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UNITED STATES OF AMERICA
FINANCIAL CRISIS INQUIRY COMMISSION
Official Transcript

Hearing on
"Too Big to Fail: Expectations and Impact of Extraordinary
Government Intervention and The Role of Systemic Risk in the
Financial Crisis."

Thursday, September 2, 2010, 9:00a.m.
Dirksen Senate Office Building, Room 538
Washington, D.C.

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- PHIL ANGELIDES, Chairman
- HON. BILL THOMAS, Vice Chairman
- BROOKSLEY BORN, Commissioner
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1 SESSION I: THE FEDERAL RESERVE:

2 BEN S. BERNANKE, Chairman

3 Board of Governors of the Federal Reserve System

4

5 SESSION II: FEDERAL DEPOSIT INSURANCE CORPORATION:

6 SHEILA C. BAIR, Chairman

7 U.S. Federal Deposit Insurance Corporation

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1 P R O C E E D I N G S

2 (9:00 a.m.)

3 CHAIRMAN ANGELIDES: Good morning. Welcome to
4 the public hearing of the Financial Crisis Inquiry
5 Commission. This is our second day examining the issue of
6 financial institutions that have become too big, too
7 important, too systemic to fail.

8 Yesterday we looked at two case studies, Wachovia
9 Corporation and Lehman Brothers, and this morning we will be
10 hearing from the Chairman of the Federal Reserve, Mr. Ben
11 Bernanke, as well as the Chair of the FDIC, Ms. Sheila Bair.

12 Welcome, Mr. Chairman. Thank you for joining us
13 here today. I might note that this is the second time you
14 have come before this Commission, first in our offices for a
15 private session when we were first convened as we began our
16 work, I believe almost a year ago. And today, in what will
17 be our final hearing in Washington, D.C., although after
18 today we will head across the country to a number of
19 communities in California, in Nevada, and in Florida, to
20 hold hearings in communities that are still gripped by high
21 unemployment, high foreclosure rates, and we're going to be
22 going to those communities to see how the seeds of this
23 crisis were sown on the ground and what the consequences are
24 today.

25 Mr. Chairman, as we have done with all witnesses,

1 we will now ask you to do, I would now like to ask you to
2 stand so I can swear you as a witness. And if you would
3 stand and raise your right hand:

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

8 CHAIRMAN BERNANKE: I do.

9 (Chairman Bernanke sworn.)

10 CHAIRMAN ANGELIDES: Thank you very much, Mr.
11 Chairman.

12 Thank you very much for your extensive written
13 testimony. And this morning we would like to ask you to
14 speak to us orally and take up to ten minutes this morning
15 to give your opening remarks, at which point, upon
16 conclusion of your opening remarks, we will move to
17 questions from Commissioners.

18 So, Mr. Chairman, the floor is yours.

19 WITNESS BERNANKE: Thank you, Mr. Chairman. I
20 won't take a full ten minutes, and I would like to say that
21 we will be submitting additional answers to your questions
22 very shortly.

23 Chairman Angelides, Vice Chairman Thomas, and
24 other members of the Commission:

25 Your charge to examine the causes of the recent

1 financial and economic crisis are indeed important. Only by
2 understanding the factors that led to and amplified the
3 crisis can we hope to guard against a repetition.

4 So-called too big to fail financial institutions
5 were both a source--though by no means the only source--of
6 the crisis, and among the primary impediments to
7 policymakers' efforts to contain it.

8 In my view, the too big to fail issue can only be
9 understood in the broader context of the financial crisis
10 itself. In my full written testimony I provide an overview
11 of the factors underlying the crisis, as well as some of the
12 problems that complicated public officials' management of
13 the crisis.

14 In understanding the causes of the crisis, it is
15 essential to distinguish between triggers: the particular
16 events or factors that touched off the crisis, and
17 vulnerabilities: the structural weaknesses in the financial
18 system and in regulation and supervision that propagated and
19 greatly amplified the initial shocks.

20 Although a number of developments helped to
21 trigger the crisis, the most prominent was the prospect of
22 significant losses on subprime mortgage loans that became
23 apparently shortly after house prices began to decline.

24 While potential subprime losses were large in
25 absolute terms, judged in relation to global financial

1 markets they were not large enough to account for the
2 magnitude of the crisis on their own. Instead, the system's
3 preexisting vulnerabilities, together with gaps in the
4 government's crisis response toolkit, are the primary
5 explanation of why the crisis has such devastating effects
6 on the global financial system and the broader economy.

7 Let me give an illustration of how
8 vulnerabilities in the financial system greatly increased
9 the effects of the triggers of the crisis.

10 In the years before the crisis, a system of so-
11 called "shadow banks," financial entities other than
12 regulated depository institutions, had come to play a major
13 role in global finance.

14 As it grew, the shadow banking system, including
15 certain types of special-purpose vehicles such as those
16 financed by asset-backed commercial paper, and some
17 investment banks had become dependent on short-term
18 wholesale funding.

19 Such reliance on short-term uninsured funds made
20 shadow banks subject to runs, much like commercial banks had
21 been prior to the creation of Deposit Insurance.

22 When problems in the subprime mortgage market and
23 other credit markets became known, the providers of short-
24 term funding ran from the shadow banks, disrupting short-
25 term money markets. Thus, the vulnerability--in this

1 case, the excessive dependence of many financial
2 institutions on unstable short-term funding--greatly
3 amplified the effects of the trigger, in this case the
4 prospective losses of subprime mortgages.

5 Among the consequences of this instability were
6 sharp declines in high volatility in asset prices,
7 widespread hoarding of liquidity by financial institutions,
8 and associated reductions in the availability of credit to
9 support economic activity.

10 Many of the key vulnerabilities of the financial
11 system were the product of private sector arrangements,
12 including, as just noted, over dependence of many financial
13 institutions on an unstable short-term funding, poor risk
14 management, excessive leverage of some households and firms,
15 misuse of certain types of derivative instruments,
16 mismanagement of the mortgage securitization process, and
17 other problems.

18 But important vulnerabilities also existed in the
19 public sector, both in the United States and in other
20 countries. These vulnerabilities included both gaps in the
21 statutory framework, and flaws in the performance of
22 regulators and supervisors.

23 Important examples of statutory gaps were the
24 absence of effective authority to regulate and supervise
25 some important types of shadow banks such as special-purpose

1 vehicles, and broker-dealer holding companies, the lack of
2 authority or responsibility to take actions to limit
3 systemic risks, and the absence of a legal framework under
4 which failing systemically critical nonbank financial firms
5 could be resolved in an orderly way.

6 Where appropriate authorities existed, financial
7 regulators and supervisors--both in the United States and
8 abroad--did not always use them effectively. For example,
9 bank supervisors in many cases did not do enough to force
10 financial institutions to strengthen their internal risk
11 management systems and to curtail risky practices; and bank
12 capital and liquidity standards were insufficiently
13 stringent.

14 The recent financial reform legislation addresses
15 many of the statutory gaps I have mentioned, and the Federal
16 Reserve and other agencies are taking strong steps to
17 tighten the regulation of financial institutions, to give
18 regulation and supervision a more systemic and multi-
19 disciplinary orientation, and to make supervision more
20 effective.

21 Many of the vulnerabilities underlying the crisis
22 were linked to the existence of so-called too-big-to-fail
23 firms, those whose size, complexity, interconnectedness, and
24 critical functions were such that their unexpected failure
25 was likely to severely damage the financial system and the

1 economy.

2 Because of the grave risks presented should a
3 too-big-to-fail firm file for bankruptcy protection, in the
4 short run governments have strong incentives to prevent such
5 events from occurring; hence, too big to fail.

6 However, in the longer term, the existence of
7 too-big-to-fail firms create severe moral hazard problems
8 which can lead to the buildup of risk and future financial
9 instability, while complicating the resolution of financial
10 crises.

11 The existence of such firms also creates an
12 uneven playing field between the largest firms and their
13 smaller competitors. It is critical that the
14 too-big-to-fail problem be solved. An important component
15 of the solution contained in the recent financial reform
16 bill is the development of a resolution framework that
17 allows the government to resolve a failing systemically
18 important nonbank financial firm in an orderly way, while
19 imposing appropriate losses on creditors, protecting
20 taxpayers, and limiting risks to the broader financial
21 system.

22 Tougher regulation and supervision of
23 systemically important firms, and steps to increase the
24 resilience of the financial system, are also important if we
25 are to bring a decisive end to too-big-to-fail.

1 The findings of this Commission will help us
2 better understand the causes of the crisis, which in turn
3 should increase our ability to avoid future crises, and to
4 mitigate the effects of crises that should occur.

5 We should not imagine, though, that it is
6 possible to prevent all crises. A growing dynamic economy
7 requires a financial system that effectively allocates
8 credits to households and businesses. The provision of
9 credit inevitably involves risk taking.

10 To achieve both sustained growth and stability,
11 we must provide a framework which promotes the appropriate
12 mix of prudence, risk-taking, and innovation in our
13 financial system.

14 Thank you, Mr. Chairman.

15 CHAIRMAN ANGELIDES: Thank you very much, Mr.
16 Chairman. We will now begin with questions. I will start
17 the questioning, and then we will go to Vice Chairman
18 Thomas, and then to the balance of the members.

19 So I would like to talk to you for a few minutes
20 about the runup to the crisis, because I believe a lot of
21 the focus is always on did the government do the right thing
22 in the grips of the crisis; the real question for me has
23 always been how did we get to the position where we faced
24 such Draconian choices.

25 And one of the things that struck me as we

1 reviewed our case studies is the failure of regulator
2 supervisors to identify and contain systemic risk in
3 too-big-to-fail institutions before the crisis hit.

4 Yesterday we looked at Wachovia where assets grew
5 from about \$250 billion to \$782 billion by 2007, and a very
6 aggressive growth rate of 17 percent; a tangible asset to
7 tangible equity ratio of 23 to 1; the acquisition of a big
8 book of pay option ARMs from Golden West, which in and of
9 itself was three times Tier One Capital.

10 But, no recognition by the Fed or the OCC of
11 systemic risk. In fact, no downgrading of the institution
12 until July of '08.

13 A similar fact pattern at Lehman. Even though we
14 realize the Fed was not the prudential supervisor, but again
15 I'm talking in a larger sense here: very aggressive growth,
16 leverage of 39 to 1.

17 Let me just ask you: Why such a big miss? And I
18 want to put this in context, that some of your folks who
19 have spoken to us here, like Mr. Alvarez and Mr. Cole, whom
20 we interviewed, talked about the fact that, well, gee, we
21 had--and I think it was maybe Mr. Cole who used the word
22 "myopic look". "We looked at safety and soundness."

23 But shouldn't have systemic risk been part of a
24 safety and soundness regime, even in the 2000 period? Was
25 this a substantial miss? How fundamental was the failure of

1 proper supervision to the metastasizing of this problem?

2 WITNESS BERNANKE: Mr. Chairman, first of all it
3 should be recognized that large, complex international
4 financial institutions do have an appropriate role. And the
5 fact that you were seeing growth and complexification of
6 these institutions in a world of financial innovation,
7 international capital flows, financial supermarkets, and a
8 whole variety of other innovations, in itself should not be
9 surprising. That was happening not only in the United
10 States but it was happening globally.

11 So there clearly was a reason for the growth and
12 for the more complex institutions.

13 Now that being said, it is certainly true that
14 the system did not sufficiently anticipate the systemic
15 risks associated with these institutions. That was,
16 frankly, partly due to the regulatory structure that was
17 given to us by Congress.

18 As you had mentioned, our charge was to focus on
19 the safety and soundness of individual institutions. There
20 was no provision, no authority to address systemic risk in
21 an institution. In fact, when the Fannie and Freddie law
22 was redone and there was additional regulation put on Fannie
23 and Freddie, the Congress explicitly said that you are not
24 allowed to consider systemic risks when you are looking at
25 the safety and soundness of this institution.

1 Now--and furthermore, there was no--

2 CHAIRMAN ANGELIDES: Was that part of the Gramm-
3 Leach-Bliley--

4 WITNESS BERNANKE: No, that was part of the
5 Fannie and Freddie's, of the law that created the FHFA, the
6 new institution.

7 And furthermore, there was no--there was no
8 collective assignment, as there is under the more recent
9 reform legislation, to look for systemic risks. Many of the
10 risks that occur obviously are interactions of the size and
11 complexity of individual firms, but features of the entire
12 system. They are emergent properties, if you will, of the
13 overall system.

14 Now having said all that, I must also agree that
15 supervisors in the United States and around the world
16 underestimated the risks associated, for example, with
17 insufficient liquidity. Much of the crisis was a liquidity
18 problem, or a bank run essentially.

19 We underestimated the extent to which risks
20 remained concentrated within important financial firms. And
21 so I'm not claiming that we found all those problems.

22 But there was a combination of the structure of
23 the system, the underlying trends toward greater and more
24 complex firms, together with some mistakes and shortcomings
25 on the part of regulators.

1 CHAIRMAN ANGELIDES: Let me ask you [microphone
2 is off]--thank you so much. It is early. It has been a
3 long journey for this Commission.

4 And this is not a matter of political ideology,
5 but there does seem to be, within the financial markets,
6 there was--it appears to be a greater and greater reliance
7 also on self-regulation. Mr. Alvarez in an interview he did
8 with our staff, I believe in March, talked about the
9 deregulatory environment in which policy decisions were
10 made. And again, without regard to Party--I'm going to say
11 that very squarely here.

12 Mr. Cole talks about recognizing some of the
13 problems in institutions and the ride up the roller coaster,
14 but the pushback from financial institutions. So how much
15 of this was also a function of a shift away from an
16 aggressive regulatory regime to, frankly, just a common view
17 that we should be more reliance on self-regulation, internal
18 risk management by the institutions, and replacement of
19 regulation?

20 WITNESS BERNANKE: Well I think there's some
21 truth to that. It was--there was some change I think in
22 overall philosophy. As firms became more complicated, there
23 was a greater and greater understanding that regulators
24 could not replicate all the risk assessments that the firms
25 themselves could do, and we had to rely more on their own

1 assessments. And instead of looking at the risks
2 themselves, making sure that they had good systems in place,
3 and that they were taking appropriate steps to address those
4 risks.

5 So it was certainly a problem, and it was
6 exacerbated I think by the fact that there's always
7 implicitly an international competition. Before the crisis,
8 one of our main concerns was London and Tokyo, were they,
9 you know, taking away the financial industry from the U.S.?
10 And was excessive regulation doing that?

11 So those were some of the concerns. That being
12 said, I think that innovation in the financial system partly
13 to avoid regulation but also in part to respond to the
14 legitimate changes in the economy; I referred to the shadow
15 banking system a moment ago, the development of new types of
16 financial institutions, off-balance-sheet vehicles, nonbank
17 mortgage lenders, much bigger investment banking activities
18 and so on.

19 Our bank regulatory system was designed for a
20 bank-centric financial system, and that's where it came
21 from. And as all these nonbank activities grew we, we the
22 country, were not sufficiently proactive in establishing a
23 regulatory framework to encompass all of those aspects.

24 CHAIRMAN ANGELIDES: All right. Thank you. But
25 it does seem to be, particularly if we are entering into an

1 era of larger and larger banks, that if we're going to have
2 banks that are too-big-to-fail it would also seem to me that
3 we need regulators who are too-tough-to-fold.

4 This is going to be a particularly challenging
5 environment with a set of even larger banks, and fewer of
6 them. Would you agree with that? That the challenge going
7 forward is even more dramatic?

8 WITNESS BERNANKE: I think it is very, very
9 important. As I said before, the most important lesson of
10 this crisis is we have to end too-big-to-fail. And I
11 believe that we, in a much different way than we did before
12 the crisis, we now have the tools to address that.

13 In particular, tougher regulation and oversight
14 will reduce the risks. The existence of a resolution regime
15 will increase market discipline, because creditors will know
16 that they can lose money. And strengthening the resilience
17 of the financial system itself will reduce the incentive of
18 the government to intervene in these situations.

19 My projection is that, even without direct
20 intervention by the government, that over time we are going
21 to see some breakups and some reduction in size and
22 complexity of some of these firms as they respond to the
23 incentives created by market pressures and by regulatory
24 pressures as well.

25 CHAIRMAN ANGELIDES: So our staff prepared for us

1 what I thought was an excellent--all the information you
2 already know, by virtue of being Chairman of the Fed and
3 your background, but it was striking. Our staff did for us,
4 and it's posted on our website, essentially a history of
5 too-big-to-fail; also, governmental rescues, from Franklin
6 National, to Continental Illinois, through the multiple
7 rescues in 2008.

8 And as I look at it, you almost can take the view
9 that, you know, Wall Street seems to believe that a
10 financial sucker is born every crisis. And so I think one
11 of the biggest questions that Americans have is: How do we
12 break this cycle?

13 What is the single most important thing that
14 should have been done, and can be done in the future, to
15 break the cycle? The single most important policy action
16 that we can take?

17 WITNESS BERNANKE: There has to be a credible way
18 to let firms fail--in fact, to require that they fail. I
19 mean, I think it is striking that the new rules do not
20 permit discretion. They do not allow so-called open-bank
21 assistance, which allows the government to assist a firm to
22 continue to exist.

23 Rather, what it does it provide a system for
24 trying to take a firm into receivership in a way that does
25 minimal damage to the system.

1 It's not going to be easy. I mean, let me just
2 be clear. This is not going to be easy to implement,
3 because these are large, complex firms with multi-national
4 presence.

5 CHAIRMAN ANGELIDES: And significant power.

6 WITNESS BERNANKE: And significant power. But
7 it's a very important step to take away the discretion. If
8 I might just cite the example of FDICIA, the law passed in
9 the early '90s, which created a set of well-specified
10 triggers under which the FDIC has to come in and close a
11 bank, except under extreme circumstances--the systemic risk
12 exception. There is no systemic risk exception for the
13 resolution regime in the Dodd-Frank bill.

14 That has worked very well. And the analogy to
15 using that, applying that to large firms I think is very
16 important. So I could hardly agree with you more,
17 Mr. Chairman, that this was a catastrophe, and it is bad in
18 the long run as long as in the crisis, and we must address
19 it.

20 CHAIRMAN ANGELIDES: All right. Let me talk for
21 a moment about failed institutions. As you know, we had Mr.
22 Fuld here from Lehman yesterday. We had Mr. Baxter from the
23 Federal Reserve Bank of New York.

24 You have stated I think on many occasions that
25 the failure of Lehman had significant consequences. So in

1 our role as Commissioners trying to do our level best to
2 understand the history of his crisis, we're trying to--at
3 least I am--trying to unfurl the set of decisions, the whys,
4 the wherefors.

5 When you first testified to Congress I believe
6 after the failure of Lehman, you had essentially said in
7 your testimony--and I'm shortening this up--that Lehman was
8 not rescued essentially because the market, the
9 participants, had had time to prepare in the wake of market
10 developments.

11 And I say this, as I said yesterday, it seems to
12 me the decision to allow Lehman to fail was a conscious
13 policy decision. Now I'm not implying that people said, oh,
14 just let them go down, but that like any other policymakers
15 you were weighing a whole set of factors.

16 Now since early on it seems though the Fed and
17 other officials have indicated that it was solely due to a
18 lack of legal authority, the inability to make the loan
19 under 13.3, the lack of sufficient collateral; but when I at
20 least look at the chronology, it seems to me you were trying
21 to deal with a whole set of complex factors.

22 We released yesterday a chronology of different
23 events along the way, and it seems to me, you know, there
24 was serious consideration of financial assistance, the Fed
25 stepping into the shoes of the clearing banks if that was

1 necessary. You know, Mr. Dudley, for example, I think in
2 July proposed a Maiden Lane type solution.

3 Mr. Geithner had told the FSA, I think as late as
4 a few days before the failure, that government assistance
5 was possible. And as late as I think the last few days,
6 there's a Federal Reserve Board of New York document, I
7 think Mr. Parkinson circulates, that talks about an FRBNY
8 financial commitment. "We should find a maximum number of
9 how much we are willing to finance before the meeting
10 starts, but not divulge our willingness to do so to the
11 Consortium. The terms of any liquidity support should be
12 long enough to guard against a fire sale, but on a short
13 enough fuse to encourage buyer of Lehman assets to come
14 forward two months to a year in duration?" And then there's
15 a note, "Lehman is bigger and more global than Bear."

16 So there seems to be a robust debate about the
17 efficacy of financial support. There certainly seemed to be
18 political considerations--and I don't necessarily mean at
19 the Fed, but among Treasury, White House, which is
20 legitimate. People are trying to weigh the mood of the
21 country, how policymakers are going to view this. There's
22 an awareness of impacts, a larger triparty book than Bear, a
23 bigger and more complex institution to unwind.

24 I don't see any documents or discussion along the
25 way about legal bars or government analysis of a shortage of

1 collateral. This is all by--and I see Mr. Alvarez's opinion
2 in March of 2009 saying the Fed has wide latitude in terms
3 of how it defines collateral.

4 My real question for you is: What was the mix of
5 policy considerations? I understand, because I've been in
6 transactions on the private side and the public side, that
7 there will be legal barriers, obstacles that have to be
8 respected, but it doesn't look as though that cut this
9 discussion off.

10 What were the biggest considerations? Would you
11 have saved Lehman if you had the legal authority? But in
12 rolling up to that decision, trying to determine were they
13 too-big-to-fail, not too-big-to-fail, you've already said
14 you thought it had significant disastrous consequences, but
15 what were the things you were trying to weigh, the decision-
16 making factors?

17 WITNESS BERNANKE: So I can only speak for
18 myself. I don't know everybody's view on that.

19 CHAIRMAN ANGELIDES: Okay. Great.

20 WITNESS BERNANKE: So first of all there was of
21 course, we were trying to arrange a private takeover over
22 the weekend, and we wanted that to be done on the best
23 possible terms that we could.

24 And for that reason there was some benefit I
25 think in the weeks prior to Lehman to keep our hands, you

1 know, a little bit up to the vest in terms of what we were
2 willing and able to do. So there was some of that going on
3 in the week prior to the Lehman weekend.

4 That being said, let me just state this as
5 unequivocally as I can. As you know, before I came to the
6 Fed Chairmanship I was an academic, and I studied for many
7 years the Great Depression, financial crises, and this is my
8 bread and butter. And I believed deeply that if Lehman was
9 allowed to fail, or did fail, that the consequences for the
10 U.S. financial system and the U.S. economy would be
11 catastrophic.

12 And I never, at any time, wavered in my view that
13 we should do absolutely everything possible to prevent the
14 failure of Lehman.

15 Now on Sunday night of that weekend, what was
16 told to me was that--and I have every reason to believe--was
17 that there was a run proceeding on Lehman, that is people
18 were essentially demanding liquidity from Lehman; that
19 Lehman did not have enough collateral to allow the Fed to
20 lend it enough to meet that run; therefore, if we lent the
21 money to Lehman, all that would happen would be that the run
22 would succeed, because it wouldn't be able to meet the
23 demands, the firm would fail, and not only would we be
24 unsuccessful but we would have of saddled the Taxpayer with
25 tens of billions of dollars of losses.

1 So it was both a legal consideration, but also a
2 practical consideration. Legally speaking, we are not
3 allowed to lend without a reasonable expectation of
4 repayment. The loan has to be secured to the satisfaction
5 of the Reserve Bank. Remember, this was before TARP. We
6 had no ability to inject capital or to make guarantees.

7 The unanimous opinion that I was told, and I
8 heard from both the lawyers and from the leadership at the
9 Federal Reserve Bank of New York, was that Lehman did not
10 have sufficient collateral to, to borrow enough to, to save
11 itself. And therefore any attempt to, to lend to Lehman
12 within the law would be futile and would only result in loss
13 of cash.

14 In some cases you can take the going-concern
15 value of the firm into consideration, but in this case
16 Lehman was under a run. It's going-concern value was
17 melting away because its customers, its counterparties, its
18 employees, and so on, were not going to be sticking with
19 this firm.

20 So I believe as of Sunday night that it wasn't
21 just a question of legality; it was a question of whether
22 there was anything we could conceivably do that would
23 prevent the failure of the firm. And therefore, it was with
24 great reluctance and sadness that I conceded that there was
25 no other option.

1 There was never any discussion which says here's
2 how we can save Lehman; should we do it or not? We never
3 had a discussion like that. The discussion was: There is
4 no way. And that was my belief, and that is how I
5 proceeded. Because, as I said, if I could have done
6 anything to save it, I would have saved it.

7 Now you asked, appropriately, about the--

8 CHAIRMAN ANGELIDES: Can I ask one question on
9 that, very quickly?

10 WITNESS BERNANKE: Certainly.

11 CHAIRMAN ANGELIDES: Which is, you said you
12 represented your own views. There were differential views,
13 though, expressed? I've seen in the e-mails concerns about
14 the politics. Bear's been bailed out. The GSEs. There
15 seems to be some political reluctance. Mr. Wilkinson's
16 writing e-mails: can't stomach a bailout.

17 WITNESS BERNANKE: Well it's certainly
18 understandable that people would have those concerns, but I
19 must say that in my own case, and as far as I know in the
20 cases of the other principals, the primary consideration was
21 the knowledge that the failure of Lehman would have
22 catastrophic consequences.

23 Let me just say one word about the testimony you
24 referred to, which has gotten--which has supported this myth
25 that we did have a way of saving Lehman. This is my own

1 fault, in a sense, but the reason we didn't make the
2 statement in that testimony, which was only a few days after
3 the failure of Lehman, that we were unable to save it was
4 because it was a judgment at that moment, with the system in
5 tremendous stress and with other financial institutions
6 under threat of run, or panic, that making that statement
7 might have, might have even reduced confidence further and
8 led to further pressure.

9 That being said, I regret not being more
10 straightforward there, because clearly it has supported the
11 mistaken impression that in fact we could have done
12 something. We could not have done anything.

13 CHAIRMAN ANGELIDES: One last question on this
14 subject. That is, a loan was made under the PDCF to the
15 broker-dealer I believe in the amount--I mean, I guess
16 authorized, \$50 billion but I think the daily amounts were
17 \$29- \$30 billion, and I have the numbers exactly with me,
18 that you were able to do that because?

19 WITNESS BERNANKE: Because they had sufficient
20 collateral to make--to support the loan.

21 CHAIRMAN ANGELIDES: That was not available on
22 the night before at the Holding Company level?

23 WITNESS BERNANKE: Correct.

24 CHAIRMAN ANGELIDES: Because the Holding Company
25 had a capital hole, in your judgment?

1 WITNESS BERNANKE: I believe it had a capital
2 hole, but in any case the calculations were that the
3 liquidity demands on the Holding Company were much greater
4 than the collateral that they had available to meet those
5 demands. And moreover, by the way, we didn't do anything to
6 prevent the broker-dealer from lending to its own Holding
7 Company, and it didn't seem to decide that was a smart thing
8 to do, either.

9 CHAIRMAN ANGELIDES: Of course at that point they
10 had filed bankruptcy. And I'm not going to take your time
11 with yesterday's dialogue with Mr. Baxter about what I
12 referred to as the smoking letter about whether in fact the
13 Holding Company had the ability Sunday night. We'll
14 continue to look at that matter and what transpired.

