senior lender; that the

1 fortress balance sheet makes the senior short-dated
2 liability of that institution informationally insensitive.

3 So that is the objective through capital
4 requirements.

5 COMMISSIONER HENNESSEY: So the functional
6 parallelism can be addressed on the capital side rather than
7 by having the government guarantee liabilities for shadow
8 banks? Is that the concept?

9 WITNESS McCULLEY: That is the concept, as well
10 as having strong liquidity buffers for shadow banks, as well
11 as conventional banks. So it's a belt-and-suspenders, that
12 if you tell a shadow bank by regulatory powers that you
13 will--

14 COMMISSIONER HENNESSEY: --on liquidity--

15 WITNESS McCULLEY: --be robust on capital, and
16 you will be robust on liquidity, then you dramatically
17 reduce the odds of a run.

18 And the problem for a run is that, once one
19 institution is run upon, then you get effectively a
20 contagion effect.

21 COMMISSIONER HENNESSEY: Okay. But then your
22 functional parallel does not require the government to
23 necessarily guarantee any of the--explicitly guarantee the
24 liabilities of a shadow bank if they are sufficiently strong
25 from a regulatory standpoint on both capital and liquidity

1 requirements?

2 WITNESS McCULLEY: That is my interpretation,
3 yes.

4 COMMISSIONER HENNESSEY: Okay.

5 CHAIRMAN ANGELIDES: Mr. Hennessey, can I just
6 ask a quick question on your time that related to what
7 you're talking about? Should I also--the capital and
8 liquidity on one side must also be combined with some
9 prudence on the asset side?

10 WITNESS McCULLEY: Certainly I think part of
11 regulation, whether it's a conventional bank or a shadow
12 bank, is having guidelines on what is a permitted and not a
13 permitted asset.

14 So I said belt-and-suspenders. There needs to be
15 a third one in this trio. So, yes, that. Regulation is
16 about how much capital, how much liquidity, and what type of
17 activities that you can engage in so as to ensure safety and
18 soundness.

19 CHAIRMAN ANGELIDES: All right. I apologize. I
20 just wanted--

21 COMMISSIONER HENNESSEY: Not a problem.

22 So, and I agree with what you were saying before
23 with Peter, which is obviously if your shadow bank has
24 access to the Discount Window, or something else, then you
25 have to have the strong supervision of it. But the converse

1 isn't necessarily the case?

2 What I hear you saying is, you do not have to
3 provide shadow banks with access to the Discount Window, or
4 an FDIC-like guarantee of liabilities, as long as you've
5 covered your belt and suspenders and buckles? Is that--

6 WITNESS McCULLEY: Yes, I think that's right.
7 It's important that you don't have to have mirror treatment
8 from the standpoint of their liabilities. But you do have
9 to have essentially a similar framework for capital,
10 liquidity, and activities.

11 And then I come back to something that I know is
12 important to you and everybody else, is that if a
13 systemically important institution gets into trouble, that
14 you can orderly unwind it so that if one house in the
15 neighborhood goes down, you don't have a spreading of the
16 fire through the entire neighborhood.

17 COMMISSIONER HENNESSEY: Okay. Good. Now let me
18 take that, and let me zoom all the way out. Because as
19 legislation is moving through the House and Senate, lots of
20 elected officials like to say how the action they're taking
21 is going to make sure this never happens again.

22 And what I always come back to is: What do you
23 mean by "this"? And what it sounds like is, in this piecing
24 together what I'm hearing from you, and what I've heard from
25 the two Secretaries, is that we are not necessarily ending

1 up in a situation where a large financial institution won't
2 fail. Right? They may fail. You may have the resolution
3 authority. You can still have runs on large financial
4 institutions, if all of the regulatory protections and
5 oversight you're talking about happen; it just won't spread
6 to the rest of the system if what you've designed is robust?
7 Is that the way to think about it?

8 WITNESS McCULLEY: I think that's a good way to
9 think about it. We have seen a disorderly unwind of a
10 systemically important institution, and that was ugly.

11 So that we want to avoid. And the architecture
12 that's evolving should include, critically, a means to avoid
13 that.

14 As Secretary Geithner was testifying, we can't
15 outlaw failure in our system. In fact, in a capital system
16 you don't want to outlaw failure. Capitalism is about
17 winners and losers. And when you lose, you go broke and
18 have a proper funeral. But you don't want to have that
19 become a systemic event.