15 WITNESS BERNANKE: I can only tell you what I
16 knew at the time. And what I knew at the time, and what I
17 was informed, and what I believed, was that there was no
18 capacity for them to borrow sufficiently, have enough
19 collateral to borrow sufficiently to meet their obligations.

20 CHAIRMAN ANGELIDES: Was that based on an
21 analysis? Or was that based on the private Consortium's
22 analysis?

23 WITNESS BERNANKE: That was based on analysis at
24 the Federal Reserve Bank of New York, primarily, which had
25 been going on through the weekend. And of course prior to

1 that, we had done a lot of analysis based on our presence at
2 Lehman during the summer.

3 CHAIRMAN ANGELIDES: All right. One final
4 question--I'm exhausting my time, but this is very quickly.
5 I want to ask you, as we look at the genesis of this crisis,
6 it's hard not to look at the actions of the Federal Reserve.
7 And I know Mr. Thompson is going to want to talk about this,
8 so I will just ask very quickly, when you look at the
9 opportunity to regulate subprime lending under HOPA, rules
10 were adopted in 2001 that end up covering only 1 percent of
11 the loans, when you look at the referral of unfair and
12 deceptive lending practices to Justice, only two
13 institutions, I think the Desert Community Bank in
14 Victorville, California, and the First American Bank in
15 Carpenter, Illinois, only two referrals in six years; a
16 decision not to examine nonbank subsidiaries; was this a
17 very significant failure, looking back in retrospect?

18 WITNESS BERNANKE: It was, indeed. I think it
19 was the most severe failure of the Fed in this particular
20 episode.

21 CHAIRMAN ANGELIDES: All right. Well, I think
22 Mr. Thompson will want to ask some more about that. I will
23 defer the rest of my questions, if I have any, to Mr.
24 Thomas. Thank you very much, Mr. Chairman.

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

1 And thank you, Mr. Chairman. It's nice to see you again.

2 Let me say first of all, for those of us who have
3 been around for awhile, some folks might move us in the
4 category of "Mr. Senator" as having been around forever, and
5 you look at the political situation just in terms of
6 coordination and ability to move quickly, which is always
7 difficult in a political body, in the fall--well, December
8 '07 through '08, fall of '08, spring of '09, and of course
9 now today, historically when you look back, that actually
10 was a Presidential election period.

11 There was a change in government. And for those
12 of us who have been actually involved in these kinds of
13 processes, I want to thank you, and I want to thank the
14 others who were involved. Because it took, in my opinion, a
15 degree of aggressiveness that, had you not been bold enough
16 to carry out, circumstances might have been significantly
17 different.

18 So thank you.

19 After the fact, you get people who may have been
20 pretty upset--some behind closed doors; some in open doors--
21 now beginning to take a look at really where we were, and
22 situations that would have occurred.

23 Obviously you talk about gaps. The reason we
24 talk about gaps is because we now know they were gaps.
25 Before we knew they were gaps, it's always hard to find the

1 gaps.

2 One of my worries is, now being more acquainted
3 with the complexity, the failure of transparency, what
4 people thought was adequate capital carrying out various
5 kinds of behaviors, and the complexity that's now present,
6 not just nationally but internationally, one of the concerns
7 I have is--well, your final statement about obvious needs in
8 terms of the structure that we have on a flexibility in
9 movement, that when you try to look at dealing with
10 too-big-to-fail, and so we aren't going to let that happen
11 again, and you set up a structure, is there any concern
12 about some of these structures might be too complex to
13 unravel in a time period that's meaningful, given the
14 circumstances?

15 Because at some point, what I've heard from
16 virtually everyone--and we just heard the testimony
17 yesterday on some of the derivatives products and some of
18 the synthetics built off of derivatives, they're still
19 trying to unwind them in the Lehman Bankruptcy.

20 What concerns can you share with us in terms of--
21 I mean, I often think, you know, you've got the cartoon of
22 the child who's going to go out in the snow. So the mother
23 puts on one layer, two layers, three layers, and it finally
24 then is allowed to go outside and play and it can barely
25 move getting outside.

1 You can set up a structure to make sure that it
2 doesn't happen, but how do you keep the flexibility to allow
3 the system to function? Where are we in terms of your
4 concerns with the Dodd-Frank legislation, providing some
5 additional tools, comfort level, and now understanding
6 better, and more importantly, if we are now not going to
7 have these crisis interventions when we do fail, unwinding
8 structures in a reasonable way?

9 WITNESS BERNANKE: That's an absolutely central
10 question. Of course as you know, Chairman Bair has written
11 a testimony which addresses this issue in some detail.

12 VICE CHAIRMAN THOMAS: As we say, she's next.

13 WITNESS BERNANKE: She's next on the program, I
14 understand. It's a very difficult problem. Certainly the
15 kind of firms we're talking about are much more complicated
16 than the small- and medium-sized banks which are the typical
17 companies that are unwound through the FDICIA process, for
18 example. So this is not at all an easy process.

19 However, I think we will be much better off if
20 you think about--one thing I feel people don't always
21 appreciate is that we tried to do these very complex
22 operations, you know, within hours, within a weekend. And
23 certainly we'd of been much better off if we'd had an
24 extended amount of time to understand, and study, and
25 prepare, and make plans, and that is an important part of

1 what the FDIC's new Division on Complex Firms is about.

2 They will be aided, as will we at the Federal
3 Reserve, by living wills--that is, by a required document
4 that firms will provide which will explain how they would be
5 wound down. And if those living wills are not satisfactory,
6 we have the authority to require them to simplify their
7 legal and organizational structure as necessary to make it
8 feasible.

9 So it is going to be very difficult, but
10 certainly we will be in a much better place than we were
11 prior to this crisis.

12 I think the one area where it's going to take a
13 lot of effort is the international element, because these
14 firms--one of the banks that we supervise has offices in 109
15 countries, each one with its own bankruptcy code and its own
16 rules and so on. And we're going to need to develop sort of
17 the moral equivalent of tax treaties with other
18 jurisdictions whereby we have rough agreements on how we
19 would cooperate and work together to unwind a firm, and that
20 will be very challenging.

21 But it is something that is currently being
22 heavily investigated by international bodies like the
23 Financial Stability Board, and I think it should be a top
24 priority.

25 VICE CHAIRMAN THOMAS: And where are we in terms

1 of those discussions? Because that was definitely one of
2 the concerns that I had. We can resolve our problems, and
3 if we can't get an international agreement, given the
4 complexity and multi-national nature of today's financial
5 structure. And of course the farther away you get from the
6 cliff, the less you want to kind of make the sacrifices that
7 allow for that international stability.

8 What's your comfort level in where we're going on
9 that?

10 WITNESS BERNANKE: Well one word on domestic,
11 which is there was just a roundtable, and the FDIC is well
12 advanced in developing some rules to explain how they will
13 invoke these powers. And we are working with the FDIC to
14 try to develop more knowledge about how you would go about
15 unwinding U.S. firms.

16 As you agreed, the international aspect is very
17 difficult. But there is a very concerted effort. As I
18 mentioned, the Financial Stability Board and the Basel
19 Committee, the Bank for International Settlement, and other
20 international bodies are looking at this very seriously.

21 I think what we will have to do is work primarily
22 with the principal countries. Although this bank is in 109
23 countries, there are 4 or 5 countries which are the most
24 important that we have to work with, which have the largest
25 banks and bank presence.

1 So it's going to require again some agreements,
2 some MOUs, some work together, some ideas about how you're
3 going to divide assets, how you're going to reconcile
4 different bankruptcy codes and the like. So there's a lot
5 of work to be done. And, you know, I think we have a way to
6 go still, but obviously we are very focused on doing that,
7 and we have a lot of cooperation and goodwill from our
8 international partners.

9 VICE CHAIRMAN THOMAS: And, Mr. Chairman, you
10 indicated, I think the phrase was "the regulations given to
11 us by Congress," and we always look for the ability to
12 structure legislation with the flexibility under regulations
13 to not put you into a statutory straitjacket, but I had some
14 concerns yesterday in testimony.

15 When you look at that period in late September,
16 early October, in attempting to deal with Wachovia, and in
17 the minutes of the FDIC discussions they take the very
18 extraordinary step of accepting the concept of hopefully no
19 dollar exposure but responsibility for backup on the
20 Citi/Wachovia structure. That's put to bed.

21 And then literally the very next day, IRS issues
22 2008-83, fundamentally changing a two-decade-old Tax Code
23 provision. And you may recall some of us from the Article I
24 part of government being fairly sensitive because there's a
25 difference between "needed" and "desirable."

1 And it concerns me very much that whoever was
2 meeting came up with an idea that could solve the problem,
3 but didn't fully appreciate the consequences of inventing
4 solutions when you're charged with not carrying out
5 activities, and the argument was "we weren't given the power
6 by Congress," but where you came up with an idea that could
7 be inventive, you go ahead and do it.

8 The real difficulty for me in the long run in
9 these kinds of situations is whether the Executive Branch is
10 a demand center, or whether it's a command center. And
11 clearly there are times when it has to be a command center,
12 both domestically and internationally. But more often the
13 argument that we had to be a command center is used to do
14 what you want to do, rather than not.

15 Did you have any behind-the-scenes' knowledge of
16 IRS and Treasury deciding to create a, what we call in the
17 business, a rifle-shot in terms of picking up losses of a
18 company that they could acquire? Which just kind of
19 fundamentally violated a portion of the Tax Code, as I said,
20 that had been honored for a couple of decades, which
21 actually changed the result of what happened to Wachovia in
22 finding a home, in my opinion--and others may argue.

23 Any reaction to what I just said?

24 WITNESS BERNANKE: All I can say is, I just don't
25 know the facts in that. But I can say that I have, I have

1 no knowledge; I had no inside knowledge, or any other kind
2 of knowledge, of this fact before it occurred.

3 From my perspective, putting aside the very
4 important procedural and legal issues that you raise, it was
5 inconsequential because one way or the other Wachovia was
6 going to get protected. And that was the thing I was
7 concerned about.

8 I did not advocate or get involved in any way
9 with the tax decision.

10 VICE CHAIRMAN THOMAS: Well our concern is that
11 in a crisis which we went through, necessity can be the
12 mother of invention, but you'd better come up with a
13 solution coming out the other end that doesn't provide you
14 or embolden you with the opportunity to do what happened
15 again.

16 I know some of my colleagues got pretty
17 frightened when they were presented with the option that you
18 must pass what's on this piece of paper before tomorrow
19 morning or the world as you know it is going to end.

20 You get away with that once, and I'm hopeful that
21 as we continue to move forward you spend a lot of time
22 consulting with those who actually believe they have some
23 role to play, not after the fact but during it.

24 Do you have a comfort level now in terms of your
25 ability to communicate with the Legislative Branch that

1 perhaps you couldn't do in that crunch timeframe?

2 WITNESS BERNANKE: Yes, certainly with the
3 benefit of time. Clearly these activities were not things
4 that I wanted to do. The Federal Reserve took an enormous
5 amount of heat for them, and came under a lot of pressure
6 politically and legislatively because of those actions.

7 So I would much rather have not have had to do
8 them. And I am very happy to see that we're moving towards
9 a system where there is a well-designed framework for
10 addressing these problems. And I hope that we can make it
11 workable so that we will avoid any such freelancing in the
12 future.

13 VICE CHAIRMAN THOMAS: Well just let me say,
14 Mr. Chairman, you have taken a lot of heat. But in the
15 final legislative battle in terms of the legislative
16 product, I think you did pretty well defending your position
17 in the way the final legislation was written.

18 One last question in terms of comparisons, which
19 are always questions that we wind up trying to examine
20 because we don't know what happened behind closed doors.
21 How was Lehman different from AIG? If there was a run on
22 AIG, capital was locked up in insurance subsidiaries, no
23 buyer. There had to be differences, obviously.

24 What to you were the differences?

25 WITNESS BERNANKE: There was a fundamental

1 difference, which was--again, the issue was could we make a
2 loan that was adequately secured? That was reasonably
3 likely to be paid back?

4 Unlike Lehman, which was a financial firm whose
5 entire going-concern value was in its financial operations,
6 AIG was the largest insurance company in America. And the
7 Financial Products Division, which got into the trouble, was
8 just one outpost of this very large and valuable insurance
9 company.

10 And therefore--and in fact that's why they
11 created this, because they wanted to ride on the coattails
12 of the AAA rating of AIG.

13 So unlike Lehman, which didn't have any going-
14 concern value, or not very much, AIG had a very substantial
15 business, a huge business, more than a trillion dollars in
16 assets and a large insurance business that could be used as
17 collateral to borrow the cash needed to meet Financial
18 Products' liquidity demands.

19 So that's a very big difference. And indeed, the
20 Federal Reserve will absolutely be paid back by AIG.

21 VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.
22 I just want to thank you, once again, for in political terms
23 your bravery and willingness to move in the way that you
24 did. Thank you, very much.

25 CHAIRMAN ANGELIDES: Mr. Georgiou?

1 COMMISSIONER GEORGIU: Thank you for joining us
2 today, Dr. Bernanke. After reading and re-reading your
3 prepared testimony, with all respect, I find a less-than-
4 thorough discussion of one area that I think is exceedingly
5 important, which is the erosion of market discipline
6 associated with the creation of the engineered financial
7 instruments that became toxic assets on the balance sheets
8 of our financial institutions.

9 These assets became a significant cause of the
10 liquidity crisis faced by these institutions when they
11 couldn't meet their obligations, either because they
12 couldn't sell the assets without a steep discount and ever-
13 increasing discount, and couldn't borrow against the assets
14 as collateral except with a large and increasing haircut.

15 And of course when they faced collapse, these
16 institutions turned to the American Taxpayer through the
17 Federal Reserve and others to essentially rescue them from
18 their excesses.

19 You have spoken to the deterioration in mortgage-
20 origination standards which, you know, they were problematic
21 to be sure caused in many instances by differential
22 financial rewards to mortgage originators who were paid more
23 to steer borrowers to mortgage products that produced
24 greater returns to the mortgage holders and greater costs to
25 the borrower, which of course resulted in a higher

1 likelihood of default by the borrower, but you didn't
2 address what I regard as frequently perverse incentives of
3 the other parties to the mortgage securitization process,
4 all of whom were compensated in cash when the products were
5 created without regard to its success or failure to perform
6 as represented to the investor-owners.

7 The underwriting investment banks legally
8 responsible for the exercise of due diligence on the
9 products, the lawyers who drafted the prospectuses, the
10 accountants who created the accompanying financial
11 statements, the credit rating agencies that rated these
12 securities, all received their fees in cash when the
13 securities were sold, and only if they were sold.

14 So is it any surprise that every participant in
15 the chain opined that everything was in order when we know
16 that it was not?

17 Some 92 to 94 percent of the mortgage-backed
18 securities and their tranches that were created that were
19 rated AAA have now been downgraded, and many of them
20 exceedingly severely. And we're not speaking here only of
21 simple mortgage-backed securities, but collateralized debt
22 obligations in which miraculously in a process I've likened
23 to Medieval alchemy, they take the BBB tranches of mortgage-
24 backed securities, which are the first ones to suffer a loss
25 when the borrowers default, and miraculously put them all

1 together and somehow create a security that's not just rated
2 AAA, but Super Senior, and actually essentially sold as a
3 product that cannot fail, but of course fail they did.

4 And then we go to CDO-squared, CDO-cubed, and
5 synthetic CDOs which are creations that are essentially bets
6 on the success or failure of the underlying other
7 securities, when they then have other things to sell.

8 So the financial reform legislation attempts to
9 address some of these problems by prohibiting differential
10 compensation to mortgage originators for steering borrowers
11 to riskier products, and by requiring issuers to hold 5
12 percent of the products they created.

13 Since it seems to me that nothing focuses the
14 mind of Wall Street bankers more than having their own money
15 at risk and their own skin in the game, it is hoped that
16 greater discipline and diligence will be exercised when the
17 creator knows that their own financial future depends on the
18 performance of their creation.

19 So I apologize for such a long intro,
20 Dr. Bernanke, but I would ask you to comment on the
21 initiatives put in place by the Federal Reserve in
22 exercising its responsibility to be the safeguard of the
23 safety and soundness of America's financial institutions to
24 address some of these issues.

25 WITNESS BERNANKE: Sure. I did refer in my

1 testimony to the problems with the originate-to-distribute
2 model, which goes all the way from the initial mortgage loan
3 all the way to the securitization, and there were clearly a
4 lot of problems there.

5 We are trying to address them. Although, as I
6 said earlier, we were late in developing mortgage
7 underwriting standards under HOPA, we did in fact in 2007-
8 2008 establish some very strong standards, and I'm sure they
9 will be maintained by the new Consumer Protection Agency.

10 We also have put out--we also have banned--the
11 Federal Reserve has banned yield-spread premiums, which
12 allow lenders to be compensated on the basis of the type of
13 mortgage that they provide. And so we have tried to address
14 the front end of originate-to-distribute.

15 COMMISSIONER GEORGIU: Right.

16 WITNESS BERNANKE: On skin-in-the-game, I think
17 we all agree that we want to create good incentives, and
18 that is one way to do it. And the Fed is also involved in
19 making sure that incentive compensation contracts for both
20 executives and other employees of financial firms reflect
21 appropriately the long-run returns to their activities and
22 not the short-run returns, as you were describing.

23 The only--

24 COMMISSIONER GEORGIU: And how would--if I could
25 just probe you on that, how would you propose to rejigger

1 those compensation incentives to reflect the long-term
2 performance?

3 WITNESS BERNANKE: Well we are asking the--since
4 the nature of the business differs across institutions--
5 we're asking for proposals. We're asking for companies to
6 show us what they're going to do, and we work with them and
7 make sure we're satisfied.

8 But the basic principal is that returns should
9 depend--first of all, they should be risk-adjusted. So if
10 you take a riskier action, that should be taken into
11 account.

12 And secondly, there should be a longer horizon so
13 that, not just whether you made the sale, or made the deal,
14 but rather how did it work out over a number of years.

15 COMMISSIONER GEORGIU: Right.

16 WITNESS BERNANKE: And so things like nonvested
17 stock, and things of that sort, are ways to achieve that.
18 So that is another step.

19 COMMISSIONER GEORGIU: And some have suggested a
20 basket--an index based on a basket of the securities created
21 so that you can actually track over time the success or
22 failure of those securities, and compensate people more or
23 less depending on how they perform.

24 WITNESS BERNANKE: For capitalism to work, you
25 have to have incentives tied to performance. And I think

1 one of the things people are very upset about is the fact
2 that it seems like a lot of people who drove their companies
3 into the ditch walked off with lots of money, and that's not
4 good capitalism, and it's not good for--it's not a good
5 ethical outcome, either.

6 The only comment I would make, though, one thing
7 which is puzzling in a way is that these firms that packaged
8 the securities, whether it was by mistake or not, ended up
9 being pretty exposed to them, and they took a lot of losses
10 in many cases. And so we have to figure out why, even
11 though they were so exposed to these securitized products,
12 they weren't more careful. But that's clearly a key issue.

13 COMMISSIONER GEORGIU: Well thank you. And I
14 think the answer at the end there is: Sometimes they just
15 got caught without being able to sell them all. I mean, you
16 know, it is a game, to some extent, like when there's
17 musical chairs, the music stops and you're not necessarily
18 finding a seat. And I think that to some extent happened to
19 some of these institutions.

20 Let me turn--I appreciate your considerations,
21 and I encourage you, as you look at these institutions on a
22 go-forward basis, you consider that kind of--those kinds of
23 thoughts as you evaluate their soundness.

24 There's some data that we've seen that suggests
25 that the sixth largest U.S. banking organizations, which are

1 BofA, JPMorgan Chase, Citigroup, Wells Fargo, Goldman Sachs,
2 and Morgan Stanley, now are actually larger as a result of
3 mergers and the elimination of other institutions than they
4 were even in 2007 just before the height of the crisis.

5 Apparently they are now--they were 58 percent of
6 GDP in 2007, and something like 63 percent of GDP in 2009,
7 which had gone up from 17 percent of GDP in 1995. So
8 there's been a consolidation and a growth.

9 And I guess my question to you would be: Given
10 their increasing size, do you really believe that these
11 institutions would not or would not be allowed to fail by the Fed if
12 they
13 got into financial trouble today?

14 I mean, I hope it doesn't happen, but let's just
15 say for the sake of argument that a diminution in some other
16 asset class results in serious stress to both the balance
17 sheet and the liquidity needs of these institutions. Are we
18 really in any better shape today to avoid the bailouts that
19 have been so criticized in the last few years?

20 WITNESS BERNANKE: The Federal Reserve was
21 created, but we're always well within the law, and we always
22 did what was--only exerted our legal powers. And the
23 changes in the bill that was just passed has, for example,
24 eliminated the ability of the Federal Reserve to lend to an
25 individual institution.

So I would say--and it also has specified of

1 course to the resolution regime how we must deal with a
2 failing systemically critical firm. So, you know, barring
3 some midnight session of Congress which rewrites the law, I
4 don't see any way that it would be feasible for the
5 government to bail out a firm in the same way that happened
6 during the crisis.

7 So it's very important that we make sure that our
8 methods that we do have, the resolution regime, et cetera,
9 that they work. And that's something we're very much
10 engaged on.

11 I think it's also very important that we make
12 sure that firms--although we're always going to have big and
13 complicated firms, we want to make sure that they're big and
14 complicated for the right reasons, for good economic reasons
15 and not because they're simply trying to hide behind
16 too-big-to-fail. And my belief is that, again, the
17 combination of tougher oversight, additional capital
18 required for a systemically critical firm, tougher
19 resolution regime, and those things are going to take away
20 some of the attractiveness to firms of being too big and
21 will I think help us over time with market discipline to
22 reduce the size and complexity of some of these firms.

23 COMMISSIONER GEORGIU: I noted on page 17 of
24 your prepared testimony you did speak to the size of the
25 firms and, in certain respects, the unmanageability with

1 regard to risk of some of the institutions.

2 I wonder if--some have suggested that they've
3 simply gotten too large. I'm not sure I agree. I
4 understand the notion that we need large institutions to
5 compete in a global marketplace, and to meet the financing
6 needs of large--our own large corporations and other
7 borrowers, but it's not inconceivable and commonly utilized
8 that when a large credit facility is necessary people enter
9 into syndicates. If one bank isn't big enough, somebody,
10 one or two of them take a lead and bring others in. And so
11 you still end up pulling together the resources necessary.

12 You know, we've had some extraordinarily
13 startling testimony in the course of our eight months or so
14 of hearings. We heard from the CEO, the Chief Financial
15 Officer, and the Chief Risk Officer of AIG that they did not
16 know that the products sold by the Financial Products
17 Division had provisions in them that, if the AIG's ratings
18 went down, or the tranches that they had insured against in
19 the credit default swaps, the failure of which they'd
20 insured against, went down, that they had collateral calls
21 which were ultimately what brought AIG to the brink of
22 insolvency.

23 And the same, similar kind of astonishing
24 testimony from Citigroup's then-CEO, Chief Financial
25 Officer, and Chief Risk Officer, that they did not know that

1 their banking subsidiary had sold collateralized debt
2 obligations with a liquidity put associated that permitted,
3 if they were downgraded, permitted the holders to
4 essentially put them back to Citibank to the main holding
5 company and get--and they did so. In one day they took \$25
6 billion and bought this stuff back, which was a third of
7 their then-capital of \$75 billion on some \$3.3 trillion of
8 assets.

9 I mean, these were astonishing risk management
10 failures. And some have even speculated that really they
11 couldn't possibly have meant it when they testified here
12 that they didn't know.

13 But assuming for the sake of argument that they
14 did not know, that really can't--ought not to occur on a go-
15 forward basis. So are these institutions so complex and so
16 diverse in their product mix that they've become too large
17 to manage? And if that's the problem, then how do we
18 address that from the Federal Reserve's perspective?

19 WITNESS BERNANKE: Well it's our responsibility,
20 and the other regulators', to make sure that their
21 management is effective and that they have good risk
22 management system.

23 And if we are persuaded that they cannot manage
24 the risks of the corporation because it's too large or
25 complex, we are able--we have the authority to make them

1 divest, or to change their structure. And that is not even
2 counting the new authority that if a firm is viewed as being
3 systemically risky, that it could be broken up on that
4 ground, as well.

5 So we do have some authority there. And in the
6 case, for example, of Citi, which you mentioned, they are in
7 fact--they have created a very substantial portion of their
8 company, put it into a separate structure which is being
9 sold off.

10 So I agree with you that, where there is failure
11 of risk management, or business management, because of size
12 or complexity, it is very important that the firm and the
13 regulators work to address the problem, and I assure you
14 that we will.

15 COMMISSIONER GEORGIU: Thank you, very much. If
16 I might, could I reserve two minutes of my time?

17 CHAIRMAN ANGELIDES: You've got one minute and
18 seventeen seconds, but we will graciously grant you the
19 forty-four seconds.

20 COMMISSIONER GEORGIU: Thank you very much.

21 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

22 COMMISSIONER HOLTZ-EAKIN: Thank you,
23 Mr. Chairman, and thank you, Mr. Chairman for spending this
24 time with us today.

25 I guess I would like to follow those who preceded

1 me in thanking you for your service during this very
2 difficult period. And more generally, to the Federal
3 Reserve for its cooperation with this inquiry throughout.
4 It's really been very helpful.

5 I don't have a particularly systematic set of
6 questions. I have a couple of things I'm curious in, but I
7 want to go back to the trigger that you mentioned, the
8 housing bubble subprime crisis.

9 You touched on this some in your written
10 testimony, but could you just walk us through your
11 view of the causes of the housing bubble? And I'm
12 interested in the points of recognition within the Federal
13 Reserve when we had a housing bubble, and sort of what your
14 policy options were in light of that.

15 WITNESS BERNANKE: So bubbles by their very
16 nature are extremely difficult to understand, even after the
17 fact.

18 The house prices began to increase fairly rapidly
19 in the middle to late '90s. And then of course they
20 accelerated to some extent in the early 2000s, and then
21 peaked in 2005-2006.

22 My own view is that there are many factors that
23 contributed to that. In my testimony I discussed two that I
24 think are important.

25 One was the interaction of expectations and

1 optimism on the one hand, and innovation and mortgage
2 instruments on the other. What you saw was an increased
3 willingness on the part of lenders to make loans to people
4 who were really not qualified on the expectation that
5 appreciation in the value of their homes would allow them,
6 by giving them more equity, would allow them to refinance
7 into more standard instruments.

8 And what we saw as the crisis progressed was
9 increasingly sketchy instruments that had, if they had even
10 existed prior, had been reserved only to very limited groups
11 of customers. But now you had people who had not bought a
12 house before using Option ARMs, and Interest Only, and other
13 complex mortgage instruments whose primary purpose was to
14 bring the monthly payment to as low a level as possible.

15 And again, that worked okay as long as prices
16 were rising. But of course prices couldn't rise forever.
17 And once they stopped rising, the whole process unwound. So
18 I think that was very important. And people like Bob
19 Shiller have pioneers in identifying those issues.

20 Another factor which I have talked about since
21 2005 is the so-called "global saving glut." All that really
22 means is that, for a variety of reasons--and the timing here
23 works well--going back into the '90s the U.S. has been a
24 major recipient of global capital flows, and a lot of those
25 capital flows have gone into relatively safe fixed-income

1 instruments like mortgage-backed securities, or securitized
2 credit products.

3 That includes not only the excess savings from
4 Asia, emerging markets, and oil producers, but also even the
5 gross savings from Europe and other places that have been
6 looking for those kinds of instruments.

7 And so that demand both reduced mortgage rates,
8 reduced spreads, and gave investment houses in the U.S. and
9 elsewhere an incentive to create these new products, the
10 alchemy that Mr. Georgiou was talking about, taking
11 uncertain mortgages and by restructuring them creating these
12 tranches of so-called AAA Senior, Super Senior debt, et
13 cetera.

14 So I think that was probably important.

15 The controversial issue, because it matters so
16 much for the future of how monetary policy is conducted, is
17 what role did monetary policy play? And there's a lot of
18 conventional wisdom about this. And I think the only honest
19 answer is: We really don't know exactly how big the role
20 was.

21 But I have tried to give some arguments why I
22 think that the view that monetary policy was a principal
23 cause is not supported by the evidence, and I can repeat
24 that if you'd like, but very briefly there was the fact that
25 the previous relationships between monetary policy and

1 housing prices don't look remotely like what they would have
2 had to have been in order to account for the increase in
3 house prices in the recent episode.

4 Cross-country, we don't see any relationship
5 between monetary policy and housing prices. And finally, I
6 think even if there had been some relationship, it would
7 have been very questionable that we should have, you know,
8 substantially raised interest rates in the situation in
9 2003-2004, given what was happening in the macro economy as
10 an attempt to try and close off the housing bubble.

11 My strong preference--and I said this in my very
12 first speech as a Governor in 2002--was that we should use
13 supervision and regulation to approach bubbles. We didn't
14 do that--

15 COMMISSIONER HOLTZ-EAKIN: Thank you.

16 WITNESS BERNANKE: --going forward we need to be
17 able to do that. And that's very important.

18 On the Fed's views, the Fed has taken criticism
19 for not, quote, "recognizing the obvious," et cetera. We
20 always of course knew the house prices were rising quickly,
21 but as of 2003-2004 there really was quite a bit of
22 disagreement among economists about whether there was a
23 bubble, how big it was, whether it was just a local or a
24 national bubble. So we were certainly aware of that risk
25 factor.

1 But, you know, frankly we--by the time it was
2 evident that it was a bubble and that it was going to create
3 risk to the financial system, it was rather late to address
4 it through monetary policy.

5 COMMISSIONER HOLTZ-EAKIN: So if you rolled the
6 clock forward then, and we get into the subprime mortgage
7 crisis, there's a point at which I believe you say it will
8 be contained and not spill over. And without pointing
9 fingers, I'm just curious, what was the basis of that
10 judgment? And what were the things you didn't know--because
11 it obviously did.

12 WITNESS BERNANKE: So this was related to, in
13 fact the thinking was that if house prices did come down
14 some, and that 25-30 percent was not what people were
15 contemplated, but if they did come down some, that the
16 economy could manage that okay.

17 And when I said what I said, it was based on the
18 observation that even under very bad scenarios, the total
19 losses in subprime adjustable rate mortgages, for example,
20 were unlikely to be more than say \$300 or \$400 billion,
21 which is a lot of money obviously, but compared to global
22 financial markets where there's \$60 trillion of equity value
23 in markets around the world, it was just a very small amount
24 of money.

25 So the loss of \$3- or \$400 billion of equity

1 value would do almost nothing to the world economy.

2 But what happened here was that the financial
3 system had these vulnerabilities and weaknesses, which I
4 talked about in my longer testimony, and what was a
5 relatively small factor in the scheme of things triggered
6 these weaknesses and led to a much bigger crisis.

7 And so what I did not recognize when I thought
8 and said that this crisis was contained was that it was
9 based on my view that the losses were going to be, you know,
10 manageable. What I did not recognize was the extent to
11 which the system had flaws and weaknesses in it that were
12 going to amplify the initial shock from subprime and make it
13 into a much bigger crisis.

14 COMMISSIONER HOLTZ-EAKIN: And so if we then move
15 to the crisis, I want to talk a little bit about
16 too-big-to-fail institutions in both the history we have to
17 investigate, and then going forward.

18 So as it sort of bleeds into the broader
19 financial markets, what institutions are you watching
20 carefully? And by what criteria are you selecting the ones
21 that you really are worried about?

22 WITNESS BERNANKE: You mean today?

23 COMMISSIONER HOLTZ-EAKIN: At the time. You
24 know, as the crisis begins to unfold, what was the nature of
25 the Fed's criteria for identifying institutions that they

1 needed to be on watch against?

2 WITNESS BERNANKE: Well, again, to begin with
3 it's important to remember that the Fed was not a systemic
4 regulator at that time.

5 We had some very specific responsibilities for
6 bank holding companies, principally. We did not have
7 responsibilities for AIG, or for the investment banks, or
8 for Fannie and Freddie, or for mortgage bankers. So many of
9 the areas where there were problems, we simply did not have
10 an ongoing authority or supervisory presence.

11 And so we did not get heavily involved in any of
12 those situations until well into the crisis when, say, maybe
13 around the time of Bear Stearns when it was evident that
14 some important financial institutions were under a lot of
15 stress. And at that point, the Fed, the Treasury, and to
16 some extent the FDIC and other agencies, were then coming
17 together to try to think about how to address them.

18 So we came rather late to some of these firms.
19 And that was simply the nature of our responsibilities and
20 our authorities.

21 In terms of which firms to pay attention to,
22 there are multiple criteria. Certainly size is important.
23 But size is by far not the only criterion. For example,
24 Bear Stearns was not that much larger than WaMu for example-
25 -

1 COMMISSIONER HOLTZ-EAKIN: Right.

2 WITNESS BERNANKE: --but Bear Stearns was a much
3 more complex firm. It had a large presence in the triparty
4 repo market--that is, in the short-term money market--and in
5 securities lending, and other short-term financing. It had
6 a large derivatives book. So it was very interconnected.

7 The nature--a very important aspect of the crisis
8 was a rolling panic: the notion that as confidence was
9 lost, firms that were vulnerable from a liquidity point of
10 view came under increasing attack. And in some cases also
11 via the Stock Market, the declines in stock prices reduced
12 confidence, et cetera, as well.

13 It was our view that the failure of Bear Stearns,
14 for example, would lead to some of the same effects we saw
15 with Lehman six months later. That is, huge stresses in the
16 repo markets; problems in the commercial paper market, other
17 money markets; and that those short-term liquidity stresses
18 would feed over into other firms, even those firms that
19 didn't have direct counterparty relationships with Bear
20 Stearns.

21 So it was those criteria: Size.
22 Interconnectedness. Complexity. And also performance of
23 critical functions.

24 So, for example, banks like JPMorgan and Wachovia
25 had very important roles in various payments and settlements

1 and other infrastructure-type aspects of the financial
2 system, and that was an additional consideration as we
3 looked at these firms.

4 COMMISSIONER HOLTZ-EAKIN: Thank you. I don't
5 want to put words in your mouth, but when we talked
6 yesterday with former Under Secretary Steel about this, it
7 really appeared that in the crisis what mattered most was
8 not size, interconnectedness, complexity, but which markets
9 were showing signs of distress and panic. And if firms were
10 in that market, that was the criteria for intervention.

11 And the reason I wanted to push this is, in the
12 sort of new legislation there's a whole lot of ex-ante sort
13 of thinking about who is going to be the systemically
14 important institutions, which it doesn't appear that you
15 could anticipate because you don't know the markets that
16 will be distressed.

17 Do you think that's a fair concern?

18 WITNESS BERNANKE: Well it is a fair concern.
19 The legislation requires us to identify systemically
20 important institutions for the purposes of oversight, but I
21 don't believe that you have to be pre-identified as
22 systemically important for the resolution regime to apply to
23 a firm.

24 I think that's a decision that's made at the
25 time.

1 COMMISSIONER HOLTZ-EAKIN: Okay, but how then
2 could they prepare a living will if they have not been
3 identified as someone who should be resolved?

4 WITNESS BERNANKE: Well I think that for firms
5 that are on the cusp, if you will, I think prudence might
6 have us work with them on these issues in any case. I think
7 that would be important for complex firms.

8 But you raise an important point.

9 COMMISSIONER HOLTZ-EAKIN: I'm just trying to
10 figure out how this works.

11 The second question I have--this is a slight
12 tangent--but on the living will, I'm just wondering how you
13 think about this, is we relied in the past on systems of
14 internal risk assessment as a substitute for direct
15 measurement of the risk exposures of firms because they were
16 too complicated for us to do an assessment of the risk, so
17 we wanted to make sure they had good systems.

18 If firms are too difficult to resolve, can we
19 rely on their plans for resolving themselves if we don't
20 understand how to do it? It sounds like the same thing.

21 WITNESS BERNANKE: They have to come up with the
22 plan, but then we have to--so they are better placed than we
23 are to figure out the best way to unwind the firm. But we
24 have to take the responsibility, with their cooperation, of
25 assuring ourselves that it is a workable plan. And the

1 responsibility for that is the Fed, the FDIC, and whatever
2 other regulator is relevant. And so we are going to put
3 together a lot of expertise and try and figure that out.

4 At the Fed, one of the lessons we have taken from
5 the crisis is that we really need to take a much broader,
6 more multi-disciplinary approach. We need to bring in more
7 finance people, more economists, more payments' people, more
8 lawyers, more accountants, to supervise--to supplement the
9 supervisory activities and make sure we really have the
10 breadth of perspective that we need to get this done.

11 COMMISSIONER HOLTZ-EAKIN: Okay. So, sorry to
12 jump back and forth, but going back now to as the crisis
13 unfolded and the Fed's decisions about where to actually
14 intervene with institutions, I want to ask again about
15 Lehman versus AIG, just for thinking about the criteria for
16 intervention. And what I'm not sure I understand is what
17 you said about AIG, that it was easy to make a loan in that
18 case, and I guess I just want to walk through the logic of
19 that.

20 Because you said you didn't want to loan to
21 Lehman because you would be lending into a run, and that
22 they didn't have sufficient assets and you wouldn't get
23 repaid.

24 AIG had no buyer, so it looked a lot like Lehman
25 in that regard. There was clearly a run, a liquidity run.

1 And you did ultimately lend into it. And indeed, had to go
2 back and lend a lot more in short order. So it didn't look
3 like you both lent into the run and stopped it; it looked
4 like it continued, to me.

5 And what I'm confused about is your assessment of
6 the ability to get repaid. Because my understanding--and
7 this could be wrong--is that a lot of the assets they had
8 were not available as collateral for loans; they would be
9 locked away in the insurance divisions in the firm.

10 And so what is the difference in the thinking
11 about Lehman versus AIG and the nature of Fed intervention?

12 VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the
13 gentleman two additional minutes to cover the answer.

14 COMMISSIONER HOLTZ-EAKIN: Thank you.

15 WITNESS BERNANKE: So first, both of them bet the
16 criterion for us trying to save them if at all possible.
17 They both were systemically critical. But AIG had a
18 completely separate business, an ongoing business, that had
19 a going-concern value. It had a lot of shareholder equity.

20 It had subsidiaries that we're seeing now that
21 they're trying to sell off that have substantial value. And
22 so it was our assessment that they had plenty of collateral
23 to repay our loan--because it was in a separate business
24 that did have a lot of going-concern value and did have a
25 lot of assets.

1 Now it is true that in the fourth quarter they
2 lost more money than any company in history, like \$62
3 billion, and that made things much more difficult, and
4 therefore required some additional help from the Treasury in
5 terms of capital, et cetera.

6 But I think at the time that we made that
7 decision, the problems with AIG didn't relate to weaknesses
8 in their insurance businesses, it related very specifically
9 to the losses of the Financial Products Division. The rest
10 of the company was, as far as we could tell, was an
11 effective, sound company with a lot of value, and that was
12 the basis on which we made the loan.

13 COMMISSIONER HOLTZ-EAKIN: So the calculation is,
14 you can lend into the run at AIG and stop it eventually--
15 perhaps it took longer than you thought--

16 WITNESS BERNANKE: As long as they have enough
17 collateral to--

18 COMMISSIONER HOLTZ-EAKIN: --and there's no
19 capital hold on an ongoing concern, but the same is not true
20 for Lehman?

21 WITNESS BERNANKE: Lehman did not have enough
22 collateral in terms of financial assets, and its going-
23 concern value was tied up completely in its financial
24 operations. It didn't have a separate business, insurance
25 or other business, that provided additional value and

1 protection.

2 COMMISSIONER HOLTZ-EAKIN: Well, last question,
3 and just briefly. What would be different now--Bear,
4 Lehman, AIG--with the new authorities of the Fed? How would
5 that have played out if you had had the authorities you have
6 now? What would you have done in each case?

7 WITNESS BERNANKE: Well, in the case of Bear,
8 remember Bear was acquired by JPMorgan--

9 COMMISSIONER HOLTZ-EAKIN: But it was a
10 subsidized acquisition.

11 WITNESS BERNANKE: A subsidized acquisition.
12 Maybe the existence of this resolution regime might have
13 changed the bargaining position somehow.

14 COMMISSIONER HOLTZ-EAKIN: Okay.

15 WITNESS BERNANKE: So if we could have gotten
16 them acquired, I think that would have been the first
17 choice. But without any kind of subsidy.

18 Barring that, I think in all three cases they
19 would have been appropriate candidates for the application
20 of this regime and we would have supported that.

21 COMMISSIONER HOLTZ-EAKIN: And so in particular
22 AIG, a firm you assessed to be a healthy, ongoing concern,
23 would have been resolved?

24 WITNESS BERNANKE: I don't see what the
25 alternative would have been, unless we could have somehow

1 stopped the run through some kind of cheery words of some
2 kind. I don't know how to do that.

3 COMMISSIONER HOLTZ-EAKIN: If you figure that
4 out, let me know. Thank you.

5 WITNESS BERNANKE: I'll let you know.

6 (Laughter.)

7 CHAIRMAN ANGELIDES: Senator Graham.

8 COMMISSIONER GRAHAM: Thank you, Mr. Chairman,
9 and thank you, Mr. Chairman, for your excellent insights
10 today.

11 I'll have to say it seems to me that we sort of
12 have three options in looking at this issue of what to do
13 when the too-big-to-fail institutions get in trouble, one
14 which the legislation has provided apparently as a somewhat
15 neater and cleaner funeral service as to how to bury the
16 body.

17 The others are steps that might be taken to keep
18 the institution healthy, such as the kind of more rigorous
19 oversight and regulation that you have discussed.

20 Or, the third option, might be the option of the
21 late 19th and early 20th Century with a similar situation.
22 And that is, to try to change the basic structure of the
23 too-big-to-fail institutions.

24 Beginning shortly after the Civil War, the growth
25 of the commercial and industrial trust became a source of

1 concern. And at both the federal and the state level there
2 were a number of efforts made to try to contain their more
3 predatory policies.

4 Finally, people despaired of that, and then in
5 the early 20th Century they moved towards breaking up the
6 trust as the only way to keep them from fundamentally
7 damaging our capitalist system.

8 Apparently this legislation has decided that is
9 not going to be the option that we will use, and in fact the
10 statistics are that these institutions are growing rapidly
11 as an even more dominant force within our economy.

12 You indicated some optimism about the ability to
13 supervise these institutions, and you stated that there will
14 be indicators that will indicate--that will be indicative of
15 whether this more strenuous regulation is accomplishing its
16 intended purpose.

17 I will have to say I am not that optimistic.
18 First, I'm not optimistic domestically. For the last three
19 decades, the American People have elected governments, both
20 Republican and Democratic, which have tended to support
21 looser and looser standards of regulation. Some of the most
22 significant occurred during a Democratic Administration.

23 At the international level, we see the influence
24 of these largest institutions. It's been reported currently
25 that in Basel that the Committee is under a great deal of

1 pressure to weaken the standards for collateral and
2 liquidity that had originally been proposed.

3 So what is your--what is the basis of your
4 optimism that domestically there is the political will for
5 sustained stronger supervision; and that there will be
6 international support for that kind of effort, so that
7 stronger supervision at home is not seen as a means of
8 neutering our ability to be an effective competitor in the
9 global financial markets?

10 WITNESS BERNANKE: Well, Senator, you've raised
11 some good issues there. I think if there's a lack of
12 political will, there is probably no solution that is
13 sustainable.

14 I think that the combination, as I said before,
15 ideally we would like to see firms restructured in a way
16 that makes economic sense, and that is consistent with
17 market forces. And the best way to do that, at least in
18 principle, would be to combine tough oversight and
19 regulation, including such things as surcharges for--capital
20 surcharges for firms that are systemically critical, which
21 would both make them safer but also make it more onerous to
22 be a systemically critical firm. Combine that with the
23 resolution regime, or similar things that create more market
24 discipline. And in principle--and of course I recognize
25 this may not happen; but I think we should try to work to

1 make it happen--in principle that would give firms the
2 incentives to break up, restructure, and change their form
3 in ways that will respond to the market, respond to the size
4 and complexity, which is what is really needed, and
5 eliminate the incentive to become big, just to become too
6 big to fail.

7 Now you said that the bill doesn't give us the
8 authority. In fact, it does give us the authority if we
9 despair of these other methods and we believe that a firm
10 is, its size and complexity is dangerous. We have both the
11 living will requirement, but in addition we also have the
12 authority of the regulators collectively to break up firms,
13 if necessary.

14 You may ask if there is political will to do
15 that? And I don't know the answer to that question. But
16 certainly that is the charge that Congress has given the
17 regulators, and we take very seriously that charge.

18 So I think we have put in place some reasonable
19 approaches, but I certainly appreciate your historical
20 perspective which says of course that over the long run you
21 have to take into account the political influence of these
22 large institutions. I think that is an issue.

23 COMMISSIONER GRAHAM: Well, and in terms of the
24 will of the institutions themselves, there has been quite a
25 division in American industry. Some industries have adopted

1 levels of self-regulation which have provided a defense-in-
2 depth against unacceptable behavior.

3 For instance, the nuclear power industry has
4 developed some very impressive processes within the
5 industry, nongovernmental, for best practices and
6 enforcement of those best practices.

7 On the other hand, the deep-water oil and gas
8 drilling industry has had almost none of that, and we have
9 just seen one of the manifestations of the failure to have
10 any kind of internal controls.

11 Is there any indication that within the financial
12 community, are they more like the nuclear power industry?
13 Or are they more like deep-water drilling in terms of their
14 indicated willingness to provide defense-in-depth by their
15 own actions?

16 WITNESS BERNANKE: Well it's an interesting
17 question. Historically, again to go back to the historical
18 analogies, there was a lot of self-regulation in the
19 financial industry.

20 There was a time when the principal regulatory
21 agency was the clearinghouse of the banks themselves within
22 a city, and they monitored the health and stability of the
23 other banks because they recognized if one bank failed that
24 they were at risk as well.

25 Clearly we have gone a long way away from that

1 model, and we are now primarily in a government regulatory
2 model. And I think that is the dominant factor.

3 I hope, again, though, that regulation itself is
4 not going to be adequate. We need to have market
5 discipline. We need to have incentives in place for firms
6 to manage their own risk, to take their appropriate
7 decisions based on the market signals and the incentives
8 that they are receiving.

9 And it's the combination of those two things that
10 I see as having the best chance of managing the risk in this
11 sector. But it is, I think--you know, I don't think we're
12 really at the nuclear power type of model at this point.

13 COMMISSIONER GRAHAM: Mr. Chairman, could I have
14 two additional minutes for a question?

15 CHAIRMAN ANGELIDES: How could I say no to you?
16 Two minutes for the Senator in the deliberative body with no
17 time limits.

18 (Laughter.)

19 COMMISSIONER GRAHAM: I was very intrigued with
20 your statement that there are going to be some indicators,
21 some markers of whether this more rigorous supervision is
22 accomplishing its objective.

23 What would you put down in the vertical column as
24 the--what are those indicators, particularly that have some
25 capacity to be quantified, that you'll be looking at to

1 answer the question: Is the tougher regulation working?

2 WITNESS BERNANKE: Well certainly one important
3 set of indicators relates to the cost of capital for these
4 firms. If they're not too big to fail, then an important
5 source of their market advantage will be eliminated.

6 So for example you would expect to see wider risk
7 spreads, or higher CDS spreads, reflecting the increased
8 conviction of the market that they could fail; and that
9 those spreads should be more responsive to market
10 developments.

11 So that would be one set of things. And then we
12 could also look at things like return-on-equity, which
13 should not be artificially increased by too big to fail
14 characteristics of the firm.

15 COMMISSIONER GRAHAM: And do you see the Fed
16 developing this report card of indicators and periodically
17 making it available to the public so that there will be the
18 capacity for continued public monitoring of how well the
19 supervisory system is functioning?

20 WITNESS BERNANKE: Well some of the indicators I
21 just suggested are already obviously public, and anyone can
22 look at them.

23 We have developed--we are well along in
24 developing a quantitative surveillance mechanism which will
25 be looking at a whole variety of financial and other

1 indicators of individual firms, and using them as a
2 supplement to the on-site supervision that the supervisors
3 do.

4 I am not sure yet, you know, in what form we will
5 communicate this information to the public, but we certainly
6 want to make sure the public is confident that firms are
7 safe and sound. So we will try to find ways to communicate
8 that effectively.

9 COMMISSIONER GRAHAM: Well, just to conclude,
10 going back to the importance of the public seeing that this
11 is not only in their individual interest but also in the
12 broader societal interest to have effective regulation so we
13 reduce the likelihood of firms getting into the extremis
14 situation where you have to plan the cleaned-up funeral, I
15 believe that keeping the public informed is a critical
16 element of building that support. So I would urge you to
17 make this as communicative and as publicly available as
18 possible.

19 WITNESS BERNANKE: Thank you.

20 COMMISSIONER GRAHAM: Thank you.

21 CHAIRMAN ANGELIDES: Thank you, Senator. Mr.
22 Thompson.

23 COMMISSIONER THOMPSON: Thank you very much, Mr.
24 Chairman. It's out of order today. I didn't realize that.

25 CHAIRMAN ANGELIDES: It's a little switch-up, you

1 know, last session.

2 COMMISSIONER THOMPSON: Keep us all on our toes.

3 Thank you, Dr. Bernanke, for joining us. While
4 this hearing is about too big to fail, I would like however
5 to go back to the broader issue of the crisis, if I might.

6 So would you describe for us the role that the
7 Federal Reserve plays in monitoring or managing credit
8 standards in our country?

9 WITNESS BERNANKE: Well as I mentioned earlier,
10 the Federal Reserve has had a role in consumer protection.
11 So we have created rules, for example, on required
12 documentation; escrow accounts; and other standards of
13 underwriting that would apply to mortgages.

14 The other main area that I can think of is, like
15 other bank regulators, we want to make sure that banks--
16 while it's their decision what kind of risk to take, and
17 what loans to make--that they are adequately capitalized in
18 order to deal with any losses that might occur.

19 And so we are pressing for, on the one hand,
20 strong risk-sensitive capital standards which will tie the
21 amount of capital that banks have to hold to the risk of the
22 loans that they make, and therefore if they make a riskier
23 loan they need to hold more capital, and they have to judge
24 for themselves whether economically it makes sense to do
25 that.

1 And we also want to continue to work with the
2 accountants and the SEC and others to make sure that banks
3 have adequate reserves against losses.

4 So by providing adequate capital and reserves,
5 banks have I think the right incentives to make adequate
6 loans. We don't generally--some countries, and it's an
7 interesting idea, some countries, the authorities actually
8 intervene in things like loan-to-value ratios, down-
9 payments, and things of that sort. You know, we haven't
10 done that in this country, but I think we ought to look
11 broadly at how we might ensure that we don't have a system
12 where credit gets too easy in the boom and too tough in the
13 downturn.

14 COMMISSIONER THOMPSON: In your written testimony
15 you commented about the innovation that occurred in the
16 market, primarily around originate-to-distribute model and
17 what have you, which clearly was facilitated by lax lending
18 standards.

19 Could the Federal Reserve not have stepped in as
20 it saw this model being developed in this innovation really
21 putting the economy at risk?

22 WITNESS BERNANKE: Well as I've said, I think we
23 bear some responsibility there. And I think primarily in
24 two areas.

25 The first was in the underwriting standards and

1 the application of the HOPA regulations. The problem there,
2 again acknowledging the concern, you know one of the
3 problems there was that, although the Federal Reserve had
4 the authority to write rules, we had no enforcement
5 authority.

6 We would have had to rely on state and other
7 regulators to enforce those rules. And it was partly
8 because we weren't supervising these firms that we didn't
9 see what was going on quite as clearly that we didn't
10 respond as quickly as we should have. But that was an
11 important failure, as I've agreed many times.

12 The other area where both we and other bank
13 supervisors I think should have been more effective was in
14 risk management more generally. The firms did not have
15 enough information about what the brokers were doing on
16 their behalf, what kinds of standards they were applying.

17 They didn't know their own exposures to subprime
18 and other types of mortgages. As was pointed out, they
19 relied too heavily on the credit rating agencies who
20 themselves had flawed models that ignored correlated risks
21 across housing prices across parts of the country.

22 So I think those were the two areas where the Fed
23 could have--the Fed and other bank regulators--could have
24 done more. One was at the underwriting level, and the
25 second was just in the general risk management of the firms

1 to understand their exposures both in terms of their own
2 losses, but also their reputational and operational risks
3 that they were taking as they were packaging these
4 mortgages.

5 COMMISSIONER THOMPSON: Given my background the
6 technology business, I have an appreciation for the value of
7 innovation, and I have an even stronger appreciation for the
8 role that technology plays in the financial services sector,
9 perhaps the largest consumer in technology as a sector in
10 our economy.

11 Given that, and given the role of innovation in
12 that sector, what more should be done to manage the
13 innovation process within the financial services sector in
14 such a way that it doesn't create a systemic risk to the
15 economy?

16 WITNESS BERNANKE: I think one of the lessons of
17 the crisis is that innovation is not always a good thing.
18 There are innovations that have unpredictable consequences.
19 There are innovations whose primary purpose is to take
20 unfair advantage, rather than to create a more efficient
21 market.

22 And there are innovations that can create
23 systemic risks even if from the perspective of the
24 individual firm, you know, that risk is not evident.

25 So I'm not sure I would go so far as to say we

1 need to have sort of a new product-approval safety
2 commission, or something like that--although the CFPB will
3 do some of that I'm sure.

4 But the new Financial Stability Oversight
5 Council, for example, ought to pay close attention to
6 financial innovations and regulators. As we look at the
7 risk management and the systemic consequences of these
8 decisions, we need to be assertive if there are developments
9 that we find either counterproductive from the perspective
10 of consumer protection, or systemically risky. I think we
11 ought to intervene there.