20 COMMISSIONER HENNESSEY: Let me get you--my time
21 is running out--30 seconds?

22 CHAIRMAN ANGELIDES: Absolutely. You can take
23 two. We're almost to the finish line.

24 COMMISSIONER HENNESSEY: On this point, I grimace
25 every time I hear one of these elected officials say "never

1 again." Because the way I think about this is that the
2 actual goal should be to try and change this from a 1 in 30
3 year occurrence, to a 1 in 100 or 200, or 300, just because
4 the efficiency costs of going to "never" are far too high.

5 Is that--I see some nodding here from Mr. Meier.
6 Is that a better way to--understanding that they're all
7 communicating for other purposes, is that a better way to
8 think about it? That we're not trying to eliminate the risk
9 of this happening again; we're trying to reduce it
10 significantly without having the efficiency costs be too
11 high? Mr. Neal?

12 WITNESS NEAL: It seems to me, if I think about
13 this simply, to me the bright line is around resolution.
14 Can a firm be successfully resolved, or not? I think if a
15 firm can be successfully resolved--because I think what the
16 Commission should not want to do is make financial services
17 not a--you know, not a lubricant for the economy.

18 I think you want a vibrant financial services
19 industry that competes in that regard. I think if a firm,
20 for whatever reason, however it ultimately gets looked at,
21 cannot be resolved because it's too interconnected, it's too
22 global, it's too, something, maybe it's too damaging for its
23 customers, I mean I think those are all things you might
24 consider from that regard, then you would hold it to a
25 standard that wouldn't allow it to need to be resolved in

1 that regard.

2 I think regulation of financial services to where
3 you don't have some of the excesses that took place maybe in
4 some of these exotic products, maybe in some of these
5 enormously high leverages that happened in some places,
6 makes sense for everybody. But then when you get to that
7 next step, to me again it's just--I'm just telling you my
8 view--it really gets down to where a company, a firm can be
9 resolved successfully, in which case I think they ought to
10 be regulated, but regulated with a spirit of letting them
11 compete.

12 COMMISSIONER HENNESSEY: Could we just here Mr.
13 Meier?

14 CHAIRMAN ANGELIDES: Yes.

15 WITNESS MEIER: Thank you. Commissioner, I think
16 if we manage to a perfection standard of "never again," of
17 never having defaults, or the ability for even a
18 systemically important institution to become insolvent, I
19 think we've probably, to your point, reached the line of
20 governance efficiency.

21 So I do think that it should be more along the
22 lines of institutions can fail. What's the resolution of
23 those failures?

24 And I think to a point made earlier, as well, in
25 terms of the responsibility on the asset side, I said in my

1 oral remarks that I do think there's a recognition that
2 there needs to be more, I'm paraphrasing, but there needs to
3 be more due diligence done on the part of investors, more
4 risk analysis. And you can't outsource that to a credit
5 rating agency.

6 I believe that that analysis and assessment needs
7 to be done in-house. Because it doesn't speak just to the
8 credit quality; it speaks to suitability.

9 COMMISSIONER HENNESSEY: Thanks. I think of this
10 as what elements made the system so that it was not
11 sufficiently hardened and insufficiently robust to withstand
12 the shock; whereas, most of the rest of the focus has been
13 about how do we make sure future shocks don't occur, and
14 what elements caused the shocks to be damaging?

15 I think we need to focus on all of the above, but
16 a system that's robust and hardened, so that when bad things
17 happen because regulators are not going to be perfect in the
18 future either, I think is one that is more survivable,
19 basically. Thanks.

20 CHAIRMAN ANGELIDES: Thank you. Ms. Murren. And
21 after Ms. Murren is done, I just have one thing to add into
22 this little discuss, or a question.

23 Go ahead.

24 COMMISSIONER MURREN: Thank you.

25 Along this thread, but maybe getting down to the

1 microscopic level and adding some color to it, if you reel
2 back the tape to the fall of '08, from my recollection it
3 was probably one of the more overwhelming and potentially
4 frightening periods of time for corporate America.

5 So we have G.E., who has got a sterling
6 reputation for management, good quality assets, a company
7 that's in a diversified line of businesses. Could you
8 comment on, at that particular moment in time, not with the
9 benefit of hindsight, were you worried about the viability
10 of G.E. Capital? And were you worried at the parent company
11 level about your ability to finance the company going
12 forward with long-term debt? And to what extent did you
13 believe that the government ultimately, coming in to support
14 the markets, helped you as a company with a great reputation
15 to be able to weather this?