12 COMMISSIONER THOMPSON: You made a comment in
13 your opening statement about your long-standing background
14 as a student of financial markets and financial crisis. And
15 oftentimes in a crisis leaders are asked to do things
16 they've never had to do before. Oftentimes that means
17 asking for forgiveness, as opposed to permission.

18 In hindsight, would you have preferred now to
19 have asked for forgiveness and done something to save Lehman
20 in such a way that this crisis would not have unfolded the
21 way it did in our economy and our country?

22 WITNESS BERNANKE: You know, it's really hard to
23 know what would have happened. I mean, one possible
24 scenario is that we would have--I mean, the only we could
25 have saved Lehman would have been by breaking the law, and

1 I'm not sure I'm willing to accept those consequences for
2 the Federal Reserve and for our systems of laws. I just
3 don't think that would be appropriate.

4 So I wish we had saved Lehman, but--and we tried
5 very, very hard to do so, but it was beyond our ingenuity or
6 capacity to do it. And I don't think--I'm willing to be
7 creative, but I'm not willing to--

8 COMMISSIONER THOMPSON: But you did see it
9 coming.

10 WITNESS BERNANKE: We saw there were a lot of
11 risks in Lehman and other companies as well, but the actual
12 failure was not preordained. I mean, for example we were
13 hopeful, maybe too hopeful, even up to the last day, that we
14 had two potential acquirers--

15 COMMISSIONER THOMPSON: My reference was more to
16 the consequences of their failure. You saw the
17 consequences. You predicted that.

18 WITNESS BERNANKE: I was personally convinced.
19 And I guess I would add that, you know, in our decision to
20 rescue AIG I sort of gambled--I sort of--I was sort of
21 taking a risk that, you know, it could have happened, I
22 suppose, that after a few days of market upset that the
23 market would have digested the Lehman event and people would
24 have said, well what the hell were you doing with AIG?

25 In fact, I was very, very confident that Lehman's

1 demise was going to be a catastrophe, and I knew AIG's
2 demise would be a catastrophe, and therefore I did whatever
3 I could to prevent that.

4 COMMISSIONER THOMPSON: So there was no way in
5 our system that someone with your perspective and insight could
6 have even influenced the White House to say, we cannot let
7 this happen?

8 WITNESS BERNANKE: The White House was well
9 informed, and they were very supportive as--both the
10 previous Administration and the new Administration were very
11 supportive. We thought of all kinds of creative things, but
12 we could not find a way to do it.

13 And, you know, again, I'm not prepared to go
14 beyond my legal authorities. I don't think that's
15 appropriate.

16 COMMISSIONER THOMPSON: Understood. Thank you
17 very much.

18 CHAIRMAN ANGELIDES: Thank you, Mr. Thompson.
19 Mr. Wallison. I'm just full of surprises today.

20 COMMISSIONER WALLISON: Yes. This is called
21 Chairman's discipline.

22 COMMISSIONER WALLISON: Prerogative.

23 CHAIRMAN ANGELIDES: It's called actually
24 something simpler: working from the outside in today.

25 COMMISSIONER WALLISON: Like market discipline by

1 the Chairman.

2 (Laughter.)

3 COMMISSIONER WALLISON: Okay, thank you very
4 much, Mr. Chairman, and thank you for coming Mr. Chairman.

5 I would like to explore something called the
6 discount window a little bit. My understanding of the
7 purpose of the discount window for banks is that it is an
8 opportunity for a bank to take assets that are not liquid
9 and provide them as collateral to the Fed, and the Fed in
10 turn monetizes them in effect and the bank can then use that
11 cash to meet its obligations.

12 One of the purposes of it is to address--deal
13 with runs. When a bank is facing runs, assuming that it is
14 solvent it can present collateral, including loans, which
15 are illiquid to the Fed, and if the Fed judges that those
16 loans have some value, giving them an appropriate discount,
17 it provides cash to the bank to meet the loans--to meet the
18 obligations.

19 The fact that the Fed is doing that is very
20 influential with the market. That is to say, people say,
21 well, as long as I can make these withdrawals--that is, in a
22 run--and the cash is always there, and the Fed has been
23 lending the money, the Fed must think they're solvent, and
24 that would be the only circumstances under which you would
25 do that, then the run is supposed to sort of come to an end.

1 That's the theory. The market is quite satisfied
2 that the cash is always going to be there. There's no point
3 in continuing to run and take cash out of the bank.

4 Now Wachovia is an interesting case, because as
5 far as I can understand the only thing that was considered
6 for Wachovia--which again I would like your judgment on this
7 of course--the only thing that was considered for Wachovia
8 was an acquisition. Whereas, Wachovia, at least as far as
9 we understand it, was solvent but was subject to liquidity
10 problems. That is to say, there were runs.

11 Why was it, then, that as an alternative Wachovia
12 was not able to use the discount window?

13 WITNESS BERNANKE: Well they were allowed to use
14 the discount window. And you raise a good question, and
15 perhaps I could come back with more information subsequent
16 to this hearing. But their liquidity drains were quite
17 serious, and they were--it was their judgment that they were
18 not going to be able to open up within a day or two. They
19 thought that the liquidity drains were such that they could
20 not meet them even with the discount window.

21 COMMISSIONER WALLISON: This was Wachovia's
22 judgment? They were the ones who said we cannot survive
23 this?

24 WITNESS BERNANKE: Confirmed by the Richmond
25 Federal Reserve Bank.

1 COMMISSIONER WALLISON: Okay. So it wasn't that
2 they were--anyone considered them to be insolvent? It was
3 simply a matter of their view, Wachovia's view, that they
4 could not survive this run even if they were able to provide
5 collateral to the Fed?

6 WITNESS BERNANKE: I think there was uncertainty
7 about whether they were solvent or not, because even though
8 they had regulatory capital, that capital was not very risk-
9 sensitive. And what drove--I think what initiated the run
10 on Wachovia was the failure of WaMu, which had mortgages
11 that were similar quality, similar type to those that
12 Wachovia had.

13 So part of my problem here is I don't recall
14 exactly the discussion, and I would like to get back to you
15 on that.

16 COMMISSIONER WALLISON: I'd like you to do that.

17 WITNESS BERNANKE: But your point is well taken.

18 COMMISSIONER WALLISON: All right, then let's
19 move from there to the Lehman case, because the Lehman is
20 slightly different in one sense. And that is that, although
21 the media had said that the Fed had given investment banks
22 access to the discount window, that was not exactly true, as
23 I understand it from a discussion I had with Mr. Baxter
24 yesterday.

25 What was done was that under 13.3, your special

1 powers to deal with serious financial consequences, it
2 enabled you to make available to investment banks funds from
3 the Fed for which you would be getting some kind of
4 collateral.

5 Now we were told by Mr. Fuld yesterday, and
6 nobody really disagreed with this, that Lehman was solvent.
7 Lehman had plenty of assets. It was solvent. It was
8 subject to a run. And my question to him--and I'm hesitant
9 to put words in his mouth when he responded--but my question
10 to him was: Well, why couldn't the Fed do the same thing
11 with Lehman as it does with the discount window for banks,
12 as a matter of law? And that is, we'll take all of your
13 illiquid assets, as long as we put a value on them, and we
14 will monetize them. We will provide the cash so you can
15 meet this run.

16 And Mr. Baxter said to me that there is a way for
17 the Fed to do that, but only if the Fed Board adopts a
18 resolution of some kind which changes the nature of what
19 they normally do under 13.3 to make it more like, if you
20 will, the discount window. That is to say, they can take
21 assets that are not liquid and use them for the purpose of
22 making a loan to an institution that is suffering a run.

23 Now you said that you were willing to do anything
24 to save Lehman. Is Mr. Baxter correct? Could the Fed Board
25 have adopted a resolution that said we will take any good

1 assets that Lehman has and we'll monetize them? We'll
2 provide liquidity so that Lehman can continue to meet the
3 withdrawals, or the runs that people are referring to?

4 WITNESS BERNANKE: So Lehman Brothers had a
5 holding company and it had a broker-dealer.

6 COMMISSIONER WALLISON: I'm talking about only
7 the holding company. I should have made that clear. I'm
8 only talking about the holding company.

9 WITNESS BERNANKE: All right, just for everyone's
10 information, the holding company--sorry, the broker-dealer
11 was eligible to borrow--

12 COMMISSIONER WALLISON: Right.

13 WITNESS BERNANKE: --from an existing facility,
14 the Primary Dealer Credit Facility, and it was allowed to do
15 so.

16 COMMISSIONER WALLISON: Yes.

17 WITNESS BERNANKE: So the question was: Should
18 we create a new lending provision to allow loans to the
19 holding company?

20 COMMISSIONER WALLISON: Yes.

21 WITNESS BERNANKE: We were allowed--we are able
22 to do so under the law so far as we have sufficient
23 collateral. And we were prepared to do that. And I was in
24 Washington ready to call the Board together to do that, if
25 that was going to be helpful.

1 However, what I was informed by those working on
2 Lehman's finances was that it was far too little collateral
3 available to come to our window to get enough cash to meet
4 what would be the immediate liquidity runs on the company.
5 And therefore, if we were to lend, what would happen would
6 be that there would be a continued run. There was not
7 nearly enough collateral to provide enough liquidity to meet
8 the run. The company would fail anyway, and the Federal
9 Reserve would be left holding this very illiquid collateral,
10 a very large amount of it.

11 So it was our view that we could not lend enough
12 to save the company under the restriction that we could only
13 lend against collateral.

14 COMMISSIONER WALLISON: And you are saying, then,
15 that even if the collateral was illiquid, you could have
16 lent against it, but you concluded--or someone in the New
17 York Fed concluded that there wasn't enough of such even
18 illiquid capital, illiquid assets for you to make this loan?

19 VICE CHAIRMAN THOMAS: Mr. Chairman, yield the
20 gentleman an additional two minutes.

21 WITNESS BERNANKE: That's correct.

22 COMMISSIONER WALLISON: Did you do a study of the
23 collateral that was available? Does the New York Fed have a
24 study of the collateral that was available so we could--

25 WITNESS BERNANKE: Well I would refer you to

1 them. Remember, we were working with the SEC to do these
2 liquidity stress tests that we did over the summer. And
3 then over the weekend, there was 24-hour analysis going on
4 that included not only the staff of the New York Fed, but
5 also assistance from the private sector companies that were
6 gathered there.

7 I don't have any--to my knowledge, I don't have a
8 study to hand you. But it was the judgment made by the
9 leadership of the New York Fed and the people who were
10 charged with reviewing the books of Lehman that they were
11 far short of what was needed to get the cash to meet the
12 run. And that was the judgment that was given to me.

13 So that was my understanding.

14 COMMISSIONER WALLISON: Okay, since I have a
15 minute, I'm going to ask another question on a somewhat
16 different subject--

17 WITNESS BERNANKE: Sure.

18 COMMISSIONER WALLISON: --and that is, that
19 Wachovia failed, or didn't fail but it apparently in the
20 view of the Fed it was not viable and had to be combined
21 with some other institution.

22 One of the things you said in your testimony is
23 that there were vulnerabilities and weaknesses in the
24 system. And one of those vulnerabilities that you
25 identified was the fact that the investment banks were

1 lightly regulated, or not sufficiently regulated.

2 Now investment banks were in fact lightly
3 regulated, or not sufficiently regulated, but banks like
4 Wachovia and WaMu and Citi were heavily regulated by the
5 Fed, at least in the case of Wachovia and Citi by the Fed, I
6 understand WaMu was regulated separately, but what's the
7 real difference between the regulation of banks and
8 investment banks when the outcomes seem to be the same?

9 That is, the banks get into the same kinds of
10 trouble that the investment banks get into? And what does
11 that say about the idea of providing yet more regulatory
12 power to any agency, including the Fed?

13 WITNESS BERNANKE: Well, it's a good question.
14 In the case of course, just for factual information, you
15 know Wachovia was mostly a national bank, those regulated by
16 the OCC, and the Fed was the holding company supervisor.

17 I think that part of what was happening there,
18 frankly, is that--which is why some of the CEOs feel like
19 they were hit by--blindsided by a truck, is that there was a
20 systemic problem as well as an individual institutional
21 problem.

22 There was a panic that went across--that went
23 across a variety of firms. One of the sources of the panic
24 was the subprime lending, which was something that was done
25 both by banks and by nonbanks, and we all share some

1 responsibility for that.

2 Another set of problems, though, had to do with
3 this very high reliance on unstable short-term funding--
4 repos, et cetera, and that was much more a situation in
5 investment banks and other shadow banks. And that's why, if
6 you look at the chronology of the crisis, what you see is
7 that the firms that were hit first were not banks. They
8 were Bear Stearns, which was under pressure during the
9 liquidity crisis in March of '08. They were Fannie and
10 Freddie, which had separate issues.

11 They were essentially all the investment banks,
12 Lehman, Merrill Lynch, and so on, who came under very large
13 stress early on, and then AIG. It was only when market
14 conditions got very severe that banks began to face
15 liquidity problems, as well, and banks like Wachovia, which
16 had--and Citi also--which had some substantial reliance on
17 non-core deposits as a liquidity source, came particularly
18 under pressure.

19 But your point is right. We have to improve on
20 all dimensions. And, while I would say that the subprime
21 lending in particular was done more outside the regulated
22 bank sector than within it, certainly I don't claim that
23 there weren't problems and mistakes in the regulated bank
24 sector as well.

25 CHAIRMAN ANGELIDES: All right, thank you.

1 COMMISSIONER WALLISON: Thank you.

2 CHAIRMAN ANGELIDES: Mr. Bernanke--Mr. Holtz-
3 Eakin, you have a quick follow up?

4 COMMISSIONER HOLTZ-EAKIN: Yes, I just want to
5 make sure I understand the answer to Peter's questions about
6 Lehman and lending. Here's what I don't understand.

7 Mr. Fuld said, emphatically, that all he needed
8 was a liquidity bridge, and that he had collateral. If he
9 were to give you the collateral and you've got that, and
10 then he turns out to be wrong, you are protected. Why
11 replace his judgment of what he needed with the Fed's
12 judgment of how it would work out?

13 WITNESS BERNANKE: Because in part that when we
14 make these discount window loans, we really have two sources
15 of protection. One is the collateral itself, which we
16 really don't want to own. The second is the signature, if
17 you will, of the firm.

18 So we generally don't--for example, we don't
19 generally loan, in the banking sector we don't generally
20 make loans to failing banks even against collateral because,
21 you know, because we want to have the double protection of
22 both the firm quality and the collateral itself.

23 So it was our sense that, again based on the
24 information developed in New York, that--that Lehman was in
25 fact far short of the amount of collateral that they would

1 need to meet the--meet the run; that they were essentially
2 making a Hail Mary pass at the juncture. And so what was
3 going to happen was that, again, that we would lend to them
4 on illiquid collateral, the firm would almost certainly fail
5 anyway, but the other consequence would be that the Fed
6 would have a large amount of illiquid collateral which would
7 be, you know, certainly risky at least for the Taxpayer.

8 So that was the reason. It was our view that
9 they did not have enough collateral, and that the runs,
10 based on a whole variety of short-term funding obligations--
11 the fact if they got downgraded there would be more
12 collateral calls, et cetera; that there was not adequate
13 collateral to meet the run, and therefore it would be
14 needlessly exposing the Fed and the Taxpayer to, to make
15 those loans.

16 COMMISSIONER HOLTZ-EAKIN: So that Taxpayer risk
17 was larger than your perceived catastrophe--

18 WITNESS BERNANKE: Well, no--

19 COMMISSIONER HOLTZ-EAKIN: --when Lehman fails?
20 Why not try the Hail Mary pass?

21 WITNESS BERNANKE: Well, because the--because the
22 view was that the failure was essentially certain in either
23 case.

24 CHAIRMAN ANGELIDES: Before we go to Ms. Born,
25 Mr. Vice Chairman you had a quick--

1 VICE CHAIRMAN THOMAS: Just 30 seconds. We may
2 be pounding this nail, but based upon yesterday and on
3 ongoing discussion, the final point that you responded to to
4 Mr. Holtz-Eakin is where I want to focus just a little bit
5 more.

6 That if there wasn't sufficient collateral, the
7 other thing I want to add to it, if you're able, is that it
8 wasn't sufficient collateral by an inch, by a mile?
9 Because you were looking at an ongoing process that you
10 essentially decided wouldn't be worth starting. So that
11 there was just no question about the shortfall? That it
12 would be an ongoing consequence?

13 WITNESS BERNANKE: My general tone and attitude
14 was, is there anything we can do? And I believe that that
15 goal was shared by the other principals--by president
16 Geithner, and Secretary Paulson, and Chairman Cox. And none
17 of those folks had been known for timidity in previous
18 episodes in terms of trying to find ways to prevent a
19 worsening of the financial crisis.

20 And what I heard from them was just the sense of
21 defeat. You know, that it's just way too big a hole. And
22 my own view is it's very likely that the company was
23 insolvent, even, not just illiquid.

24 VICE CHAIRMAN THOMAS: Thank you.

25 CHAIRMAN ANGELIDES: All right, Ms. Born.

1 COMMISSIONER BORN: Thank you very much, and
2 thank you, Mr. Chairman, for being willing to appear before
3 us today.

4 You previously have said that over-the-counter
5 derivatives were a mechanism that transmitted shock during
6 the financial crisis. And I would like to explore with you
7 some of the ways that they did so, and their relevance to
8 systemic risk.

9 As you've said today, the potential failure of
10 AIG was caused by AIG Financial Products Division's enormous
11 sale of credit default swaps without sufficient resources to
12 post collateral as required by their contracts.

13 Was AIG considered to be of systemic importance
14 in part because many of the world's largest and most
15 important financial firms were AIG's counterparties on these
16 credit default swaps and thus could have been impacted with
17 AIG's failure?

18 WITNESS BERNANKE: So it's a subtle point, but I
19 would distinguish just a bit from the actual financial
20 exposure and the fact that the world knew that AIG was the
21 counterparty of many of the world's leading global financial
22 firms.

23 In some cases, you know, those exposures were
24 manageable. In some cases, they would have been more--would
25 have been more substantive. But at the time we were at the

1 brink of a global run, a run on all financial institutions,
2 and the progenitor of runs is uncertainty.

3 When people don't know whether a bank or a
4 company is sound, then that's when they go take their money
5 out. Years--I mean, two years later we are still not
6 entirely sure what the net exposure of some of these
7 companies to AIG was. Certainly on the day that AIG failed,
8 if it had failed, investors around the world would not have
9 known, you know, what the net exposure of a given bank was
10 to AIG.

11 And so my sense was, over and above the direct
12 losses and hits to capital, et cetera, that would have been
13 experienced not only through these derivative counterparty
14 agreements but also through just straight commercial paper,
15 corporate bonds, and other vehicles, that this would have
16 triggered an intensification of the general run on
17 international banking institutions. So that was a very
18 significant concern.

19 As I talked to the Commission when we met a year
20 ago, there were a number of other features of AIG that were
21 also of concern, but that was an important one.

22 COMMISSIONER BORN: So in other words, in
23 addition to the real credit exposures and financial
24 difficulties that might have been expected, there was
25 uncertainty about what the exposures were, what institutions

1 had them, how much they were, lack of transparency in this
2 market, that in essence fueled the panic?

3 WITNESS BERNANKE: Absolutely.

4 COMMISSIONER BORN: I think you quite
5 appropriately in your testimony distinguish between
6 derivatives transactions themselves and the infrastructure
7 for trading, clearing, settlement of those instruments. And
8 exchange trading, of course, provides price discovery and
9 transparency. Counterparty, centerparty clearing, and
10 settlement allows for reduction of counterparty risk and
11 adds to the transparency of the process and the safety
12 through margins, and marking to market.

13 So in your view, was the trading in, of
14 derivatives over the counter as opposed to exchange trading
15 in derivatives a problem that posed some risk because of the
16 lack of transparency? Because of the existence of
17 counterparty risk in the over-the-counter arena?

18 WITNESS BERNANKE: Yes, certainly. And AIG of
19 course is the poster child for that. It was not so much the
20 losses that their counterparties experienced on the
21 movements in the derivatives themselves, but rather the
22 counterparty risk that was the problem.

23 I'm sure you know that the Fed was quite
24 concerned about clearing of settlement arrangements for
25 derivatives prior to the crisis. And the Federal Reserve

1 Bank of New York did a lot of work to try to improve the
2 clearing arrangements for credit derivatives and also some
3 other types of derivatives. And we were very supportive of
4 the provisions in the recent financial reform legislation to
5 standardize derivatives, put them on central counterparties,
6 and the like.

7 A point that should be made, and I know you fully
8 recognize, is that if you're going to concentrate
9 counterparty risk in central counterparties, then they must
10 be safe. And for that reason we also thought it was very
11 important in Title 8 that the Fed and other agencies would
12 work together to make sure that the prudential standards
13 were imposed on those central counterparties as well.

14 But I agree with what you just said. One final
15 comment is that another area where the Fed has been active
16 is in trying to strengthen the so-called trading book
17 capital requirements for banks, which essentially will make
18 it more costly. To the extent that banks still use over-
19 the-counter derivatives, the capital cost will be higher for
20 selecting the underlying risks, both counterparty and
21 fundamental risks. So that that's another incentive to put
22 these instruments on exchanges.

23 COMMISSIONER BORN: We have heard from the
24 Federal Reserve's staff yesterday about interconnectivity of
25 large financial institutions through their counterparty

1 exposures in OTC derivatives contracts, and the relevance of
2 that in assessing systemic risk of those institutions.

3 And I wanted to ask you about Lehman Brothers,
4 for example. You have said that if it had been--you knew
5 before it was allowed to fail that the failure would be
6 catastrophic. And Mr. Baxter said yesterday that there was
7 a significant concern at the Fed that the OTC derivatives
8 market would be severely impacted by the failure.

9 Was this a concern of yours with respect to
10 Lehman Brothers? Did it also enter into your concerns about
11 Bear Stearns, and Wachovia, and other large institutions
12 with concentrated derivatives positions?

13 WITNESS BERNANKE: Yes. It's not the only aspect
14 of interconnectedness. There's a lot of funding
15 relationships and so on. But it certainly is an important
16 one.

17 It's very difficult to unwind these positions
18 quickly. And when you lose a counterparty, then you have to
19 replace your protection. And so it was a significant
20 concern. And one indication of our concern about Lehman was
21 of course that we took a lot of steps to try to put foam on
22 the runway, so to speak, as the expression went.

23 And one of those things we did was to work with
24 the OTC markets to try to get them to address these
25 concerns.

1 Another dimension of this, by the way, one of the
2 things we got to work on very quickly was the credit default
3 swaps in Lehman that others were trading and trying to
4 arrange for settlement of those as efficiently as possible.
5 And given the problems with counterparties and ambiguities
6 of clearing and so on, that itself was a fairly complex
7 process.

8 So the short answer to your question is that this
9 was an important aspect certainly for the investment banks,
10 for Lehman and Bear Stearns and to a significant extent also
11 to the other institutions that had broker-dealers in those
12 kinds of exposures.

13 COMMISSIONER BORN: May I just have time for one
14 last question?

15 CHAIRMAN ANGELIDES: Would you like two minutes?

16 COMMISSIONER BORN: Yes, that would be fine.

17 With respect to these concerns, I assume that the
18 concerns went beyond credit default swaps to all over-the-
19 counter derivatives' interconnectivity. As you know, credit
20 default swap were a relatively small amount of the over-the-
21 counter world of derivatives at that point, and there were
22 massive connections with other kinds of over-the-counter
23 derivatives between the big dealers like the investment
24 banks and their counterparties; and that the same problems
25 of potential credit exposure, lack of transparency,

1 potential concerns about what the exposures were applied
2 generally to the whole over-the-counter derivatives market?

3 WITNESS BERNANKE: Yes. There were some types,
4 like equity derivatives, that shared some of the problems,
5 just the operational problems that credit derivatives had in
6 terms of clearing and settlement.

7 But more generally, when are bespoke derivatives,
8 for example, you had both counterparty risk and you also had
9 the complexity of trying to value the positions. And that
10 becomes serious when you're trying, in a crisis trying to
11 figure out what exposures are, and whether a company is
12 solvent or not. So, yes.

13 COMMISSIONER BORN: Thank you.

14 CHAIRMAN ANGELIDES: Great. Mr. Hennessey?

15 COMMISSIONER HENNESSEY: Thank you. Thank you,
16 Mr. Chairman, for coming.

17 Yesterday Mr. Fuld argued that there was no
18 capital hole at Lehman, and that the slow six-month
19 counterparty pullback from Lehman which turned into a run in
20 mid-September was unsupported by the reality of the health
21 of his bank.

22 We heard the same thing from the heads of Bear
23 Stearns, that their firm was fundamentally healthy and that
24 they were brought down by whispers, rumors, and an
25 unsubstantiated run.

1 I believe I heard you just say that you thought
2 that Lehman was probably insolvent. In your view, did
3 Lehman and Bear fail only because of unjustified liquidity
4 runs? Or were there also genuine solvency problems at these
5 firms?

6 WITNESS BERNANKE: So as I said before, one of
7 the reasons that some of the CEOs felt so blindsided was
8 that there was a general panic. There was obviously a
9 general financial crisis that put companies under
10 extraordinary strain.

11 That being said, there was certainly a hierarchy
12 and the weaker companies were certainly the first to feel
13 pressure. So Bear Stearns was widely viewed to be the
14 weakest of the investment banks, and Lehman was widely
15 viewed to be the second weakest, and so on. And there were
16 clearly losses and liquidity issues at those companies.

17 In particular, in the case of Lehman they had
18 raised some capital in the spring, but they had not
19 succeeded in spinning off a substantial position that had a
20 lot of embedded losses in it, and they had not succeeded in
21 raising additional capital, which suggested that they were
22 not able to persuade new investors to come in.

23 So it was a combination of general fear
24 certainly, but also some legitimate concerns about both the
25 asset position of the company--you know, its balance sheet--

1 but also I think some concerns about the longer term
2 viability of the firm, the business model, and other issues
3 that were concerning folks as well.

4 And it's just the nature of financial
5 institutions that they live on confidence. When their
6 counterparties and customers and creditors don't believe
7 that they were sustainable, then the pressure mounts very
8 quickly.

9 COMMISSIONER HENNESSEY: Good. I hear a lot more
10 discussion about how to prevent failure of these firms than
11 about what will happen if or when the next failure occurs.

12 Now the government has the new resolution
13 authority, and at some point these large nonbank financial
14 firms will have living wills. But those mechanisms are not
15 yet in place. It takes time to implement them.

16 We were discussing before some of the
17 international aspects of the resolution authority, which I
18 imagine are nightmarishly complex. And at the same time,
19 your 13.3 authority has been curtailed, and there won't be
20 the TARP around.

21 Are you confident that the government, including
22 the Fed, has the tools it needs to deal with a failure of a
23 too-big-to-fail firm if and when it should next occur?

24 WITNESS BERNANKE: Well I'd prefer not to be
25 tested in the next few days, if you wouldn't mind.

1 (Laughter.)

2 WITNESS BERNANKE: That being said--

3 COMMISSIONER HENNESSEY: We all hope that won't
4 be the case.

5 WITNESS BERNANKE: That being said, the FDIC has
6 embarked on this with admirable urgency, as Chairman Bair
7 will tell you in a little while, and they are moving very
8 quickly to try to set up the rules which will be needed to
9 implement this.

10 It's not only a question of implementation, but I
11 think the benefit of this--and I'm sure Mr. Wallison would
12 agree--would be having some certainty in advance about how
13 the process will be run and, you know, what the effects will
14 be on particular creditors, and so on, of the firm.

15 So it is a work in progress right now for sure,
16 but we are working very quickly to try to put it into
17 operation.

18 COMMISSIONER HENNESSEY: Is it, if I could, is it
19 just a timing thing in terms of getting these mechanisms up
20 and running? If you don't have the ability to provide a
21 firm-specific loan anymore, and the TARP isn't there to
22 provide capital injections, is there a scenario on which you
23 might need to put money into a firm where there is or is not
24 a tool to actually do that?

25 WITNESS BERNANKE: Well remember that Treasury

1 can provide a loan, as long as it's repaid, either from the
2 company in receivership or, if necessary, from an assessment
3 of the financial industry.

4 So if money is needed to prevent a disorderly
5 failure, or to facilitate the bridging process, et cetera,
6 then--then the government can provide that.

7 And the Fed, meanwhile, is of course very limited
8 in our ability to go beyond just our normal lending to a
9 sound company. But that was a change we were comfortable
10 with as long as these alternative authorities were provided.

11 COMMISSIONER HENNESSEY: Good. Systemic risk.
12 You hear a lot of people talk about it. I haven't heard a
13 precise definition, other than people usually say it means
14 risk to the system, which--

15 (Laughter.)

16 COMMISSIONER HENNESSEY: --doesn't--and I
17 understand that there's always going to be discretion
18 involved, and that it's been much more of an art than a
19 science. Are there efforts underway, or has anyone done any
20 good work in trying to turn this from an art to science to
21 eventually some sort of engineering where you can measure
22 this and analyze systemic risk?

23 WITNESS BERNANKE: Yes. There's right now an
24 active academic research literature looking at some of these
25 things, trying to identify, for example, what some of the

1 criteria are; how big; how interconnected, those sorts of
2 things.

3 There is some criteria involving things like
4 correlation. You know, how correlated is the stock of
5 company X with other shares of other companies, and what
6 does that say about its systemic importance, and things of
7 that sort.

8 So there is an academic literature underway. The
9 Federal Reserve has to set up a set of rules that will
10 govern how we recommend to the oversight council which
11 companies are to be treated as systemically critical for the
12 purposes of special oversight.

13 And so we're going to have to write a rule which
14 puts down on paper in a way that is legally sensible what
15 are the criteria we're looking at.

16 So to some extent it is going to ultimately
17 remain subjective, and I think the systemic criticality of
18 any individual firm depends on the environment. So our
19 decisions vis-a-vis some of the firms we addressed might
20 have been different in a more calm environment.

21 So the overall economic and financial environment
22 also matters, not just the characteristics of the firm. But
23 we are cognizant that we need to be more specific. And as I
24 said, there is a literature to draw on, and we have a
25 project at the Fed right now trying to write this rule that

1 will govern our recommendations.

2 COMMISSIONER HENNESSEY: Good. I'll end with an
3 easy one. Other than your own speeches, what do you think
4 are the most important writings on the crisis as a whole?
5 If you could recommend that people read two or three really
6 good speeches, books, papers, whatever they happen to be,
7 what are the most important or under-appreciated works out
8 there?

9 CHAIRMAN ANGELIDES: And by the way, that is pre-
10 December 15th when our report comes out.

11 (Laughter.)

12 WITNESS BERNANKE: Well, I think there's a lot of
13 interesting work. I know you're familiar with sort of the
14 narrative histories and so on, and I won't bother to go over
15 those. But I think, again not to sound too professorial,
16 there is some interesting academic work already looking at
17 these issues, and I even made reference in my testimony to
18 Gary Gorton's work where he is pretty clear to identify the
19 analogies between what happened to the shadow banking system
20 and classic bank runs, 19th Century style bank runs. I
21 think that work is very interesting.

22 There's also quite a bit of interesting work by
23 people like Markus Brunnermeier at Princeton, which looks at
24 the dynamics of a panic in the repo market and how that
25 cycle of increasing haircuts in margin worked. And he and

1 others have also done some of the work I referred to a
2 moment ago on trying to identify systemically critical firms
3 by looking at their financial characteristics.

4 Maybe I can come up with a few other things,
5 given a little bit of time, but there is some interesting
6 work underway in this area.

7 CHAIRMAN ANGELIDES: Could you provide us
8 "Chairman Bernanke's Fall Reading List"?

9 (Laughter.)

10 CHAIRMAN ANGELIDES: If you would give us--

11 WITNESS BERNANKE: Only if you take a test on it.

12 (Laughter.)

13 CHAIRMAN ANGELIDES: Well, we're taking a test.

14 WITNESS BERNANKE: I'll do that.

15 CHAIRMAN ANGELIDES: And we may just post it on
16 the web, too, as our featured event of the day. But, no,
17 all kidding aside, it would be great if there are a few
18 pieces you think--

19 WITNESS BERNANKE: If you would like to
20 understand that this is not the first time through, read The
21 Lords of Finance book, which won the Pulitzer Price for its
22 history of the Great Depression, and you will feel
23 sometimes, doesn't this seem awfully familiar.

24 CHAIRMAN ANGELIDES: Right. Ms. Murren.

25 COMMISSIONER MURREN: Thank you. And thank you,

1 Mr. Chairman, for your comments and for your time today.

2 My question begins actually in your written
3 testimony where you reference the Gramm-Leach-Bliley Act as
4 having limited the regulators' ability to really get a whole
5 picture of any one enterprise's risks and financial position
6 and activities.

7 And I was wondering if, when you think back to
8 how the crisis unfolded--part of our charge is to determine
9 what caused it--in your mind does this act rise to the level
10 of causation? Or is it simply one of many factors that were
11 part of the whole unfolding of the crisis?

12 WITNESS BERNANKE: I think it was one of many
13 factors. And you could point to specific examples where it
14 caused problems.

15 For example, the Fed was somewhat reluctant to
16 examine nonbank subsidiaries of bank holding companies
17 feeling that the sense of the law was we needed to defer to
18 whoever was nominally the regulator.

19 And so for that reason we were probably not as
20 aggressive as we should have been in terms of identifying
21 some of the consumer protection issues that arose from
22 mortgage companies and other nonbank lenders. So that would
23 be one example.

24 Another example, which is more complex, has to do
25 with the role of off-balance sheet vehicles. This turned

1 out to be a big problem in that under the existing
2 accounting--under the existing accounting rules at the time,
3 if a bank did not have a majority ownership of an off-
4 balance sheet vehicle, it didn't have to consolidate that
5 vehicle with its own balance sheet, and its capital charges
6 were limited only to explicit commitments of liquidity or
7 capital to the vehicle.

8 And so in actuality it turned out that the
9 exposures via these vehicles were much greater than
10 understood, in part because the banks themselves didn't have
11 good monitoring systems, and also because in the event, for
12 reputational reasons, they often came to rescue these
13 vehicles when they got into trouble, even though they were
14 contractually obliged to, and that cost them money as well.

15 And so there was some, I think a little bit of
16 uncertainty about, given that these off-balance sheet
17 vehicles might have been sponsored by the bank which
18 therefore would make them responsible in some sense of the
19 direct bank supervisor, like the OCC, but they were also
20 obviously a part of the overall holding company. I think
21 there was a little bit of uncertainty about whose
22 responsibility these were, and maybe there was not
23 sufficiently aggressive attention paid to those off-balance
24 sheet--I'm sure there was not sufficiently aggressive
25 attention paid to those off-balance sheet vehicles.

1 So I do think that there were some problems
2 there, and some things fell between the cracks. I wouldn't
3 want to elevate it to a principal cause of the crisis, but
4 it was one of the reasons that some of the risks that faced
5 the overall companies on an enterprise-wide basis were not
6 adequately appreciated.

7 COMMISSIONER MURREN: And with that in mind, with
8 the new legislation that's recently passed, had that been in
9 place at the time what actions would have been taken that
10 might have been different? Or what would have been
11 different about the body of knowledge that you and other
12 regulators might have had about those enterprises that would
13 have allowed you to act perhaps more preemptively?

14 WITNESS BERNANKE: Well, I think the clearest
15 case was the nonbank subsidiaries where we, for example, did
16 not--we only began a pilot program to look at nonbank
17 lending subs in 2007 or so, working with the other
18 regulators of those subs trying to identify consumer
19 protection issues.

20 In the absence of GLB, I think we would have been
21 earlier looking at some of those problem areas and been less
22 reticent in going into those.

23 Again, the issue of off-balance sheet vehicles is
24 more complicated, but I think that the situation in the
25 legislation now, which rather than letting these issues fall

1 between the cracks essentially gives multiple responsibility
2 and says you have to both look at this, is more likely to
3 identify those problems in the future.

4 COMMISSIONER MURREN: Thank you. Another
5 question, just to touch back on something that came up
6 earlier which is the housing bubble, can you talk about your
7 feeling as to the relationship between securitization and
8 the housing bubble?

9 WITNESS BERNANKE: I think there was a
10 relationship. So securitization was the other end of the
11 originate-to-distribute model. And there was a big demand
12 for securitized products, which came in part from foreign
13 investors, but not entirely of course.

14 To create the raw material for securitized
15 products, you had to have lots of mortgages being made. And
16 as a result, to expand the number of potential home buyers
17 you had to lower the standards. And so you got increasingly
18 weak underwriting, and more and more exotic mortgage
19 instruments being used to expand the number of people who
20 could get mortgages, and therefore buy houses.

21 And what this did was, I don't remember the exact
22 number, but some very substantial fraction of the mortgages
23 issued in '05-'06 were subprime or at least nonprime
24 mortgages. And that obviously increased the overall demand
25 for houses.

1 So you see a chain going from demand for
2 securitized products, the demand for raw material, to
3 pressure to weaken underwriting standards to expand the
4 number of people borrowing, to increase house prices. And
5 then it was a circle, because again as house prices rose
6 lenders became even more comfortable making more risky
7 loans, and that just was a self-fulfilling prophesy, at
8 least until prices got to the point where they couldn't be
9 sustained any further.

10 So there was indeed a connection there.

11 COMMISSIONER MURREN: And so your feeling is it
12 was really more the demand that was driving the process, as
13 opposed to the push from the originators who stood obviously
14 to do rather well in an environment where they could
15 continue to create and originate mortgages? Or do you think
16 it's both?

17 WITNESS BERNANKE: So I think if there was a
18 push, it may have come not so much from the ultimate
19 mortgage-makers who themselves are agents of the banks, or
20 investment banks. There was probably some push coming from
21 the folks who were creating those securitized products--the
22 salesmen going out and saying, here's an attractive
23 investment vehicle, look, it's rated AAA.

24 So there certainly was some pressure coming from
25 that side. But clearly there was an awfully strong demand,

1 both domestically and abroad, for, given how low--in
2 particular, you know, given that Treasury yields were pretty
3 low, and given the demand for longer term safe, fixed-income
4 assets, that demand partly from abroad drove Wall Street to,
5 you know, to create these products to satisfy that demand.

6 COMMISSIONER MURREN: Terrific. Thank you.

7 WITNESS BERNANKE: You're welcome.

8 CHAIRMAN ANGELIDES: All right, Mr. Chairman,
9 just a couple of quick wrapups. I have a couple of quick
10 items and, I know, very quickly, that Member Georgiou and
11 also Senator Graham have a couple of quick questions.

12 I want to ask you about something we talked about
13 both historically and going forward. We've talked about the
14 challenge of the fact that we have too-big-to-fail
15 institutions, and going forward we have institutions that
16 may be not only too big but too few to fail, fewer
17 institutions, larger scale, and how there will be a
18 challenge of political will for regulators to be as tough as
19 they need to be.

20 But it seems to me there was and is an
21 accompanying question. And that is one of resources. And I
22 don't just mean resources in sheer numbers. I mean, let's
23 be blunt about it. A lot of the Wall Street guys are like
24 greased pigs. They're hard to catch. And, you know,
25 they're inventing new products. Sometimes you can call it

1 "innovation," and as you noted that may be a kind word in
2 many respects.

3 And I guess my question is: To what extent was
4 the kind of mismatch here a problem? And what will it be in
5 the future? And I don't just mean, look, there's been a
6 diminution of the ethos of public service, there's been
7 growing compensation gaps. Being in the public arena, as we
8 all know, is no picnic. And I guess my question is: What's
9 your confidence level that we can attract the resources?

10 You know, I saw almost no debate during Dodd-
11 Frank about the resource level, the talent level, that you'd
12 need to be able to have effective oversight. And to what
13 extent was that a problem, and will it be a problem?

14 WITNESS BERNANKE: No, it's a very good question,
15 and you're right that we can't outspend Wall Street in terms
16 of hiring people, obviously. And they have very strong
17 incentives to evade regulation in certain circumstances.

18 Just a couple of comments. One is that this is
19 one of the reasons why having some market discipline will be
20 very helpful. We need to have the additional set of eyes
21 that comes from investors. And when we see spreads opening
22 up, or stock prices going down, that's a signal we should
23 pay attention to because clearly you have very talented
24 people who are in the markets and are assessing these firms,
25 and their information, you know, is transmitted to prices.

1 We should pay close attention to that.

2 The other comment--and I think one of the things
3 we learned, and we learned this from our stress testing and
4 some other areas, is that we really need to use all our
5 resources.

6 So it's one thing to have experienced
7 supervisors, and collectively among us, and the FDIC, and
8 the OCC, we have a cadre of very experienced supervisors,
9 but given the innovations in finance, and global capital
10 flows and the like, we need to bring in other expertise as
11 well.

12 And so at the Fed we have, as I said we've taken
13 a much more multi-disciplinary approach to bring in
14 economists, financial specialists, and other types of
15 experts to support the supervisory work.

16 So I think that will be helpful. And, you know,
17 Mr. Thomas mentioned how the Fed had retained a lot of the
18 supervisory authority. I think one of the reasons for that
19 was because we have a lot of those skills which are going to
20 be necessary to make this work.

21 All that being said, you know, it's just simply
22 never going to be the case that the government can pay what
23 Wall Street can pay. And we're going to have to work very
24 hard and watch very carefully to make sure that we, you
25 know, that we are successful in oversight.

1 Again, we don't have to replicate every business
2 decision, or evaluate every asset. We can't do that. But
3 what we can try to do is make them convince us that they
4 have systems and risk management in place that will
5 plausibly deliver the right answers and give us confidence
6 that they're doing the right thing.

7 But you're absolutely right, that this is an
8 important issue as a practical matter as we try to implement
9 this law.

10 CHAIRMAN ANGELIDES: All right. Final question
11 from me, and it's something you talked about and we've
12 talked about internally. I know my friend John Thompson and
13 I have wrestled with this a little. You talked about the
14 magnitude of subprime lending. I think you talked about the
15 order of a trillion dollars.

16 You talked about the magnitude of this asset
17 class. I think you talked in your testimony about some days
18 we have fluctuations in the market that are as great.

19 WITNESS BERNANKE: Right.

20 CHAIRMAN ANGELIDES: And so, again, not to speak
21 for my colleagues here, I clearly see that these toxic
22 assets entered the pipeline and were pushed through it; that
23 these toxic mortgages flowed through this pipeline.

24 But what I'm trying to get a sense of as we do
25 our work is, as you know a healthy patient or a healthy

1 person can get pneumonia and survive it easily. A frail,
2 elderly patient gets pneumonia and it's the death knell.

3 To what extent--in this instance it appears this
4 was the infection. I don't necessarily want to do "what
5 if?s" but I'm going to ask it.

6 What was the dominant phenomenon here? The
7 toxicity, or the fragility of the system? You know, the
8 infection or the weakness of the body?

9 WITNESS BERNANKE: The theme of my longer
10 testimony was triggers versus vulnerabilities, exactly what
11 you're talking about.

12 Part of the reason--well, if we had had a
13 healthy, strong, stable financial system, it could have
14 accepted this problem without creating such a major crisis.
15 So I believe very strongly that it wasn't subprime lending,
16 per se--although obviously that was a bad thing and caused
17 significant problems--but rather it was the fact that the
18 system as a whole had structural weaknesses. And so, if you
19 like, the e. coli got into the food supply and that created
20 a much bigger problem.

21 CHAIRMAN ANGELIDES: But the fact that it was the
22 housing asset, which was so broadly held by 67, 69--65 to 69
23 percent of the population, the middle class, it was the
24 biggest asset, the fact that the e. coli got into the most
25 widely eaten food product, was that--did that exacerbate it?

1 Or was it the nature of the securitization that exacerbated
2 it?

3 I mean, what would have been--could it have
4 happened with other asset classes? And again I don't know
5 that we want to game it, but what were the unique features
6 that allowed this to metastasize?

7 WITNESS BERNANKE: So if you were just to do a
8 macro economic model and looked at the effects of the house
9 price up and down, and ignored all the financial crisis
10 effects, just looked at the effects on consumer wealth and
11 the like, you would not find anything like the crisis that
12 we've seen. The magnitude would not be big enough.

13 What caused the crisis was essentially, as--well,
14 there are many things that caused the crisis, but it's the
15 e. coli effect; that there was an awful lot of dependence on
16 short-term, unstable funding, which is analogous to the
17 deposits in banks before the period of Deposit Insurance.

18 Since these deposits were not insured, they were
19 prone to run. And when people think there's something wrong
20 with the assets they're lending against, even if it's only
21 one percent, or two percent, they say, well, what the hell,
22 I'm going to take my money out, and why should I lend
23 against this potentially risky product?

24 And that panic, which in turn forced people to
25 sell assets into illiquid markets, brought down asset

1 prices, created more problems for other firms, it was that
2 dynamic that was a very important part of this.

3 And so I still think of this as more of the
4 trigger, the e. coli, than of the factor that itself would
5 have caused the system to seize up.

6 CHAIRMAN ANGELIDES: Commissioner Georgiou, for
7 your remaining--

8 COMMISSIONER GEORGIU: Thank you. And to follow
9 up on that, Dr, Bernanke, another problem we heard a great
10 deal about during our hearings was this notion of regulatory
11 arbitrage and capital arbitrage, where institutions held
12 assets off-balance sheet to avoid capital requirements, and
13 in some cases mischaracterized assets to put them into
14 categories that required them to hold less capital under the
15 rules.

16 You know, we talked about Citi at its peak. If
17 you brought in all the dispersed assets, had some \$3.3
18 trillion in assets with roughly \$75 billion in capital,
19 which was only a little over 2 percent. And, you know, a
20 third of that got used in one liquidity put on one set of
21 CDOs.

22 Obviously in hindsight almost everyone agrees,
23 including your predecessor as Fed Chair, that more capital,
24 less leverage would have ameliorated the financial crisis.

25 It may be facile to say that the system would

1 have been safer had the financial institutions been required
2 to raise and hold more capital, but the mere fact that it's
3 facile does not necessarily make it untrue.

4 I wondered if you could tell us what the Fed's
5 views are going forward regarding capital requirements, and
6 what particular provisions you put in place to ensure that
7 the financial institutions that have grown so large and are
8 prone to be rescued are well capitalized on a go-forward
9 basis?

10 WITNESS BERNANKE: Thank you. I think it's
11 important, when you think about the situation going forward,
12 to recognize that there are two big things happening.

13 One is the financial reform legislation recently
14 passed in the U.S. Congress and signed by the President.
15 The other is a substantial reform of international capital
16 standards, which is currently going on, and I'll be
17 attending the Basel meeting next weekend in Switzerland.

18 So the United States agrees--Secretary Geithner
19 has talked about this--we agree, Chairman Bair, that
20 stronger capital standards are absolutely essential as one
21 of the key components going forward to assure the safety of
22 the system.

23 And so what we are talking about with our
24 international colleagues in Basel now is, first, having more
25 capital; having higher quality capital that is not using

1 intangible assets and other things that are not loss
2 absorbing as capital; making capital more risk-sensitive so
3 that it responds more to losses and absorbs losses more
4 effectively; creating some counter-cyclicality in capital so
5 that capital be built up in good times and run down in bad
6 times; and finally, we're working with the accountants and
7 others to--you know, we've gone beyond the situation you
8 talked about where Citi had all these off-balance sheet
9 assets which were not consolidated and has been very largely
10 changed now by new accounting rules which will require
11 consolidation where there is substantial ownership of those
12 assets.

13 And on top of that, we are looking for
14 international leverage standards, and international
15 liquidity standards. So we expect to have some very
16 substantial improvements in those regulations
17 internationally, to create a level playing field, and I do
18 believe that as we go forward that those rules and their
19 implementation will be of the same order of magnitude of
20 importance in assuring a safe financial system going forward
21 as the changes, very important changes being made in the
22 recent legislation.

23 COMMISSIONER GEORGIU: Thank you, Dr. Bernanke.

24 CHAIRMAN ANGELIDES: Senator Graham, you had a
25 quick closing question?

1 COMMISSIONER GRAHAM: Yes. Chairman--

2 CHAIRMAN ANGELIDES: One each, but very quickly.

3 COMMISSIONER GRAHAM: The Chairman answered the
4 question that I was going to ask which related to what is
5 the status of off-balance sheet items, but I cited earlier a
6 report that there seems to be a weakening of resolve by the
7 Basel Group in terms of liquidity and capital standards.

8 Does that coincide with what you're hearing? And
9 if so, do you think that we can anticipate adequate resolve
10 at the international level to get these standards where they
11 need to be?

12 WITNESS BERNANKE: So when you're developing a
13 complex set of capital standards, it is important to consult
14 with the banks to understand, make sure you understand what
15 the implications are for how much capital they'll hold, and
16 how it will affect their business, and so on.

17 It is important to understand that. You're not
18 making good policy if you don't understand the implications
19 of your decisions.

20 That being said, that is not the same thing as
21 weakening standards. We want to make sure the standards are
22 rational and effective. And we are committed to very strong
23 standards. And I think you will see, when they come out,
24 that they will be a substantial improvement over the
25 standards that we've had in the last few years.

1 COMMISSIONER GRAHAM: Thank you.

2 CHAIRMAN ANGELIDES: Mr. Wallison?

3 COMMISSIONER WALLISON: Thank you. Just one
4 question.

5 Bank regulators have, for many years, been
6 concerned about fair-value accounting, mark-to-market
7 accounting, and some have said that that had something
8 significant to do with what happened in the financial
9 crisis.

10 What's your view of that?

11 WITNESS BERNANKE: Well I think that mark-to-
12 market accounting at times increased the procyclicality of
13 the system. There were times when markets were highly
14 illiquid and it was very hard to value assets.

15 That being said, I think we should do our best to
16 get appropriate market values of assets that do have market
17 prices.

18 Now there is a somewhat different issue when
19 you're dealing with long-term credit in the banking book
20 where there is no secondary market, and appropriate
21 valuation requires, you know, a model or some assumptions.

22 So I'm in favor of accurate accounting. I think
23 there are sometimes problems when markets are very illiquid
24 and the FASB tried to move in the direction of clarifying
25 how to deal with so-called Level 3 assets in illiquid

1 markets, but I'm also very cautious about applying mark-to-
2 market accounting to the long-term loans, the bank loans in
3 the banking book of the banks.

4 If I could say one quick thing about the Wachovia
5 question you asked me before, I would just point out that
6 the decisions there, the interventions there, were FDIC
7 decisions.

8 They must have made--I'm sure they made
9 independent judgments about the best way forward, and with
10 their concern about protecting the Deposit Insurance Fund
11 I'm sure they were trying to find the least-cost solution
12 for that.

13 COMMISSIONER WALLISON: My question--thank you
14 for that, but my question really was what importance do you
15 think mark-to-market accounting might have had in the
16 financial crisis as we understand it? That is, this huge
17 decline in asset values.

18 WITNESS BERNANKE: I think it exacerbated it
19 somewhat, but it's the nature of financial markets that
20 asset prices move up in booms and down in crashes, and that
21 is an exacerbating factor, but, you know, we don't want to
22 sacrifice accurate valuations to eliminate that issue. I
23 mean, I don't think you could.

24 So it was an issue, but I don't think we should
25 conclude from that that we should abandon mark-to-market

1 accounting.

2 CHAIRMAN ANGELIDES: Mr. Chairman, thank you very
3 much for this second appearance before us during our
4 deliberations.

5 I also want to reiterate something that the Vice
6 Chairman and others have said. Douglas Holtz-Eakin I know
7 mentioned it specifically. You and your staff at the
8 Federal Reserve have been very forthcoming and very
9 cooperative in terms of providing documents, information,
10 making folks available for interviews, and we appreciate the
11 way in which you have helped us conduct our investigation
12 and our inquiry for the benefit of the American People and
13 for history.

14 You have been very good in this regard, and we
15 look forward to continuing to do work together as we do our
16 final report. Thank you very much for being here this
17 morning.

18 WITNESS BERNANKE: Thank you, Mr. Chairman.

19 CHAIRMAN ANGELIDES: We will now take a ten-
20 minute break, members, and then Chairman Bair will be before
21 us.

22 (Whereupon, at 11:41 a.m., the meeting was
23 recessed, to reconvene at 11:55 a.m., this same day.

24

25

1 AFTERNOON SESSION

2 (11:55 a.m.)

3 CHAIRMAN ANGELIDES: The public hearing of the
4 Financial Crisis Inquiry Commission on the subject of
5 financial institutions that have become too big to fail, too
6 important to fail, too systemic to fail, will recommence.

7 Thank you, Chairman Bair, for being with us
8 today. We are going to start, as we always do, by swearing
9 you as a witness. So if you would please stand and raise
10 your right hand, I will read the oath to you:

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

15 CHAIRMAN BAIR: I do.

16 (Witness Bair sworn.)

17 CHAIRMAN ANGELIDES: Thank you. Chairman Bair,
18 thank you for your extensive written testimony. What we
19 would like to ask you for now is obviously to present to us
20 orally. We will provide you up to ten minutes to do that.
21 You know how the lights work, and the mikes work, you're a
22 pro at this, so if you would start your testimony that would
23 be terrific.

24 WITNESS BAIR: Chairman Angelides, Vice Chairman
25 Thomas, and Commissioners:

1 I appreciate the opportunity to testify today on
2 systemic risk and ending too big to fail. The events of
3 September 2008 dramatically illustrated the flaws of our
4 former regulatory and bankruptcy framework for responding to
5 distressed large and complex financial institutions.

6 My testimony discusses two cases, Washington
7 Mutual and Wachovia, that demonstrate the dilemma we faced
8 between the risk of a wider financial crisis and the
9 prospect of bailing out bank owners and creditors.

10 While the FDIC was able to resolve WaMu under our
11 normal procedures without creating further disruption to the
12 financial system, an accelerated time frame, a lack of
13 information, and a complex organizational structure made the
14 dilemma worse at Wachovia.