16 WITNESS NEAL: I would like to take that, if I
17 can. Everybody was worried. As we progressed through
18 September with the number of failures, we did a lot of
19 contingency planning inside of G.E.

20 We had a lot of levers: a very strong company,
21 the ability to raise capital, the cash position of the
22 parent. The lever we haven't talked about a lot is the, in
23 terms of just our survivability should the debt markets go
24 away period--you know, it's hard to get your head there--but
25 should it happen, we are a finance company. So, you know,

1 we collect a lot of cash. We're a different model than
2 some.

3 We collect about \$100 billion a quarter of cash.
4 So we would of had to lean into new origination, new
5 business, if things had gotten bad enough. You know, extend
6 less new credit as we collect obligations that are owed to
7 us to build cash.

8 But we were never concerned about the viability
9 of the company. The company is strong. The company had a
10 very strong balance sheet through a very difficult time,
11 particularly in terms of the stock price, just in terms of
12 what happened. But we never, you know, foresaw a liquidity
13 situation that we couldn't handle.

14 The way you handle it might not be that
15 attractive in some cases. We did what we thought was
16 prudent. We raised equity. We put it in the financial
17 company. We cut the dividend back to the parent.
18 Ultimately the parent reduced the dividend. These were
19 painful actions in many ways.

20 And I think the never lever we would have--if
21 again the markets were just gone, totally frozen, we would
22 of had to extend less credit. The government programs that
23 we participated in, while not designed for us, they were
24 designed to stabilize the markets, and I think they did in a
25 way that was enormously beneficial, and it benefitted us as

1 well, as it did many others in that time, because this was a
2 market phenomenon unlike any that I had imagined in that
3 regard. But we would have gotten through it.

4 The G.E. Capital would probably be a smaller
5 business in the future because of it, but I think what the
6 government did was appropriate. I think in terms of TLGP,
7 CPFF, these were money makers.

8 Now at the day one you might not know if it will
9 be or not, but it turned out to be, in that regard. I think
10 they did stabilize things. So you're asking a question
11 about a game we didn't have to play in that regard. But we
12 were ready. We thought about it. We had scenario planning.
13 Some of it would have been difficult, but just to answer
14 your question, Commissioner, I think we would have come
15 through it. We're a very strong company with a very
16 successful business model.

17 COMMISSIONER MURREN: A number of witnesses have
18 made commentary about the feeling that they felt that they
19 had been the subject of market manipulation, rumors in the
20 market, those types of things. Did you at any point feel as
21 though your company, your equities or debt, were ever the
22 target of any kind of issues that might surround rumors in
23 particular relating to G.E. Capital?

24 WITNESS NEAL: You know, just my view, and I've
25 heard some of the previous testimony, again this is my

1 personal view, you know, it's pack hunting when you're in
2 the sights of some of these large hedge funds, and I think
3 things do happen.

4 You know, sometimes it's real information.
5 Sometimes it may be a rumor. I think anybody that was in
6 financial services during that period of time that actually
7 came under fire in that regard--we certainly did. We
8 survived it. Some didn't, in that regard.

9 But I do think it's those kinds of activities, we
10 call it--I call it, you know, pack hunting. Because I think
11 that that does happen. There are rumors. We certainly had
12 our share. We had one where it was reported on TV that we
13 had almost \$50 billion of unmarked CMBS. We actually had
14 less than \$100 million, and it had been marked. But it was
15 tough to undo it.

16 I don't know where it came from, but it was
17 there. But things like that happen. You know, and if you
18 get in a very difficult market, a very scary market for
19 people, if you can get put into a position where there's no
20 buyers of your stock, then the stock value can drop very
21 quickly in that regard.

22 So I think things like that do happen. And, you
23 know, I don't know if it's, you know--you know, I don't know
24 how you could prove it in some cases, but I think we felt
25 some of that, too.

1 COMMISSIONER MURREN: Thank you. Thanks to all
2 of you for coming here. I appreciate it.

3 CHAIRMAN ANGELIDES: I know the Commissioners are
4 probably anxious to go. We've had 16 hours over the last
5 two days in this room with a lot of different people, but I
6 do want to ask one--oh, go ahead, Mr. Hennessey.

7 COMMISSIONER HENNESSEY: Can I just report on two
8 current events?

9 CHAIRMAN ANGELIDES: Absolutely.

10 COMMISSIONER HENNESSEY: One, a Senator on the
11 Floor within about the past hour was asking why the
12 Financial Crisis Inquiry Commission exists if the Senate is
13 about to pass legislation, and suggested that maybe we
14 should be disbanded. So I just add that into the
15 discussion.