15 Because the risks and uncertainties of creating
16 wider market instability were just too great, we invoked the
17 Systemic Risk Exception for the first time, and were
18 prepared to implement a resolution on that basis.

19 As events unfolded, however, that resolution plan
20 was not carried out because Wachovia was sold in an
21 intervening private transaction. But the problem was equal
22 or even more pronounced for other large nonbank
23 organizations that faced collapse at about the same time.
24 Most notably, the critical shortcomings of the bankruptcy
25 process as applied to large financial institutions was

1 demonstrated by the market reaction to the September 15,
2 2008, collapse of Lehman Brothers.

3 The provisions of the Dodd-Frank Act provide new
4 regulatory tools to preserve financial stability and protect
5 Taxpayers from losses sustained by large financial firms.

6 Resolution plans mandated by regulators and
7 created by the institutions themselves will specify how a
8 systemically important institution could be resolved and
9 will help to ensure that the complex structure of an
10 institution does not prevent its orderly resolution.

11 Backup examination and enforcement authority will
12 give the FDIC better information in advance about
13 systemically important institutions, making it more likely
14 that an orderly resolution can be achieved.

15 The FDIC has already updated its supervisory
16 memorandum of understanding with the other federal banking
17 regulators to enhance our existing backup authorities.

18 Finally, the new resolution authority will make
19 the FDIC's liquidation process available for bank holding
20 companies and nonbank financial companies to provide a means
21 to unwind them without disruption, delay, and uncertainty
22 usually associated with bankruptcy.

23 Had these authorities been in place in 2008, the
24 FDIC would have already had a detailed resolution plan for
25 Wachovia. We would have had better information about its

1 structure and risk profile, and we would have faced fewer
2 impediments to effecting its orderly resolution.

3 In short, Wachovia, or Lehman for that matter,
4 could have been resolved without a bailout and without
5 disrupting financial markets.

6 More importantly, had the current law been in
7 place in 2008, investors and institutions like Wachovia or
8 Lehman would have had every reason to expect losses in the
9 event of failure and would have exerted more effective
10 market discipline over their activities.

11 Finally, I would like to highlight what I see as
12 three main areas of priority for implementation under the
13 new law.

14 Under the new Orderly Liquidation Authority, the
15 largest financial firms must develop credible resolution
16 plans, working with the FDIC and Federal Reserve, so that we
17 have the information and planning needed for an orderly
18 resolution.

19 It is critical that Living Wills are not simply a
20 paper exercise. This planning process should affect
21 business decisions so that the companies operate more
22 efficiently and reduce the possibility of any future
23 collapse.

24 Under the law, they can be required to make
25 changes if necessary to avoid creating undue systemic risk.

1 We are working with our international partners to achieve
2 legal reform for a more cooperative international insolvency
3 process.

4 These are all key steps in truly ending too big
5 to fail. I view the Financial Stability Oversight Council
6 as a forward-looking forum for members with diverse
7 expertise to share their specialized knowledge, and to make
8 recommendations on addressing emerging risks to the
9 financial system. But regulators must have the courage to
10 act on the Council's recommendations if we are to address
11 systemic risks before they resolve any damage to our
12 economy.

13 Reforms to bank capital requirements under
14 consideration by the Basel Committee will serve to weed out
15 hybrid instruments that weaken the capital structure, add
16 new capital buffers so de-leveraging need not crush lending
17 in a crisis, and place higher capital charges on the riskier
18 derivatives and trading activities.

19 I urge a prompt finalization and implementation
20 of new Uniform Global Capital Standards so that regulatory
21 uncertainty can be reduced and investors can regain
22 confidence in the long-term stability of our global
23 financial system.

24 If financial reform is about anything, it should
25 be about stabilizing the financial system so that it can

1 meet the credit needs of the real economy and support long-
2 term sustainable growth.

3 To be sure, as I've previously testified before
4 this Commission, regulatory policy is but one component of
5 restoring a more vibrant economic future. A fiscal policy
6 that promotes the efficient allocation of resources is also
7 essential.

8 In this regard, we hope the Congress will review
9 the large level of government support provided to home
10 ownership to determine whether it has resulted in the most
11 productive allocation of resources.

12 For our part, we are working with our regulatory
13 counterparts to promptly implement regulations in the areas
14 of liquidation authority and the Financial Stability
15 Oversight Council. And we are working with our counterparts
16 on the Basel Committee with regard to international capital
17 standards.

18 We are approaching these tasks with both the
19 sense of urgency and a considered view toward the long-run
20 effectiveness. Only if we create strong frameworks now for
21 exercising our authorities under the Dodd-Frank Act can we
22 succeed in putting our financial system on a sounder and
23 safer path for the long term.

24 Thank you very much.

25 CHAIRMAN ANGELIDES: Thank you, Chairman Bair.

1 We will now move to questioning.

2 So let me start the questioning, per usual. One
3 thing that struck me in the runup to the System Risk
4 Exception for Wachovia is the extent to which there was
5 really no look at the systemic implications or risk. And I
6 know that folks say, well, that wasn't the role, but it does
7 seem to me that in the context of safety and soundness that
8 people can also look, or regulators could have looked at the
9 larger risk to the system.

10 The Fed seeks risks as early as '07. The
11 downgrades by the Fed and the OCC don't come until '08. I
12 know you're not the primary supervisor--I think you've got
13 one on-site examiner.

14 You yourself say, I believe in your interview
15 with our staff, that you really didn't, I don't think you
16 got notice of the run until Friday, which is when it
17 occurred. And you don't really have real knowledge of their
18 condition until Saturday. Is that an accurate statement?

19 WITNESS BAIR: Yes.

20 CHAIRMAN ANGELIDES: To what extent was this just
21 a glaring hole in the system? Should regulators, as a
22 whole, have taken the larger view? And could they have?
23 Isn't it too simple to just say, well, that wasn't in our
24 job description?

25 WITNESS BAIR: Well, we won't say that. I do

1 think there were earlier warning signs. You're right. And
2 in fairness to the other regulators, we were earlier in the
3 week, we did see some escalating distress, liquidity
4 distress with Wachovia. We were told Friday morning that it
5 was under control, and it wasn't until Friday night when we
6 were told there a liquidity crisis that could actually--that
7 necessitated some weekend action.

8 So it was a very short timeframe to deal with
9 this. And I do think, in retrospect, we were operating with
10 imperfect information. We were relying heavily on the
11 primary regulators, as we needed to.

12 As you know, we only had one of our own
13 examiners, as a backup examiner, in Wachovia. And that is
14 not to criticize the primary regulators. Everybody was
15 working very hard and doing their job, but we have a
16 distinct role. They had \$265 billion of exposure in insured
17 deposits. They had responsibility for an orderly resolution
18 if the institution could not maintain its obligations.

19 We needed more information to make a decision,
20 direct information and an ability for us to independently
21 assess the situation, and make decisions that we were
22 comfortable with.

23 So that is a lesson that I learned going forward,
24 and this is one of the reasons why we renegotiated our
25 Memorandum of Understanding with the primary regulators. We

1 will now have five examiners full time at these very large
2 institutions, with others on an as-needed basis. And that
3 will be for any institution, regardless of its CAMELS rating
4 or how healthy it is, given the size of the institutions and
5 how quickly they can deteriorate and this will be an ongoing
6 presence.

7 And we also have the additional authority now for
8 holding companies, as well. This is Wachovia, and like WaMu
9 Wachovia had a significant amount of securities activities
10 that occurred outside of the insured depository institution,
11 which we had no information about at all because prior to
12 Dodd-Frank our backup authorities only extended to what was
13 going on inside the insured depository.

14 CHAIRMAN ANGELIDES: All right. You clearly had-
15 -we, as you know, put on the record yesterday the transcript
16 of the FDIC Board meeting in which you considered the System
17 Risk Exception for Wachovia. And you clearly had
18 significant reservations.

19 You've said: Well, I think this is one option of
20 a lot of not-very-good options. I would note for the record
21 that both Treasury and the Federal Reserve Board weighed in
22 early for us to provide a System Risk Exception. You say:
23 I've acquiesced in that decision. I'm not completely
24 comfortable with it.

25 I'm looking for my notes, but I think you also in

1 interviews with the staff indicated that this was something
2 that the White House and the Federal Reserve wanted to move
3 on.

4 Were the reservations just ones of you're trying
5 to absorb it Saturday and you've got to make a decision--

6 WITNESS BAIR: Right.

7 CHAIRMAN ANGELIDES: --early Monday morning? Or
8 were there some fundamental reservations about, for example,
9 apparently--not getting into the gossip of who was mad at
10 who--but there did seem to be, according to your interview,
11 a philosophical difference when then New York Reserve--Mr.
12 Geithner, how's that, it's been a long series--Federal
13 Reserve Board of New York president, Mr. Geithner, a
14 disagreement about whether creditors, bondholders, should be
15 fully protected.

16 What were the reservations?

17 WITNESS BAIR: Well, I think--I don't think there
18 was any question in my mind we had to do something that
19 weekend. And we had--the system was highly unstable. We
20 had a very successful, I felt, resolution of WaMu.

21 But other things were going on. The TARP bill
22 was in flux. Lehman I think served as a catalyst for all of
23 this. We had had a stabilizing event with Indy Mac earlier,
24 where we'd had a bank run before and after the bank closing.
25 So we had redoubled our efforts to assure insured depositors

1 that their money was safe.

2 But my worst--we were guaranteeing about \$5
3 trillion of insured deposits, and my worst nightmare was
4 that bank depositors would start losing confidence in the
5 system and pull their money out.

6 We had already lost wholesale funding. The
7 shadow sector had completely seized up. Insured deposits
8 were staying, but if that changed we would have truly had a
9 cataclysmic situation.

10 So I didn't feel that we could afford on Monday
11 morning any risk that Wachovia would open and run out of
12 money, or have a disruptive situation. That was just not a
13 risk that we could tolerate.

14 So it was clear to me over the weekend we needed
15 to do something. Really the issue was whether we did the
16 System Risk Exception and provide what we call Open Bank
17 Assistance to them, or whether we tried to put it through a
18 normal resolution process.

19 That was the discussion I wanted to have more of,
20 but the time just did not permit it. And at the end of the
21 day, I don't second-guess what I did. The statute clearly
22 says that this needs to be a collaborative decision with the
23 FDIC, the Fed, and the Treasury, in concurrence with the
24 President. And the other parties had spoken on this and
25 felt strongly that a Systemic Risk determination with Open

1 Bank Assistance would provide the greatest amount of
2 stability.

3 So there was a philosophical disagreement over,
4 you know, bondholders. We don't feel--I felt and still feel
5 that equity shareholders and term bondholders know their
6 money is at risk, and should understand they take losses,
7 especially with insured banks where the process has been
8 around for a long time and should be, and I think is,
9 clearly understood by the market.

10 So there was a philosophical disagreement. That
11 isn't to say I'm right, or anyone is wrong, it's just that
12 it was, and it was a factor in these discussions. But I
13 don't look back. We had a discussion. We made a decision.
14 We moved on. And the good news was, on Monday the decision
15 we took over the weekend did stabilize the situation for
16 Wachovia.

17 CHAIRMAN ANGELIDES: And I guess on reflection,
18 and this isn't second-guess, but with respect to WaMu you
19 did not fully protect bondholders, right?

20 WITNESS BAIR: We did not. We did not.

21 CHAIRMAN ANGELIDES: And you think that was the
22 right decision?

23 WITNESS BAIR: I absolutely do think that was the
24 right decision.

25 CHAIRMAN ANGELIDES: For market discipline

1 purposes?

2 WITNESS BAIR: Yes. Absolutely. WaMu was not a
3 well run institution. I think that was clear from our
4 supervisory perspective.

5 CHAIRMAN ANGELIDES: When the OTS let you in,
6 right?

7 WITNESS BAIR: That's right. And Permanent
8 Subcommittee investigations in the Senate did a very good
9 review, as well. And there were a lot of troubling things
10 going on at that bank. And we can debate about whether
11 regulators should have been more on top of it, but, you
12 know, it shouldn't be just regulators; it should be
13 shareholders, and creditors putting pressure on those
14 institutions, too, for better risk management. And that was
15 not done.

16 And so that's where the losses should have been,
17 and I think it was a very appropriate resolution. And it
18 was consistent with our statutory process. That is the
19 process Congress told us to use.

20 CHAIRMAN ANGELIDES: Right. I'm going to
21 surprise my fellow members by saying this is my last
22 question to you, at least for now.

23 And that is, as I have read the materials
24 prepared for this hearing, this portion of our
25 investigation, not only interviews with all the principals,

1 but also historical materials. Our staff prepared an
2 excellent staff report for us, which has now been posted on
3 the Web, in which they traced the history of bailouts over
4 time.

5 And there's this pattern of institutions growing
6 like a weed, using high leverage, taking on enormous risks.
7 I think we've seen it all along the path. I mean it is, as
8 I've said, it's almost like financial groundhog day again
9 and again.

10 You look at this, and it's hard not to come away
11 with a view that what Wall Street has needed is not a series
12 of bailouts but a financial intervention.

13 (Laughter.)

14 CHAIRMAN ANGELIDES: But what I'm concerned about
15 at this point is, how do you break this repeat pattern? And
16 it is something we asked Chairman Bernanke. The fact is, we
17 have fewer, bigger banks now. It is going to be an enormous
18 test of will of the regulators to be able to constrain--you
19 know, it's always hard.

20 I think you said in your interview the job is to
21 take the punch bowl away. And that is the job of prudential
22 regulators. But tell me the risks you see here and the
23 challenge of that. And to what extent was that a failed
24 challenge in the run-up to this crisis?

25 Everything was good. People were booking

1 profits--

2 WITNESS BAIR: Yes.

3 CHAIRMAN ANGELIDES: --very hard to be the ones
4 to say: This is spiraling out of control.

5 WITNESS BAIR: Right. Well, that's right. It is
6 the job of regulators to take away the bunch bowl. You need
7 to do it when times are still good. You don't want to wait,
8 once things start turning bad. It's just going to be too
9 late.

10 But that requires political support, as well.
11 And I think in the early 2000s there were efforts to try to
12 rein in some of these really questionable mortgage lending
13 practices that we were seeing when I was at Treasury, and
14 there was just no political will to do that.

15 So I think that has to be--I think the new
16 Financial Stability Oversight Council is the vehicle where
17 Congress has placed accountability for making those
18 decisions with that Council. And it will be our job, and we
19 need to have the courage to exercise the decisions, and do
20 so even if we get pushback from it. Because you need to act
21 when things are still profitable.

22 If you wait until the losses start occurring, it
23 is going to be too late. I think I do not under-estimate
24 the importance for increased capital standards. Excess
25 leverage--the combination of excess leverage with too big to

1 fail was a toxic combination in feeding this crisis.

2 And, you know, the private sector held the up-
3 side, with the assumption being that the government was
4 going to take the down-side. That in and of itself fed
5 risk-taking.

6 So getting rid of too big to fail, restoring
7 market discipline through effective resolution authority,
8 and increasing capital requirements to de-leverage, making
9 sure that there are bigger cushions there so when the next
10 cycle comes--there will be another cycle. We can't do away
11 with cycles.

12 But when it comes, there is more of a capital
13 cushion to absorb the losses so you won't have a situation
14 where you've got to do a government bailout or confront a
15 failure situation.

16 So I think the tools are there. The regulators
17 have to use them. But the Congress and the political
18 leadership need to support the regulators when they need to
19 make unpopular decisions.

20 CHAIRMAN ANGELIDES: I'm going to break my own
21 rule, because you just said something that I've got to
22 follow up on. Do you really believe at this point that the
23 market believes that the too big to fail doctrine has been
24 broken?

25 WITNESS BAIR: Well, I think it's up to us to

1 effectively inform the new authorities that Congress has
2 given us. I think if they think it is still around, I think
3 they should read the statute itself. The statute--and we
4 pushed for this language--the statute very specifically
5 prohibits any kind of open-institution assistance.

6 So what happens, it's going to have to be
7 Congress doing it. Because the regulators simply have no
8 authority to do bailouts anymore, and we think that is a
9 good thing. We don't think we need it, if we have
10 resolution tools, which Congress also gave us.

11 CHAIRMAN ANGELIDES: Thank you very much,
12 Chairman.

13 Mr. Vice Chairman?

14 VICE CHAIRMAN THOMAS: Thank you. I am tempted,
15 but I guess I won't ask you if the scope of the legislation
16 extends to Kabul, Afghanistan, based upon this morning's--

17 WITNESS BAIR: Well, no it doesn't, but we have
18 made a high priority of--we have a lot of education and
19 training that we do with developing countries. I don't
20 think Afghanistan has been one of them, but I think this is
21 a key issue of having deposit insurance systems, and
22 credible deposit insurance systems, in developing countries
23 as well.

24 VICE CHAIRMAN THOMAS: I do want to thank you for
25 your written testimony, especially because--I don't know if

1 I've been reading as widely as I normally do, but I have not
2 really seen--let me say, I thought your testimony, the
3 written testimony, was very good in a succinct way on where
4 we were, where we are, but more importantly where we can go.
5 Now I don't know whether we will go, but that we can go.

6 WITNESS BAIR: Right.

7 VICE CHAIRMAN THOMAS: One of the difficulties,
8 especially in these very complex areas today, we used to
9 just go ahead and bite the bullet and make law. And then of
10 course you have a statute that you have to deal with, and
11 then you get to promulgate regulations from a narrow
12 opportunity.

13 I think it does make sense, once we come out the
14 other side of these, to pass law with significant regulatory
15 capability in fleshing it out, because it makes it not only
16 timely and appropriate but I think the better value is that
17 there can be adjustments over time without having to go back
18 through.

19 The problem with that course is, you have this
20 big splash about having passed the law, and then you've got
21 to roll all the regulations out.

22 What was your reaction, and how should we read
23 the--it's in the SEC's jurisdiction, not yours, but it was
24 the first one out of the chute in terms of the rating
25 agencies.

1 WITNESS BAIR: Right.

2 VICE CHAIRMAN THOMAS: It's kind of like Bear
3 Stearns and then Lehman. That was an aberration, and
4 hopefully the next few that role out will be well done, done
5 in a way they don't get flipped or put on the spot like we
6 did with the rating agency adjustment attempt.

7 What was your take on that event? You had
8 preferred something else rolling out first?

9 WITNESS BAIR: Well I think actually the
10 legislation itself really eliminates the ability of
11 regulators to use ratings in any way.

12 VICE CHAIRMAN THOMAS: Right.

13 WITNESS BAIR: And so certainly with structured
14 financial products the ratings were a terrible failure, and
15 definitely fed the crisis. That's not to let investors off
16 the hook. Investors should have been doing their own due
17 diligence, too. But the ratings were not good.

18 I think--and for corporate debt, there's a better
19 record, frankly. And to eliminate our ability to use them
20 at all, especially in more traditional areas, for the
21 ratings to perform better is going to create some unique
22 challenges for us. Especially for the smaller banks, we
23 rely on ratings of certain types of investments that they
24 hold, in terms of the risk weighting, how much capital they
25 have to hold against those exposures.

1 And so if we can't use ratings at all, we have to
2 find something else. And I'm not sure that there are
3 alternatives out there that are going to be any better, or
4 cost effective, especially for smaller banks.

5 So that said, Congress has told us they don't
6 want us to use ratings as all. So we are going to do our
7 best to make that work. We have an ANPR out, an Advanced
8 Notice of Proposed Rulemaking out, asking for comments on
9 what kind of alternatives we can use for banks in setting
10 capital standards, where we do rely on ratings a lot.

11 And so I'm hoping we can get some good thinking
12 on that and move forward in a way that's consistent with
13 Congressional intent. But it was quite sweeping in its
14 elimination of the use of ratings.

15 VICE CHAIRMAN THOMAS: And it was pretty reactive
16 in terms of the Street's reaction to that, at least on an
17 initial basis in terms of the rating agencies.

18 WITNESS BAIR: Right--

19 VICE CHAIRMAN THOMAS: I mean, they weren't going
20 to rate.

21 WITNESS BAIR: There was, but I think the SEC
22 acted very quickly to provide the relief that's necessary.

23 VICE CHAIRMAN THOMAS: But if you don't want to
24 have that repeated 232 times, or it's going to be a long
25 time getting where we need to go.

1 WITNESS BAIR: That's right. And I think we are
2 all committed to being very careful, deliberative, and
3 transparent about this, as well.

4 VICE CHAIRMAN THOMAS: And then a specific point,
5 because you have a--you're in front of us, and you had a
6 unique role on the Wachovia weekend.

7 On page 10, as you run through what happened and
8 the choices, I was struck--and I've mentioned this over the
9 two days of the hearings--that when you look at September
10 28, 29, and then 30, and as the chairman indicated the
11 minutes, it was clear that you had to take an extraordinary
12 position--i.e., an extraordinary measure--which it was
13 assumed would not put you at risk, but there was a potential
14 for risk.

15 I imagine it was fairly animated in terms of
16 behind-the-scenes discussions with all the players to reach
17 that point, notwithstanding you came out with a unanimous
18 decision--that's what happens when you break a huddle;

 WITNESS BAIR: That's right (laughter)

 VICE CHAIRMAN THOMAS:

19 -- everybody's now on the same page, and that was an indication
20 that you decided that was where you were going to go--and it
21 isn't so much the decision you made on the 29th, given the
22 options available to you. What kind of floored me was that
23 one day later the Internal Revenue Service decides to put
24 out the 83 Notice, which changes two decades of IRS Code tax
25 behavior.

1 And then, three day I guess--two days after that,
2 the deal which apparently was very difficult to come to a
3 conclusion that would be offered to save Wachovia, is gone
4 and Wells Fargo offers a no-strings-attached arrangement.

5 And what I have heard from some folk is that, not
6 withstanding that very interesting timing, that the Tax Code
7 change which was made by IRS, which was repudiated almost as
8 quickly as Congress could get itself focused on removing
9 that because it was a rifle shot for banks only, had no
10 consequence in the decision between your difficult motion to
11 take extraordinary action and Wells Fargo wrapping up a deal
12 that had no involvement by the FDIC, or frankly virtually
13 anyone else on a financial commitment.

14 Was that all coincidence, circumstance,
15 interesting string of events that had no relationship?

16 WITNESS BAIR: Yes, sir. We had no--we had no
17 knowledge of anything going on over at the IRS. It was not
18 a factor on decisionmaking at all. It came as a complete
19 surprise to us.

20 VICE CHAIRMAN THOMAS: But it was fortuitous,
21 right, because--

22 WITNESS BAIR: It was.

23 VICE CHAIRMAN THOMAS: --it relieved the FDIC of
24 any responsibility. And of course the Fed had no stake in
25 the game, so the only folk that potentially were at risk now

1 was, once again, a loss of revenue if in fact it was as big
2 as some people say, ten times the amount that otherwise
3 would have been available.

4 WITNESS BAIR: Right.

5 VICE CHAIRMAN THOMAS: So it is just all
6 coincidental.

7 WITNESS BAIR: It was--yes--

8 VICE CHAIRMAN THOMAS: From your perspective.

9 WITNESS BAIR: From my perspective, we didn't
10 know anything about it. We were surprised by it. And we
11 had no say in this. So once Wells came in, it was a private
12 transaction.

13 So, no, it was not a factor at all.

14 VICE CHAIRMAN THOMAS: But it was a public change
15 in the law by an Executive agency which, even in their IG's
16 statement, probably wasn't lawful, and in most of the tax
17 expert academia was clearly an over-reach.

18 WITNESS BAIR: Right.

19 VICE CHAIRMAN THOMAS: And there was no
20 discussion at Treasury in looking at options, or provide
21 alternatives in which they decided to go ahead and go
22 forward?

23 Why in the world--and I know you--

24 WITNESS BAIR: I don't know.

25 VICE CHAIRMAN THOMAS: --to answer, but I'm

1 looking--why in the world would they pull the trigger on the
2 30th based on the difficult decision you reached in your
3 minutes?

4 WITNESS BAIR: I don't know if the IRS was aware
5 of what we did. They were completely different things going
6 on. And I'm not a tax lawyer. I will defer to you in terms
7 of you obviously are very expert in tax matters, given your
8 former chairmanship of House Ways and Means.

9 VICE CHAIRMAN THOMAS: Those don't necessarily
10 follow, but--

11 (Laughter.)

12 VICE CHAIRMAN THOMAS: --but I appreciate the
13 comment.

14 WITNESS BAIR: I can't speak to it. I don't know
15 what was going on at the IRS, and I assume they were
16 completely devoid of what we were doing.

17 I don't think there was any knowledge on their
18 part, not that I'm aware of--I don't know. Again, we were
19 surprised by it. It just happened.

20 VICE CHAIRMAN THOMAS: I just wanted to ask you
21 that so we could put that on the record.

22 WITNESS BAIR: Yes, absolutely.

23 VICE CHAIRMAN THOMAS: It was an amazing series
24 of events, as far as I'm concerned, that led to a completely
25 different resolution.

1 Were you surprised by the Wells stepping up to
2 the plate--

3 WITNESS BAIR: Yes, I was.

4 VICE CHAIRMAN THOMAS: --and making that move?

5 WITNESS BAIR: Yes, I was.

6 VICE CHAIRMAN THOMAS: Okay, that's good. That's
7 a nice niche I can put that in. Thank you, very--well, I
8 think a lot of us were surprised. Thank you, very much. I
9 really appreciate, once again, the help that you have given
10 us early on and your continued willingness, obviously, if we
11 want to ask you some questions after this I know you will
12 respond--

13 WITNESS BAIR: Yes.

14 VICE CHAIRMAN THOMAS: --and provide us with that
15 additional information.

16 WITNESS BAIR: Absolutely. Thank you.

17 VICE CHAIRMAN THOMAS: Thank you.

18 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

19 COMMISSIONER HOLTZ-EAKIN: Thank you. And thank
20 you for spending this time with us.

21 First, just for the record, we ask everybody all
22 the time, and in particular Mr. Bernanke, if he could rerun
23 history would monetary policy look different? Would
24 regulation of mortgage origination look different?

25 Looking back, what should the FDIC have done

1 differently in the runup to, and the crisis itself?

2 WITNESS BAIR: Well that's a good question. I
3 think we should have been more attentive to our backup
4 authority, and our resolution functions. I think, when I
5 came to the FDIC in June of 2006 we were heavily focused on
6 the supervisory side. Primarily smaller banks we were the
7 primary regulator of.

8 We had just gotten authority to risk-adjust our
9 own insurance premiums from Congress, which was very helpful
10 because there had been an extended period of time where
11 under the law we basically couldn't charge banks anything
12 for their deposit insurance. So we weren't building up the
13 Fund as we should have been. And we weren't adjusting those
14 premiums on the basis of risk.

15 So we implemented those authorities very quickly.
16 And I think we also eliminated--there was something called
17 the "Merit System" that had been put into place before I
18 came.

19 That basically was a very streamlined examination
20 process, which I didn't think was prudent. I think any
21 bank, even if it's a perfect CAML picket one, picket fence
22 rated one institution, should have its loan files looked at.
23 And so we got rid of that.

24 So we did try to turn course a bit and start
25 providing more supervisory vigor. And in retrospect,

1 though, I think we should have focused more on our backup
2 authority and getting better up-to-speed on the large
3 institutions.

4 So I think in terms of the FDIC's role, I wish we
5 had moved on all those issues earlier.

6 COMMISSIONER HOLTZ-EAKIN: I want to now talk a
7 little bit about the WaMu episode. Chairman Bernanke just
8 testified, and if I remember how he said it correctly, he
9 said the failure of WaMu caused Wachovia's liquidity runs.

10 You just said the WaMu resolution was very
11 successful--I think those were your terms?

12 WITNESS BAIR: Yes.

13 COMMISSIONER HOLTZ-EAKIN: Do you have any
14 regrets about the way it was done? And what were the other
15 options that you felt were inferior?

16 WITNESS BAIR: Well I think there was a
17 culmination of events that led to Wachovia's liquidity
18 problems. And if there was a connection between WaMu and
19 Wachovia, it was now how the resolution of WaMu was handled;
20 it was the fact that WaMu had failed for reasons related to
21 a very large Option ARM portfolio on the West Coast, which
22 Wachovia also had because of its Golden West acquisition.

23 COMMISSIONER HOLTZ-EAKIN: And he said that, just
24 to be clear.

25 WITNESS BAIR: So that would be--no, I don't

1 think that the way that, you know--with WaMu we put that out
2 for competitive bidding. We were able to get a bid where
3 all the uninsured depositors were protected, and most of the
4 general creditors, the services providers, et cetera. So it
5 was really term debtholders that will have some recovery,
6 and equity shareholders that took the losses.

7 But Wachovia was losing uninsured deposits; they
8 were losing transaction accounts; they were losing
9 derivatives counterparties. It was part of a larger
10 escalating--I would use the word "panic," but it was a near-
11 panic situation from a whole series of events--Lehman, AIG,
12 the uncertainty of the TARP legislation. And the market was
13 confused. The market was absolutely confused.

14 And even though Lehman--excuse me, the WaMu
15 process shouldn't have surprised anybody, because for banks
16 we did have a statutory process in place that's been around
17 for a long time and should have been well understood by the
18 market.

19 It was a financial institution, and that was
20 different from what had happened with Lehman, with what had
21 happened with AIG, with what had happened with Bear Stearns,
22 and I think the market was confused.

23 So that's why I think it gets very important to
24 have this resolution authority, so the market will now
25 understand: it will be bankruptcy, or it will be this

1 resolution. But under both processes, the claims priority
2 is pretty much the same.

3 COMMISSIONER HOLTZ-EAKIN: Let me ask a little
4 bit about that. When they conducted the stress tests, it
5 was announced that the 19 large banks would not be subject
6 to prompt corrective action--

7 WITNESS BAIR: Um-hmm.

8 COMMISSIONER HOLTZ-EAKIN: --based on the
9 discovery in the stress test, despite the fact that in
10 FDICIA prompt corrective action is not discretionary; it's
11 nondiscretionary. How do you feel about that?

12 WITNESS BAIR: Well, I think--I'm not sure--I
13 don't recall that we specifically said we would not follow
14 prompt corrective action.

15 I think what was said was that the Treasury would
16 stand behind--to the extent these banks' capital
17 deficiencies were identified at these banks, they would be
18 given time to raise private capital, if they could, and the
19 Treasury would come in with the TARP capital investment.

20 So either through TARP or through private
21 capitalizations they would stay above their PCA levels. The
22 government was not going to let those 19 banks become
23 insolvent. So I think that was--so I don't know that that
24 is really inconsistent with PCA, because it really involved
25 a commitment to keep them above PCA through TARP

1 investments, if necessary.

2 COMMISSIONER HOLTZ-EAKIN: I guess the reason I
3 asked was, looking forward, you know, the new resolution
4 regime and, you know, the Dodd-Frank legislation, is
5 described as nondiscretionary.

6 WITNESS BAIR: Um-hmm.

7 COMMISSIONER HOLTZ-EAKIN: Will market
8 participants really believe that, in light of this episode?

9 WITNESS BAIR: Right. Well, again I think the--I
10 don't think it was inconsistent with PCA. I also--you
11 should also--we should focus also on the fact that PCA only
12 applies to insured depository institutions. Those 19
13 institutions were not just banks with holding company
14 structures, major investment banks. But again, I think the
15 commitment was through the TARP to keep them above--so they
16 didn't go below PCA. The government would not let them hit
17 that 2 percent trigger.

18 So I don't know if that's inconsistent with what
19 the PCA constrains. You know, the law is what the law is.
20 And we pushed very hard for very explicit statutory language
21 that says we can't provide, and the Fed can't provide, open
22 institution assistance anymore. They have to go through a
23 resolution process.

24 The only time the government can step in is where
25 a system-wide support--and perhaps that type of situation

1 can be viewed as system-wide support, I don't know, but we
2 would not want individual institutions to ever be bailed
3 out, and I think the statute is very clear on that point.

4 COMMISSIONER HOLTZ-EAKIN: So I'm fundamentally
5 evil, so I--

6 WITNESS BAIR: Okay, that's fine.

7 COMMISSIONER HOLTZ-EAKIN: --I think of things
8 all the time, so imagine the Fed--we won't use the FDIC--but
9 the Fed in principle can open up facilities eligible to
10 everybody under the law, and then an individual bank could
11 show up, and they could assess their collateral and say we
12 can help you, and everyone else they could decide their
13 collateral is not good enough.

14 Does the law really restrict actions to open,
15 individual institutions?

16 WITNESS BAIR: Well, I think the 13.3
17 restrictions are not as stringent as they are on us, and
18 frankly we push. We thought that the 13.3 restrictions
19 should be just as stringent as they are for us. And we will
20 have to--well actually now we have to go to Congress, as
21 well, for any kind of debt-guaranty program.

22 Congress did not restrict the Federal Reserve
23 Board so significantly. But it does have to be generally
24 open to everybody. I believe it's supposed to only be to
25 solvent institutions. I believe there's an express

1 provision that says if the government takes losses on those
2 facilities, that immediately triggers either a bankruptcy or
3 a resolution. So they will have to be closed, and the
4 shareholders and creditors will have to take the losses,
5 with the government having the first-priority claim.

6 COMMISSIONER HOLTZ-EAKIN: Okay. To switch
7 subjects just a little bit, I've always wondered, the role
8 of this in the financial crisis. One of the unique features
9 of Fannie Mae and Freddie Mac, among many others, is the
10 fact that there are no restrictions on the amount of their
11 securities that banks can hold in their portfolios.

12 WITNESS BAIR: Yes.

13 COMMISSIONER HOLTZ-EAKIN: And so question number
14 one is, in terms of transmission of the crisis how
15 significant do you think that was?

16 And question number two: The decision to wipe
17 out the preferred holders, many of which I believe were your
18 insured banks, how much did that impact the FDIC directly
19 and the transmission of this crisis?

20 WITNESS BAIR: Right. Well, I think the
21 internalization of risk in the financial sector is a huge
22 problem. And this is one of the things that we want to
23 focus on in our resolution plan, is requiring all of these
24 large bank holding companies and other nonbank systemic
25 entities to give us in detail who are their counterparties,

1 who does hold their debt, who does hold their debt equity.

2 Because nobody has a big picture now. And it was
3 difficult for us to try to project who was going to take--
4 who could potentially be put over the cliff with Fannie and
5 Freddie and the preferred being wiped out.

6 It turns out, we did on an inter-agency basis,
7 obviously this was not a result that the Treasury wanted,
8 and I on the margin did increase our losses, too. But I
9 think for the most part the failures occurred with banks
10 that were pretty weak and probably wouldn't have made it
11 anyway.

12 And we did provide additional time, which we are
13 allowed to under statute in prompt corrective action to give
14 them an additional time to have capital restoration plans,
15 and a lot of them did. Some of them were not able to do so.

16 But I think it does--you're right. It
17 underscores a broader problem: there's too much
18 internalization. I mean, one of the Basel Accord provisions
19 will also eliminate the ability to count as capital equity
20 held by another financial institution. That is extremely
21 important. Because if you have the--you know, if you're
22 faced with the situation where, by closing one entity and
23 imposing market discipline, you may precipitate the closing
24 of five others because they all have such tremendous
25 exposure, then you've got a real problem.

1 So I think this is something we've been very
2 focused on. And again, we will want to have--I think the
3 Basel Capital rules are addressing it in part, and we will
4 work through our resolution plans that we require these
5 large satellite institutions to have more more transparency
6 across the board for all of them.

7 COMMISSIONER HOLTZ-EAKIN: Thank you very much.
8 Thank you, Mr. Chairman.

9 CHAIRMAN ANGELIDES: Can I ask for just a quick
10 clarification? And maybe I missed it when you spoke. When
11 the GSEs were put in the conservatorship, was there a
12 consultation with you with respect to how it was done such
13 that it wiped out the preferreds?

14 WITNESS BAIR: We were asked by Treasury to try
15 to give them an analysis of how many banks would fail. And
16 we did that analysis. And we were operating under imperfect
17 information. We thought the number was fairly small.

18 It did turn out--there were some that were
19 affected--but it did turn out to be fairly small.

20 CHAIRMAN ANGELIDES: And do we have that
21 analysis? I would just ask that we get that analysis.

22 WITNESS BAIR: Okay.

23 CHAIRMAN ANGELIDES: Okay, thank you. All right,
24 Mr. Georgiou.

25 COMMISSIONER GEORGIU: Thank you, Mr. Chairman,

1 and thank you Chairperson Bair.

2 A problem that we've heard a great deal about
3 during our hearings was this notion of regulatory arbitrage
4 and capital arbitrage when institutions held assets off-
5 balance sheet to avoid capital requirements, and in some
6 cases purposefully characterized assets in particular ways
7 to put them into categories that required less capital to be
8 held under the rules.

9 And now, with your authority extended I suppose
10 to really all these institutions that include a depository
11 function, even at Citi we found at its peak that if you'd
12 brought everything on balance sheet they had something like
13 \$3.3 trillion of assets, and about \$75 billion of capital,
14 which was just a little over 2 percent net/net.

15 You know, obviously we've heard from other people
16 in hindsight that everyone agrees that if there were more
17 capital and less leverage that the prices might have been
18 ameliorated.

19 I wonder if you have a view as to what the--how
20 to address this issue on a go-forward basis?

21 WITNESS BAIR: Well I think both the accountants,
22 as well as the Dodd-Frank help with this. FAS 166 and 167
23 requires a lot of assets that were off-balance sheet to now
24 be counted on balance sheet. We also in terms of arbitrage
25 and capital standards that were generally higher inside the

1 bank and outside the bank, we supported very strongly
2 Senator Collins' amendment to require that the capital
3 levers for bank holding companies, as well as nonbank
4 systemic financial entities, has to be at least as high, the
5 capital has to be at least as high as what we require
6 generally applicable to any bank, large or small.

7 So this will help--I think this will help a lot
8 in terms of ending the regulatory arbitrage that exists
9 between doing things in the bank or doing things outside the
10 bank where you could have greater leverage. It now has to
11 be uniform. So the generally applicable standard for banks
12 will come before for bank holding companies as well as for
13 other nonbank systemic entities. I think this will be a
14 tremendous help to us.

15 COMMISSIONER GEORGIU: Can you give us an
16 example of how that might impact a particular institution?
17 I mean, how much additional capital, either as a percentage--
18 --as a percentage would that customarily require?

19 WITNESS BAIR: Well, we have actually run some
20 aggregate analysis. I'd be happy to get the aggregate
21 numbers to you. I don't know them off the top of our head,
22 but it will increase capital levels at holding companies.
23 We've done it for bank holding companies. We haven't--since
24 the Council has not designated any particular nonbank
25 financial entities yet as systemic that would be subject to

1 this, we wouldn't have that. But for the impact on bank
2 holding companies, we could share some information with you
3 on that.

4 COMMISSIONER GEORGIU: I'd appreciate that, if
5 you would provide that.

6 We have heard, pardon some people's skepticism,
7 that we've ended the too-big-to-fail problem. I hope we
8 have, but it's not entirely clear.

9 WITNESS BAIR: Right.

10 COMMISSIONER GEORGIU: A lot of institutions
11 have grown enormously. We have these statistics that have
12 been brought to our attention by our staff that the top six
13 banking institutions held roughly--their assets were roughly
14 17 percent of US GDP in 1995, gone up to 38 percent in '02,
15 58 percent in 2007, and given the disappearance of some
16 entities and the merger of some entities into the larger
17 ones, they've actually gone up from 58 percent to 63 percent
18 of GDP in 2009.

19 So these six institutions at least--Bank of
20 American, JPMorgan Chase, Citigroup, Wells, Goldman Sachs,
21 and Morgan Stanley--all appear even today to be institutions
22 which, if they were stressed as they were two years ago,
23 would be candidates for assistance of some sort from the
24 government, notwithstanding the prohibition on particular
25 assistance to single institutions that's in the Dodd-Frank

1 bill.

2 I wonder if you could speak to that: If you
3 really believe, if push comes to shove, these institutions
4 will be allowed, with the new resolution authority, to
5 dissolve themselves?

6 WITNESS BAIR: We do. I think over time there
7 will be market pressures to downsize. I think increasing
8 capital requirements will create some pressure to downsize.

9 I think increased market discipline through new
10 resolution authority will also create pressure to downsize.
11 But I do think that with the tools we have available we can
12 do an orderly resolution. We can do it more effectively
13 once we have their own living will plans. But for the
14 largest entities that have dominant depository institutions,
15 there's a lot of information about them already.

16 So I think, yes, we can use this resolution
17 mechanism if we need to for institutions even of that size.
18 And we have the capacity to move the key functions of the
19 entity into a bridge bank and fund it temporarily to keep
20 the franchise available as we market and sell it off. And
21 this is a tool that we have used for many years, and it
22 works quite successfully.

23 So we do think it will be a system that will work
24 better than bankruptcy, and it certainly is a much better
25 alternative to bailouts.

1 COMMISSIONER GEORGIU: Okay. I think really, if
2 I could, Mr. Chairman, I would like to reserve time and
3 perhaps I will come back afterwards. Thank you very much,
4 Chairwoman Bair.

5 CHAIRMAN ANGELIDES: Thank you. Senator Graham.

6 COMMISSIONER GRAHAM: Thank you, Mr. Chairman.
7 Thank you, Madam Chairman.

8 I am concerned with the statistics that
9 Commissioner Georgiou just stated about the increasing level
10 of concentration in our largest financial institutions.

11 Why do you think this is happening? And what's
12 the argument that it's in the public interest?

13 WITNESS BAIR: I think it happened because of
14 too-big-to-fail. I think the bigger you got, the more you
15 had an implied government backstop. And the more investors
16 were willing to pump money into you to get highly leveraged
17 returns. I think it's a combination of the implicit
18 government backstops for very large financial institutions,
19 combined with capital standards that were not high enough.

20 So I do think over time--I will also say under
21 Dodd-Frank that the new Financial Stability Oversight
22 Council has the ability, at the Fed's initiative I believe,
23 to start requiring divestitures if it's determined that this
24 institution poses a systemic risk currently.

25 We also, the Fed and the FDIC jointly, if these

1 institutions do not submit a living will--i.e., resolution
2 plan--that we think is sufficient to show they can be
3 resolved in an orderly way, we also have the power to start
4 ordering divestiture.

5 So those are pretty extraordinary tools, but
6 those are tools that are available to us in the new law.

7 COMMISSIONER GRAHAM: Do you believe there is the
8 political support, both in the Executive Branch and in the
9 Congress to implement these available powers to begin the
10 process of restraining the growth of these large
11 institutions?

12 WITNESS BAIR: Well we'll find out soon. I think
13 we certainly are forging ahead, and I think everybody else
14 is just as committed.

15 I think you heard Chairman Bernanke is highly
16 supportive of resolution authority, and working with us in
17 the areas where we have joint rulemaking authority.

18 So I think it needs to be done. It needs to be
19 done in a measured, and transparent way, but also in a
20 timely way.

21 Our plan is to have a general framework out for
22 resolution authority in the very near future, and we will
23 use that as an interim final rule to solicit more detailed
24 comment, and have a more detailed plan finalized over the
25 next several months.

1 On the living will piece, the statute gives us an
2 outside marker of 18 months. I'd like to get the rule out
3 much earlier than that, if possible. So I think--you know,
4 the markets in the United States are resilient, and I think
5 if they understand what the rules are they'll be able to
6 live with the rules. But I think the important thing is to
7 get the rules out and have clarity.

8 COMMISSIONER GRAHAM: Chairman Bernanke talked
9 some about the possibility of coming up with a report card
10 indicating whether these large institutions were in fact
11 responding to some of the new incentives.

12 Do you see the utility of something like that
13 through your agency?

14 WITNESS BAIR: Yes, I do. I think I--that's the
15 first I've heard of that, so I don't know exactly what the
16 proposal is, but I think it's a good idea. It might be
17 something we'd want to do jointly with the Fed, as opposed
18 to having--we wouldn't want dueling report cards, probably.

19 But the Fed though is--we have resolution
20 authority over nonbank systemic entities. The Fed will be
21 the lead supervisor obviously for bank holding companies, as
22 they are now for the nonbank systemic entities. So I
23 assume, in terms of developing that type of institution-
24 specific report card, the Fed would have the lead.

25 COMMISSIONER GRAHAM: I also asked the chairman

1 about the difference in some other areas of the economy in
2 terms of whether the private entities have come together to
3 provide some effective voluntary oversight and enforcement
4 of their best practices, using the nuclear industry as the
5 good example, and maybe the not-so-good example being the
6 deep-water drilling industry.

7 From your perspective, are the institutions that
8 you supervise in terms of their willingness to come together
9 to provide a voluntary early line of defense against
10 inappropriate activities, are they more like the nuclear
11 industry, or the deep-water drilling?

12 WITNESS BAIR: Right. Well I think most are
13 trying to do the right thing, I really do. We just had a
14 roundtable discussion on resolution authority, and wanted to
15 start the dialogue on living wills, too, and I was
16 impressed.

17 We had many very large institutions present, and
18 they had all, it was clear to me, already given this some
19 serious thought. So I think they are taking it seriously;
20 they do understand the mandate.

21 They do understand that if they don't adhere to
22 the statutory requirements there will be other, more adverse
23 consequences in terms of the potential for forced
24 divestiture. And that wouldn't be in anybody's interest,
25 but it is there and could be used if it needed to be used.

1 So I was encouraged by that roundtable. Again,
2 there is still a lot of work ahead, but I was encouraged.

3 COMMISSIONER GRAHAM: I would suggest that that
4 movement towards a greater degree of acceptance of
5 independent responsibility might be an appropriate item on
6 your report card.

7 WITNESS BAIR: I think that's right.
8 Accountability--you know, we can't do this all, and if we
9 don't have responsible management taking ownership and
10 accountability for the changes that need to be made, it is
11 not going to work. I couldn't agree more.

12 COMMISSIONER GRAHAM: Thank you, Mr. Chairman.

13 CHAIRMAN ANGELIDES: Mr. Hennessey.

14 COMMISSIONER HENNESSEY: You really are mixing
15 things up.

16 (Laughter.)

17 CHAIRMAN ANGELIDES: No, that's the fairness
18 doctrine. Outside in/inside out.

19 COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

20 I want to follow up actually on two of Doug's
21 questions and just ask you to drill down a little bit more.

22 One is on banks holding GSE. In particular, I'm
23 interested in debt. And I just want to review kind of for
24 the record and make sure I understand it. So if I'm an
25 FDIC-insured bank, I can't hold more than a certain portion

1 of my assets in the debt of General Motors, or IBM, but I
2 can hold 100 percent of my assets in the debt of Fannie or
3 Freddie? Is that basically right?

4 WITNESS BAIR: I think that's right. I don't
5 have our capital expert--that is right, yes.

6 COMMISSIONER HENNESSEY: And who sets those
7 rules? Are those FDIC rules?

8 WITNESS BAIR: Well, those were rules--no. Those
9 would be set on an interagency basis. And I think it's a
10 point well taken.

11 COMMISSIONER HENNESSEY: So is it sort of a
12 common set of rules that FDIC and OCC and the Fed all agree
13 and say here are the rules?

14 WITNESS BAIR: That's right.

15 COMMISSIONER HENNESSEY: And is that an area that
16 should be looked at going forward to say, you know what,
17 we're going to treat these guys the same as others, given--

18 WITNESS BAIR: Absolutely. Absolutely. I think,
19 you know, while we're on the subject, we'll just go a little
20 further and, you know, there's a lower risk waiting for GSE
21 debt, too, than there was for corporate debt. And was that
22 right? No, I don't think it was, either.

23 So, yes, I'm not going to disagree with you on
24 any of that.

25 COMMISSIONER HENNESSEY: And looking back, I mean

1 my recollection during the crisis is, once you got to the
2 point where Fannie and Freddie were failing, sort of the
3 risk waiting is a long-term problem, but the real systemic
4 transmission risk was the fact that, if we broke the line
5 into GSE debt, there were banks that would fail because they
6 had bet too heavily on GSE. It was that concentration--

7 WITNESS BAIR: Right.

8 COMMISSIONER HENNESSEY: --of firm-specific risk.
9 Is that right?

10 WITNESS BAIR: This is a two-year-old
11 conversation, but I don't frankly recall when Treasury
12 started engaging us on this. I think they had already made
13 the decision that they weren't going to go above preferred.

14 COMMISSIONER HENNESSEY: Right.

15 WITNESS BAIR: I'll go back and check that, but I
16 don't think--there were others. It wasn't just banks that
17 held a lot of GSE debt. So you should probably ask
18 Treasury, too, but I don't recall that they had ever
19 considered going--

20 COMMISSIONER HENNESSEY: Let me try a smooth
21 transition, then, into Basel. Should that be a topic of
22 discussion for Basel, as well? Because agency securities
23 are held all over the world.

24 WITNESS BAIR: That's true. That's very true.
25 And I would have to--there are limitations on the ability of

1 financial institutions to hold equity in other financial
2 institutions. On the debt holdings in terms of the risk
3 weighting, I don't--I will check. If it has been
4 considered, it hasn't risen up to the principal level, but I
5 can check on that for you.

6 COMMISSIONER HENNESSEY: Related to that, I've
7 seen some of the same press reports about pushback within
8 the Basel discussions that the capital levels are too
9 stringent. Who is pushing back?

10 WITNESS BAIR: Well, those conversations are
11 confidential. So I know that's an issue with some, but
12 those are the rules--

13 COMMISSIONER HENNESSEY: Can you tell us what
14 Continent it is?

15 (Laughter.)

16 WITNESS BAIR: Well, I wouldn't disagree with any
17 of the public reports, I'll put it that way. I mean, I am
18 just really hoping we can all go with a consensus. I think
19 it troubles me if individual countries, you know, want to
20 adhere to too-big-to-fail as a basic tenet of their banking
21 system. Because that's really the alternative. If you
22 allow excessive leverage with your banking sector, knowing
23 those capital levels will not be sufficient to cover losses
24 if you get into a downturn, you're really just saying you're
25 going to be bailing them out.

1 And so that's not good for anybody. And so we do
2 need to all do this together. I think in terms of a
3 competitive disadvantage, it's more of an issue among
4 countries in Europe than it would be the U.S. versus Europe.

5 But I do hope that we can all come to agreement
6 on that. It's in everybody's interest to get rid of
7 too-big-to-fail, and an important component of that is
8 making them have capital high enough to absorb their losses
9 so they can stand on their own two feet.

10 COMMISSIONER HENNESSEY: Good. Nonbank financial
11 institutions and FDIC-insured banks, and the FDIC model of
12 course is since the deposits are insured, or at least up to
13 a certain level depositors don't have to worry about it.
14 And one thing we heard from Chairman Bernanke and others is
15 that you had liquidity runs which were parallel to the old
16 pre-FDIC bank depositor runs.

17 WITNESS BAIR: Right.

18 COMMISSIONER HENNESSEY: Reading your testimony,
19 it sounds like the same sort of liquidity runs were
20 occurring with at least Wachovia and WaMu.

21 WITNESS BAIR: Uninsured depositors, they were,
22 absolutely.

23 COMMISSIONER HENNESSEY: Uninsured depositors.
24 But were Wachovia and WaMu experiencing the same sorts of
25 liquidity runs that we hear about--

1 WITNESS BAIR: Yes.

2 COMMISSIONER HENNESSEY: --the nonbank financial
3 institutions?

4 WITNESS BAIR: Yes. Wachovia was--yes, Wachovia
5 was, yes.

6 COMMISSIONER HENNESSEY: So the nondepositor
7 liquidity problems were--

8 WITNESS BAIR: Also impacted in some banks.
9 That's right. That's exactly right, yes.

10 COMMISSIONER HENNESSEY: Okay. And then could
11 you take a minute just to drill a little more maybe into
12 explaining--because I hear so much about the way FDIC did
13 the Washington Mutual resolution--can you just simply
14 explain kind of--

15 VICE CHAIRMAN THOMAS: Would the gentleman like
16 an extra minute for her to explain it?

17 COMMISSIONER HENNESSEY: Thirty seconds for the
18 response--for my question, and whatever time she needs to
19 respond.

20 VICE CHAIRMAN THOMAS: Okay.

21 COMMISSIONER HENNESSEY: Thank you. Can you just
22 explain--

23 CHAIRMAN ANGELIDES: He says 'yes.'

24 COMMISSIONER HENNESSEY: --where you drew the
25 line, why, and what that complaint is of what your response

1 is to it? Because I'm not sure I understand.

2 WITNESS BAIR: Well, you know, I think--I'm sure
3 everybody would of liked to have gotten bailed out. I mean
4 that's, you know, if you're holding debt or equity you're
5 going to want to prefer that you'd gotten bailed out. So I
6 think--

7 COMMISSIONER HENNESSEY: Actually--actually, if I
8 could, the concern I'm hearing is that the way FDIC did it
9 was in some way upending the traditional capital structure,
10 or it sent signals to others who held bank debt.

11 WITNESS BAIR: No, no.

12 COMMISSIONER HENNESSEY: And I'm sorry, because
13 I'm confused in what I'm hearing.

14 WITNESS BAIR: No, that is not. And if you would
15 like a walk-through from our Receivership staff, I would be
16 happy to provide that.

17 COMMISSIONER HENNESSEY: Yes.

18 WITNESS BAIR: But, no, we had been on top of
19 that for several months. We did have time there working
20 with OTS and the bank. There were a lot of efforts to get
21 more capital into it.

22 They went through two different bank runs and
23 were hemorrhaging deposits badly. Their lines of credits
24 were being pulled. They had a very, very bad Option ARM
25 portfolio. Their immediate failure was triggered by

1 liquidity, but I think all of our examiners think there
2 would have been a capital insolvency. The market just
3 already knew that.

4 So we gave the bank as much time as we could to
5 get their recapitalization. It couldn't come through. But
6 fortunately as part of that recapitalization, they had
7 talked to other investors. There were a number of other
8 investors that had already been into the bank, the thrift,
9 doing due diligence.