16 And then, would note that while the Dow closed
17 down 3.1 percent today, at about 2:30 p.m. it was down
18 nearly 1000 points, which as I remember it is a larger drop
19 than on any single day in September of 2008. So back to my
20 point about needing to be robust and able to withstand
21 shocks, there are other shocks out there besides real
22 estate.

23 CHAIRMAN ANGELIDES: And I assume you're assuming
24 to the latter event, not the former event? The 1000-point
25 drop, not the one Senator on the Floor?

1 (Laughter.)

2 COMMISSIONER HENNESSEY: Yes.

3 CHAIRMAN ANGELIDES: Okay, just to be clear.

4 I just had one, and it relates really to what you
5 talked about shocks, because you talked about belts
6 and suspenders, and what was the third thing, Keith? What
7 was that phrase?

8 COMMISSIONER HENNESSEY: Buckles.

9 CHAIRMAN ANGELIDES: Buckles. But I heard you
10 also say the fourth element of that. Not so much for the
11 period of shock, but to keep liquidity in the market was the
12 resolution authority. I just want to understand
13 something.

14 It's important because you as a creditor want to
15 be able to keep lending, and you want to have some certainty
16 as to result, both in terms of priority and timing for
17 disposition of your position. Correct?

18 WITNESS McCULLEY: Resolution authority, a robust
19 one, is important because it provides assurance to the
20 marketplace that a firm can be unwound in an orderly fashion
21 with creditors taking losses but it doesn't create a
22 contagion effect.

23 CHAIRMAN ANGELIDES: Right. But the difference
24 between that and Chapter 11 would be certainty as to
25 priority? Or would it also be, for example, some kind of

1 assured DIP financing, Debtor In Possession, financing to
2 carry it through so there's an orderly liquidation of the
3 assets to retain as much value as possible?

4 You know, I'm just trying to get a simple answer,
5 why that and not Chapter 11? Or Chapter 7?

6 WITNESS McCULLEY: We tried that with Lehman
7 Brothers and it didn't work.

8 CHAIRMAN ANGELIDES: I can't remember the
9 corporate section for liquidation, 13?

10 WITNESS McCULLEY: And there have been a number
11 of proposals by scholarly, thoughtful people on this area.

12 CHAIRMAN ANGELIDES: But in simple terms, is it
13 order priority, the time frame for resolution, as well as
14 some funding mechanism so you don't have to dump assets
15 quickly?

16 WITNESS McCULLEY: That is essentially the
17 framework, including a mechanism through essentially the DIP
18 financing to provide comfort to counterparties.

19 CHAIRMAN ANGELIDES: Right. This is all about
20 comfort to counterparties, correct? So you'll continue to
21 lend in reasonably. And who would provide the DIP
22 financing?

23 WITNESS MEIER: Mr. Chairman, if I could answer
24 your earlier question, I do think the resolution process, in
25 terms of leveraged institutions with securities holdings

1 that rely on say repurchase agreements, that that resolution
2 would entail an orderly liquidation of those assets, as
3 opposed to each fully secured counterparty grabbing their
4 collateral and rushing to the market and dumping them at any
5 price.

6 CHAIRMAN ANGELIDES: Right. Okay, I understand.
7 So it's not necessarily DIP financing, because it's not an
8 ongoing concern. Correct?

9 WITNESS MEIER: Yes.

10 CHAIRMAN ANGELIDES: All right.

11 WITNESS McCULLEY: There could be some type of
12 temporary DIP financing, but it's simply temporary to bridge
13 you to the day where the funeral is conducted.

14 CHAIRMAN ANGELIDES: And presumably it would be
15 priced to attract whoever would provide it.

16 WITNESS McCULLEY: Yes.

17 CHAIRMAN ANGELIDES: All right. We could go on.
18 Thank you very, very much, for your time. To the
19 Commissioners, for your hard work.

20 And I want to, before we adjourn, I want to thank
21 Chairman Chris Dodd and the staff of the Senate Banking,
22 Housing and Urban Affairs Committee for giving us this room,
23 and giving us the support necessary to hold these two days
24 of hearings on the shadow banking system.

25 Thank you very much. The meeting of the

1 Financial Crisis Inquiry Commission is adjourned.

2 (Whereupon, at 5:05 p.m., Thursday, May 6, 2010,

3 the meeting was adjourned.)

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