10 So that when we had to start our own process, we
11 had folks who were familiar with the institution and were
12 prepared to bid. And that is the same process we use for
13 small banks now. That's the same process we use every
14 Friday.

15 COMMISSIONER HENNESSEY: Thank you.

16 WITNESS BAIR: You're welcome.

17 CHAIRMAN ANGELIDES: Heather? Ms. Murren.

18 COMMISSIONER MURREN: Thank you.

19 Thank you, Chairman Bair. I would like to
20 actually focus on the traditional bank examination process
21 for a couple of minutes.

22 WITNESS BAIR: Okay.

23 COMMISSIONER MURREN: It's been told to me that
24 that process has actually changed post-crisis; that after
25 the crisis it's gotten much more intense; that the examiners

1 are at the banks longer, and perhaps are a little tougher in
2 their judgments than they had been previously.

3 And I'm curious as to whether you think that's
4 fair, or whether you think that that's simply by virtue of
5 the environment that we're in?

6 WITNESS BAIR: Well I think our examiners overall
7 have tried very hard to take a balanced approach, and we've
8 encouraged them in Washington to take a balanced approach.

9 It is a more distressed environment. We do have
10 a lot of banks out there--it's a minority, but still a
11 significant number that have some very troubled loans still
12 on their books that they're still working through.

13 And those types of banks take more time for
14 examiners to go in and to work with them. But we've made it
15 clear that we want banks to lend. We want them to make
16 prudent loans. We want them to lend. We don't want the
17 banks or the examiners over-reacting and battening down the
18 hatches and just not extending credit. That's the worst
19 possible thing that we could have for the economy or for the
20 banking system.

21 So I think overall our examiners have set the
22 right tone. We have issued multiple pieces of guidance
23 encouraging them and banks to lend, to work with borrowers
24 when they do get into trouble whether it's a mortgage
25 holder, whether it's a commercial real estate borrower, if

1 they get into trouble to try to work out the loan, if that's
2 going to present better value and typically it will in a
3 distressed environment like this to try to do some type of
4 loan modification.

5 And so I think that's overall been as successful
6 as it can be, given the current environment. But I know
7 there are still particular cases where we hear complaints,
8 and we have an ombudsman here, and banks can engage the--
9 that's what the ombudsman is for. If they feel like the
10 examiner is not following articulated policies, they have
11 recourse.

12 COMMISSIONER MURREN: Thank you. To follow on
13 this, in your written testimony you talked about the fact
14 that sometimes it is difficult to see, particularly in the
15 larger, more complex institutions, things that may not be
16 apparent prior to failure, such as exposures and systemic
17 linkages.

18 And I'm curious as to whether, when you think
19 about the ability going forward to evaluate that, has the
20 fundamental bank examination process also evolved to include
21 those things as the portfolio of things they look at? Or is
22 that more the--

23 WITNESS BAIR: That's a really good question. So
24 I think the answer is, I would like to see that. We are
25 pushing--I'm chairman of the Federal Financial Institutions

1 Examination Council, otherwise known as FFIEC, which is an
2 interagency group focused on bank examination practices.

3 And we would very much like to update our
4 CAMELS rating process and expand the types of questions that
5 examiners traditionally ask to get more focused.

6 Right now the examination process is very, very
7 focused on credit quality on the asset side. So how well
8 are those loans performing, not so much on the liability
9 side. You know, where's your liquidity coming from? What
10 is stable? What's not?

11 So getting more information along those lines I
12 think would be extremely helpful for all banks. And so I
13 would like to see that as part of our examination process.

14 For the larger institutions we've also been
15 working with the New York Fed on more detailed information
16 on liquidity for the very largest institutions. That is
17 very much an area of focus right now.

18 COMMISSIONER MURREN: Great. I have one question
19 that's a little bit off of this topic, but has anyone done,
20 to your knowledge, an analysis of what the capital ratios--
21 what would they have had to have been post-mortgage crisis
22 to allow some of these firms to have actually survived? Was
23 it possible?

24 WITNESS BAIR: We do have those numbers, and
25 they're part of the aggregate analysis that we were doing of

1 how much additional capital would come in under the new
2 capital standards. And I would be happy to provide it to
3 you.

4 COMMISSIONER MURREN: Do you happen to recall
5 what the general numbers look like?

6 WITNESS BAIR: I think economists, different
7 people, agree, I think for Tier One Common Equity, which is
8 true loss-absorbing capital, the range is from 8 to 13
9 percent.

10 COMMISSIONER MURREN: Great. Thank you.

11 CHAIRMAN ANGELIDES: Just to follow up on that
12 very quickly, 8 to 13 percent on Tier One?

13 WITNESS BAIR: Um-hmm.

14 CHAIRMAN ANGELIDES: How does that compare to--

15 WITNESS BAIR: Tier One Common.

16 CHAIRMAN ANGELIDES: Tier One Common?

17 WITNESS BAIR: Yes.

18 CHAIRMAN ANGELIDES: How does that compare to
19 pre-crisis?

20 WITNESS BAIR: Well, there was not a Tier One
21 Capital in the U.S., especially for holding companies, that
22 included a lot of things that--

23 CHAIRMAN ANGELIDES: Excuse me? For what kind of
24 companies?

25 WITNESS BAIR: For holding companies.

1 CHAIRMAN ANGELIDES: For holding companies. I
2 just didn't hear you.

3 WITNESS BAIR: It involved a lot of things that
4 were not true losses through capital, a lot of hybrid debt.
5 So when I'm talking about Tier One Common Equity, true loss-
6 absorbing capital. We did not have a requirement for the--
7 the current requirement for risk-based capital is 8 percent,
8 for Tier One for adequate, like 10 percent for well, but
9 there was just a predominance of that had to be Common
10 Equity.

11 So the actual amount of true losses that were in
12 Common Equity was significantly lower. So that the focus of
13 Basel right now is to get the Tier One Common Equity levels
14 up.

15 CHAIRMAN ANGELIDES: But do you know where it was
16 functionally?

17 WITNESS BAIR: Functionally?

18 CHAIRMAN ANGELIDES: True loss-absorbing capital
19 was at what level?

20 WITNESS BAIR: The--I don't know off the top of
21 my head. I'd like to get the written analysis for you, if I
22 could.

23 CHAIRMAN ANGELIDES: Okay, if you would, please.

24 WITNESS BAIR: But it would probably be around 4
25 percent. Between 4 to 6 percent would be my guess.

1 CHAIRMAN ANGELIDES: Thank you. That was the
2 range. So you're talking about 4 to 6, now up to 8 to 13.

3 WITNESS BAIR: Well, again, this is being debated
4 right now. And it's not just my decision. It's part of an
5 international community. But the ranges of estimates I've
6 seen have been 8 to 13 percent, yes.

7 CHAIRMAN ANGELIDES: Terrific. Thank you. Ms.
8 Born.

9 COMMISSIONER BORN: Thank you. And thank you
10 very much, Chairman Bair, for appearing before us. I think
11 you are the only witness to have appeared publicly before us
12 twice, so I think our thanks are particularly necessary.

13 WITNESS BAIR: My pleasure.

14 COMMISSIONER BORN: I would like to explore with
15 you a little bit how over-the-counter derivatives played a
16 role in creating financial institutions that are too big to
17 fail, the topic of our hearing today.

18 And more specifically, whether the
19 interconnections between large financial institutions
20 through counterparty relationships in over-the-counter
21 derivatives, and whether the concentration of over-the-
22 counter derivatives' positions in the largest institutions
23 played a role and were significant factors in rendering
24 those institutions too-big-to-fail.

25 WITNESS BAIR: Well I think with AIG clearly that

1 was the problem. I think derivatives played a role in this
2 crisis in a number of ways. Concentrations was clearly a
3 problem. The lack of transparency in the market was clearly
4 a problem.

5 So nobody knew where the risks were. Nobody knew
6 where the exposures were. So everybody seized up because
7 nobody knew where the losses would fall next.

8 I think CDS in particular created an illusion of
9 risk-free transaction, when it just simply wasn't the case
10 because of the concentration of who was holding--who was
11 going to have to pay if there was a credit default.

12 So I think all those factors played in and were
13 major contributors to this crisis. And I am very glad,
14 thanks to your leadership, early leadership on this, that
15 Dodd-Frank has got a number of key provisions to move so
16 much of this on to exchanges and through central clearing
17 now. It will be a big help.

18 COMMISSIONER BORN: Do you think those provisions
19 will reduce the systemic risk from the over-the-counter
20 derivatives market?

21 WITNESS BAIR: I think it will certainly reduce
22 the risk. I think there's still a fairly large flexibility
23 for end users, as you know, and we'll see how that plays
24 out.

25 I think in terms of, we were disappointed in

1 terms of our own resolution process. We have a very short
2 timeframe to decide whether to accept or repudiate
3 derivatives contracts if a bank, or now a systemic financial
4 entity fails. We were hoping--right now, for banks, if it's
5 a weak bank, we can require that they have systems in place
6 so that they can tell us on basically a moment's notice what
7 their net exposures are per counterparty.

8 But for a healthy bank, we can't require that.
9 And we were really hoping to get that. That's probably
10 something we'll keep pushing for. Ironically, for nonbank
11 holding companies we, with the other regulators, can
12 institute a rule to require that they know, on a real-time
13 basis, what their net exposures are by counterparty, which I
14 think will be extremely helpful as well in terms of managing
15 risk and risk concentrations.

16 But for banks, we still have this gap that we'll
17 try to get fixed.

18 COMMISSIONER BORN: Let me just go back to one
19 factor in the financial crisis and the panics that were
20 created by--or that you were concerned would be created by a
21 failure of Wachovia, the panic that was created by the
22 failure of Lehman Brothers.

23 I know that you've said you were concerned as
24 part of the systemic risk analysis for Wachovia about the
25 counterparty relationships, including the over-the-counter

1 derivatives relationships.

2 WITNESS BAIR: Right.

3 COMMISSIONER BORN: Was your concern limited to
4 the credit default swap positions? Or was it--did it relate
5 to the overall positions, which of course were much larger?

6 WITNESS BAIR: They had a lot of structured
7 products in their trading book that we, again, just did not
8 have enough information to get up to speed on. So, no, I
9 don't think it was just CDS. John Corston, who's our lead
10 examiner, here--it wasn't just CDS, yes.

11 COMMISSIONER BORN: And do you think that, as of
12 that time, the over-the-counter derivatives market as a
13 whole was playing a role in market uncertainty and panic?

14 WITNESS BAIR: I do. Because, again, because of
15 the opacity of the market nobody knew where the risks were,
16 who was going to take the losses, and that just--you know
17 the wholesale sources of funding just completely dried up,
18 just because nobody knew where the exposures were and who
19 was going to take the losses.

20 COMMISSIONER BORN: Well let me just say, as a
21 final thing, that I think that a lot of the steps that were
22 taken on systemic risk in the Dodd-Frank bill and that are
23 being taken administratively are in the right direction.

24 I certainly hope--I think one issue has been the
25 institutional supervisor's focus on individual institutions

1 and thereby--

2 WITNESS BAIR: Yes.

3 COMMISSIONER BORN: --the ignorance, or the lack
4 of attention, lack of focus, to market-wide issues like the
5 securitization process, like the over-the-counter
6 derivatives market, and I very much hope that the Financial
7 Stability Council will look not only at the systemically
8 significant institutions, but keep an eye out for
9 systemically relevant markets and problems in those markets.

10 WITNESS BAIR: I agree with you. I agree with
11 you. The products and practices can be just as devastating
12 as individual risk institutions, perhaps more so.

13 COMMISSIONER BORN: Thank you.

14 CHAIRMAN ANGELIDES: Mr. Wallison.

15 COMMISSIONER WALLISON: Thank you, Mr. Chairman.
16 And thank you for being here, Madam Chairman.

17 I have been trying to explore a little issues
18 associated with the discount window, which I know you don't
19 manage or have any control over.

20 WITNESS BAIR: Right.

21 COMMISSIONER WALLISON: But some of the issues
22 that have come up is, what was the significance of the
23 discount window at the time that Wachovia ran into
24 difficulties?

25 What we have heard is that the plan for Wachovia

1 was to combine it with some other institution. That seems
2 to have been the only plan. Now my understanding is that
3 the discount window is available specifically for runs for
4 solvent banks.

5 Was it the view of the FDIC, or any of the other
6 regulators as far as you know, that Wachovia was in fact
7 insolvent?

8 WITNESS BAIR: Again, I don't think we had the--
9 no, at that point in time it was not. It was a liquidity
10 crisis. Though I will say, under the FDI Act a bank can be
11 closed if it becomes insolvent or if it cannot meet its
12 obligations.

13 So the Fed has no affirmative obligation to fund
14 an entity just because it's got a liquidity crisis. And
15 actually the Fed is specifically prohibited from lending
16 into a failing institution.

17 So I don't speak for the Fed. I don't know what
18 the Fed's decision making was on that, but I will say this
19 is a sensitive area for us. Because if the Fed does start
20 lending, and that is government assistance going into that
21 troubled institution, and that facilitates a lot of other
22 counterparties, right, pulling their money out, the Fed is
23 the secured lending and the Fed takes the highest quality
24 collateral when it lends into an institution.

25 If that institution then subsequently fails, it

1 will cost the FDIC a lot of money. That is why the statute
2 specifically says that the Fed should not be lending into a
3 failing institution. And actually I think can only do so if
4 we agree to that.

5 So I don't know the specific situation about the
6 Wachovia's use or not use of the discount window. I would
7 defer to the Fed on that. But I would say as a general
8 policy matter, this is a sensitive area for us. And we
9 certainly support the Fed being very careful about when they
10 use that.

11 Because if the institution ends up failing, it
12 will definitely increase our costs.

13 COMMISSIONER WALLISON: Well when I raised this
14 question with Chairman Bernanke this morning, he said that
15 you--that is, the FDIC, not "you" specifically but the FDIC-
16 -had said, at least as I heard him, the FDIC had said that
17 Wachovia was a failing institution and therefore the Fed
18 could not make that loan to them because they would not
19 normally lend into a failing institution. That's why I
20 asked the question about the solvency.

21 WITNESS BAIR: Well it was--well, I guess we were
22 acting on information from the OCC, which is not here, and
23 the Fed were providing us, and the bank's own information
24 suggesting they could not meet their liquidity needs. They
25 could not meet legal demands and obligations that they had

1 come Monday morning. And I think there was about a billion
2 in paper that they had not been able to raise on Friday.

3 COMMISSIONER WALLISON: Well just to be clear,
4 the whole purpose of the discount window is to solve
5 liquidity problems.

6 WITNESS BAIR: Right.

7 COMMISSIONER WALLISON: And so it's not a
8 question of whether they could meet their liquidity needs;
9 the question is whether people thought they were insolvent.

10 WITNESS BAIR: Right. But I think, again I--at
11 that point in time, it was not insolvent. Whether it would
12 maintain capital solvency was an open question, depending on
13 a lot of factors like what's going to happen to the housing
14 market.

15 But there were certainly a lot of credit quality
16 issues with Wachovia. I don't think anyone can suggest that
17 it wasn't a perfectly healthy institution; it just fell
18 victim to broader market events. Clearly the market was
19 reacting to some very bad decisions the management had made.

20 COMMISSIONER WALLISON: Okay, well then
21 unfortunately that leads to the next question. And that is,
22 if you approved--that is, the FDIC--approved a combination
23 between Citibank that was already a very weak institution,
24 and an institution that apparently you thought was on its
25 way to failure, and in that combination, as you said in your

1 prepared testimony, Citi had to assume \$42 billion of risk
2 on Wachovia as part of that transaction, how does any of
3 that make any sense?

4 I mean, we have Citi that's already weak and in
5 trouble. They are being asked now to merge with an
6 organization that I think you thought might be insolvent, or
7 on its way to insolvency--

8 WITNESS BAIR: Well it was clearly failing. I
9 mean, the FDI Act specifically recognizes liquidity failures
10 are capital insolvencies. From a liquidity standpoint, it
11 was clearly failing. And so, you know, I think at the time,
12 based on the information we had, we thought that Citi was
13 the stronger institution.

14 And obviously later they ran into their own set
15 of problems. But at that point, I think it was the
16 collective decision of everyone that this would stabilize
17 the situation; that this would stabilize the situation that
18 Citi was, even though it perhaps its own problems, was the
19 stronger institution than Wachovia and that would stabilize
20 the situation.

21 We had to do something. I mean, I think we had--
22 we had to do something. And I think, you know, saying,
23 well, the Fed should just lend, that, that also is a form of
24 government assistance. Some may also view it as a form of
25 government bailout.

1 And if all of the counterparties started pulling
2 out of Wachovia, with the Fed left, with a huge exposure to
3 Wachovia, and then it had failed later, I would be having a
4 very different hearing with you right now. So I think, was
5 it a perfect decision, Peter? No, it wasn't. But based on
6 the information we had and the options we had available, I
7 think it was the only course of action at that point.

8 COMMISSIONER WALLISON: All right. Thank you,
9 Madam Chair.

10 CHAIRMAN ANGELIDES: Mr. Thompson.

11 COMMISSIONER THOMPSON: It's nice to bat clean-
12 up, for a change.

13 CHAIRMAN ANGELIDES: I was going to say, the
14 clean-up batter, for a whole nine months of hearings.

15 COMMISSIONER THOMPSON: I won't take you back
16 through the past. I'd like to look forward, if we might,
17 and focus on the new regulations. It must have been a
18 hallelujah day when the Dodd-Frank bill passed and you now
19 have more things to help you control this environment.

20 WITNESS BAIR: Right.

21 COMMISSIONER THOMPSON: But I was struck by the
22 comment you made that says there's little discretion now in
23 the hands of any of the regulators, particularly in an
24 environment where innovation occurs so fast. It's a global
25 financial system, not just a U.S. financial system.

1 And crises, as they erupt or emerge can't be
2 anticipated in legislation and regulation. So do you really
3 think it is reasonable that the Congress would give you no
4 discretion whatsoever in the way they have outlined the
5 current legislation?

6 WITNESS BAIR: Well, there is discretion in terms
7 of providing system-wide support. The Fed has it through a
8 13.3 facility. I believe the Secretary of the Treasury has
9 to approve their use of that. And we would have it with a
10 Congressional approval process for providing system-wide
11 guarantees of financial liabilities.

12 So if it is truly a system-wide crisis impacting
13 all institutions, healthy and not, we do have the ability to
14 provide some system-wide support. But we also have the
15 resolution piece for the ones that are failing because they
16 were mismanaged which will be put into resolution process.

17 So I think that the combination of--well, first
18 of all, it's my fervent hope that, through greater market
19 discipline and higher capital standards we will certainly
20 have another cycle. But the kind of cataclysm we were
21 facing, I hope we do not see that again. This was truly an
22 extraordinary event.

23 We will have cycles, but I do think these
24 combination of tools will be sufficient. And I think, you
25 know, again, of the different options that are available,

1 bailouts are just not acceptable going forward. And the
2 bankruptcy, I think frequently will be the course used for
3 the weaker institutions.

4 Where they have systemic functions, the
5 government setting up a bridge and operating it as it's sold
6 off for a period of time, I think that is an important tool
7 for us to have as well.

8 COMMISSIONER THOMPSON: So there is room for some
9 judgment to be applied?

10 WITNESS BAIR: Yes, in terms--if it's a true
11 system-wide crisis, that's right; yes. But again, only for
12 generally available assistance on a system-wide basis.
13 Then, even if the government took a loss on those types of
14 facilities, as we were discussing earlier, that would
15 trigger either a bankruptcy or a resolution. So the
16 shareholders and creditors would be taking the losses, not
17 the government.

18 COMMISSIONER THOMPSON: I was also struck by the
19 fact that you highlighted the Financial Stability Oversight
20 Council as one of the three key important attributes as we
21 move forward.

22 Quite frankly, my experience in the private
23 sector has been that councils are places where people go to
24 opine and pontificate, and nothing ever gets done.

25 WITNESS BAIR: Right.

1 COMMISSIONER THOMPSON: And with the limited
2 experience, candidly, I've had in government, it's very true
3 there. So what would lead us to believe--

4 CHAIRMAN ANGELIDES: You said "councils," not
5 "commissions"?

6 (Laughter.)

7 CHAIRMAN ANGELIDES: He said "councils" not
8 "commissions." There's a very fine distinction.

9 (Laughter.)

10 WITNESS BAIR: Okay.

11 COMMISSIONER THOMPSON: So why should--

12 VICE CHAIRMAN THOMAS: Reserving the right to
13 object.

14 (Laughter.)

15 WITNESS BAIR: That's right.

16 COMMISSIONER THOMPSON: --why should we believe
17 that this Council is going to be uniquely different and keep
18 us out of trouble?

19 WITNESS BAIR: Well, you know, I think--I'm glad
20 you're skeptical because that will put pressure on all of us
21 to make sure that we don't just, you know, meet every
22 quarter and look at each other.

23 I think one thing that's been helpful, though, is
24 Congress has clearly given this new Council accountability.
25 And if there's another systemic crisis, we can't go and say,

1 well, the Fed had holding companies and, you know, the OCC
2 had national banks, and the SEC had the investment banks.
3 We're all put together in the same room, and it's our job to
4 manage systemic risk and make sure there are no regulatory
5 gaps.

6 So we have accountability. We have ownership.
7 If we don't do our job, then we should be held strongly
8 accountable. So I'm hoping that kind of pressure--plus, I
9 think people keeping our feet to the fire will help us get
10 the job done.

11 I think Congress also has prescribed specific
12 statutory roles for the Council with time frames, so we have
13 to move ahead if we're to comply with the statute, and we
14 should comply with the law and we have to move ahead.

15 So I have high hopes for it. I do. It's not
16 structured exactly the way we thought. We were thinking
17 more of an independent council with an independent chairman
18 with writing authority and more of a robust entity. But I
19 think the structure that Congress approved can work, and we
20 will do everything we can from our perspective to make it
21 work.

22 COMMISSIONER THOMPSON: So final question. If
23 you look back over the last three years, four years, and if
24 you had one bullet that you could fire as a regulator that
25 would have mitigated or, quite frankly, prevented this

1 financial calamity, what would that have been?

2 WITNESS BAIR: I absolutely would have been over
3 at the Fed writing rules, prescribing mortgage lending
4 standards across the board for everybody, bank and nonbank,
5 that you cannot make a mortgage unless you have documented
6 income that the borrower can repay the loan.

7 COMMISSIONER THOMPSON: Here, here. Thank you.

8 CHAIRMAN ANGELIDES: All right. Thank you. Any
9 more questions from Commissioners, compelling--yes. It
10 doesn't have to be compelling, it just has to be a question.
11 Go ahead, Mr. Holtz-Eakin.

12 COMMISSIONER HOLTZ-EAKIN: Following up on Mr.
13 Thompson's question, why isn't the new Stability Council
14 just the President's Working Group on Financial Markets with
15 a coat of paint?

16 WITNESS BAIR: Well, I hope--you know, the
17 President's Working Group has done some good work. It's
18 been behind the scenes, and I think that's been an area of
19 criticism, so perhaps it's not been--its contributions have
20 not been as appreciated as much, but I think it has specific
21 statutory responsibilities, unlike the President's Working
22 Group.

23 It has specific jobs, and timetables to fulfill
24 those jobs, and has specific accountability, too, whereas
25 the President's Working Group is more of an ad hoc

1 enterprise after the '87 market break.

2 So I think it will be--I think the President's
3 Working Group has done a lot of good work. I think this
4 will be a more robust, more comprehensive effort.

5 VICE CHAIRMAN THOMAS: On that point, I think
6 it's also that you're out on point; that you're seen as a
7 functioning structure.

8 WITNESS BAIR: Yes.

9 VICE CHAIRMAN THOMAS: Any of the ad hoc
10 structures are inside change and you've got to cover over
11 them. I like the exposure idea and the fact that you're
12 supposed to be a team, and it will be apparent if you are or
13 you aren't.

14 WITNESS BAIR: Right. I think that's right. I
15 agree with that.

16 COMMISSIONER HOLTZ-EAKIN: Thank you. You know,
17 the Working Group has been around a long time, but I don't
18 think it has a terribly illustrious history of success.

19 WITNESS BAIR: Well the FDIC was not a member of
20 the President's Working Group, and actually until 2008 I
21 think. But anyway--

22 COMMISSIONER HOLTZ-EAKIN: You must explain.

23 WITNESS BAIR: I think it did. It has made some
24 good contributions.

25 CHAIRMAN ANGELIDES: And we really don't need an

1 empirical study of its effectiveness, do we?

2 COMMISSIONER HOLTZ-EAKIN: Can we request that?

3 (Laughter.)

4 CHAIRMAN ANGELIDES: Anyway, thank you very much,
5 Commission members. Thank you very much, Chairman Bair, for
6 being here not only twice before, but I might add I noticed
7 in the work up here for being interviewed by our staff
8 twice.

9 WITNESS BAIR: Yes.

10 CHAIRMAN ANGELIDES: So at the end of the day--

11 WITNESS BAIR: Well, we want to help and
12 contribute to your success, as well.

13 CHAIRMAN ANGELIDES: And we'll sign a copy of the
14 book for you.

15 WITNESS BAIR: Okay, great.

16 CHAIRMAN ANGELIDES: Or we'll present you with an
17 enhanced e-version of the book that maybe links to some of
18 your testimony.

19 VICE CHAIRMAN THOMAS: Mr. Chairman, I'm
20 wondering if she's been so attached to us from an offensive
21 or a defensive point of view?

22 (Laughter.)

23 VICE CHAIRMAN THOMAS: But thank you very much
24 for your help.

25 CHAIRMAN ANGELIDES: And I want--

1 VICE CHAIRMAN THOMAS: And early on it was very
2 helpful.

3 WITNESS BAIR: Good.

4 CHAIRMAN ANGELIDES: I want to make just a few
5 thank-you here.

6 I want to thank, first of all, all the people
7 around the country who did tune in to watch us on C-Span. I
8 have been quite struck by the number of people who have
9 walked up to me who have said they have watched these
10 hearings, not because of us so much but because of this
11 tremendous hunger to understand what's happened to our
12 country.

13 I want to thank all our witnesses who came before
14 us. I want to thank the Commission Members and the staff--
15 let me start with the Commission Members for their
16 preparation, for their seriousness, and I really think for
17 the way in which we've gone about this set of hearings to
18 try to learn information, and gather it not only for
19 ourselves but the public.

20 I want to thank the staff, who has put in a
21 tremendous number of hours and effort, a real testament to
22 public service.

23 I want to thank Chairman Dodd for, once again,
24 making this room available to us. And I want to remind
25 everyone that, while this is our last hearing in the

1 Nation's Capital, we are going to be in four cities across
2 the country: Bakersfield, Las Vegas, Miami, Sacramento,
3 communities that are struggling with double-digit
4 unemployment, and that are in the grips of some of the most
5 severe foreclosure crises in this country.

6 So thank you all very much. This public hearing
7 of the Financial Crisis Inquiry Commission is adjourned.

8 (Whereupon, at 1:20 p.m., Thursday, September 2,
9 2010, the hearing was adjourned.)

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