MEMORANDUM FOR THE RECORD ("MFR")

Event: Interview with Former Treasury Secretary Paulson

Type of Event: Group Interview

Date of Event: April 2, 2010, 11:30 a.m.-1:00 p.m.

Team Leader: Chris Seefer

Location: FCIC, large conference room

Participants - Non-Commission:
- Henry “Hank” Paulson, Former Treasury Secretary
- George Madison, General Counsel, US Treasury Department
- Mike Gordon, Counselor to the General Counsel, US Treasury Department
- Alex Krulik, US Treasury Department
- Kevin M. Downey, Williams & Connoly
- Sam Davidoff, Williams & Connoly

Participants - Commission:
- Tom Greene
- Chris Seefer
- Gary Cohen
- Tom Stanton
- Carl McCarden
- Clara Morain
- Shirley Tang

Date of MFR: April 2, 2010

Summary of the Interview or Submission:

Chris Seefer began the interview by introducing himself and briefly summarizing the mandate of the Financial Crisis Inquiry Commission (FCIC), noting specifically its statutory mandate to investigate GSEs and their role in the financial crisis. He explained his focus was on the business practices of GSEs and their problems.

Chairman Angelides and Vice Chairman Thomas entered the conference room and introduced themselves. After brief introductions, Sec. Paulson, Chairman Angelides, and Vice Chairman Thomas exited the conference room and spoke privately. Approximately ten minutes later, Sec. Paulson reentered the conference room and the interview resumed.

Fannie Mae’s Business Practices

Chris asked Sec. Paulson to explain what he saw in terms of the business practices at Fannie Mae, given indications from documents and from discussion in Sec. Paulson's book about an initial briefing with Mr. Nason that the GSEs were "clearly a disaster waiting to happen" when Sec. Paulson arrived at Treasury. Chris also asked Sec. Paulson to "fast-forward to meetings leading up to conservatorship" when he described the Fannie Mae Board as "cheeky," and to comment on the problems Treasury found with Fannie Mae's business that led to the decision to put the GSEs into conservatorship.

Sec. Paulson said, "first of all thank you for reading the book because a lot of the book really deals with Fannie and Freddie. Now, when I came to Washington I actually didn't know as much about Fannie and Freddie as maybe you would've expected me to know – it just had not been an area of particular interest to me generally. Mr. Nason came and spent time with me and the concern I had was [that] it was just hard to ever explain how you'd have a business model with a congressional charter, with implicit government support but without explicit government support, for a private company. And then the capital was set by law, and there was a regulator that didn't have the power of a normal safety and soundness regulator." Sec. Paulson said that shortly after he became Treasury Secretary, mid-term elections shifted power from Republicans to Democrats, and although the White House wanted "much tougher regulation," Sec. Paulson said to staffers that while "I agree with you on every count, you'll get nowhere, and the structure [of the GSEs] is so flawed that I don't want to leave Washington without there being some major attempt to make it better and get a regulator who was more power." Sec. Paulson said that he had "a lot of concern about the portfolio" as well. He said that he did not understand why the GSEs maintained portfolios at all.

Sec. Paulson emphasized that his access to information about Fannie Mae and Freddie Mac was limited because Treasury was not the GSEs' regulator. "We weren't the regulator. We didn't have access to the information, and we didn't try to do what the regulator did, so I couldn't tell you specifics about their business practices," he said. Sec. Paulson also emphasized that he strongly favored getting GSE reform passed, even if the final bill did not go as far as he or the White House would have liked. "I was less focused on their practices and more focused on a flawed structure and a model which we thought made no sense from a safety and soundness perspective," he said. The GSEs "were so big – the elephant was getting pretty big for tent – and it caused huge dislocations in the market. So I knew they were very big and had the flawed structure. And [if] we can't change structure, lets at least get a real regulator there. That was just a judgment – that we could have our talking points and be totally right, but to me, it's not a partisan issue because there were people on both sides of isle [who advocated on behalf of the GSEs]."

"Fast-forwarding," Sec. Paulson said that when the credit crisis hit in the summer of 2007 with housing at its epicenter, "all of the flaws that have been brought to the surface by the credit crisis - of the appallingly bad underwriting standards and the kinds of subprime loans being made – when the crisis came those stopped. The horse was already out of barn by then. But another problem was that lending essentially shut down on the private side, so now we were in a situation where very responsible people who wanted to buy or refinance to prevent losing their homes under very reasonable terms were having difficulty doing so. Essentially the only game in town was Fannie and Freddie." Sec. Paulson explained that what he believed at the time "and I still believe that the key here to getting through the crisis was to limit the decline in housing and the more effective thing you could do was to make sure there was funding [available] for mortgages… [S]o they [Fannie and Freddie] were the game in town. The only game in town," he said.

Sec. Paulson said that during this period, he took a trip to "ground zero of the housing crisis" to hold town hall-style meetings in cities including Burbank and Stockton, where he met California Governor Schwarzenegger, and Orlando, Chicago, and Kansas City. "I was literally sickened in terms of what I saw in terms of what had happened to some people, the terms of the mortgages," he said. "But in lot of ways, it was water over the damn. Everyone needed mortgage funding." Sec. Paulson explained that in the context of discussing the stimulus, what he had seen on his trip was "an impetus to go back to the President [to say] 'we need to do something and put money in hands of those who need it… to do something unconventional.'" He said that the GSEs came up in the course of negotiations over potential government action in response to the crisis, and that congressional leadership exerted pressure to have Fannie and Freddie guarantee more subprime loans, which the Secretary said he did not support. Congress favored raising the portfolio limits so that the GSEs could issue more jumbo loans, which the Sec. Paulson also opposed. "I wanted [the GSEs'] efforts to be focused on plain vanilla, average, standing conforming loans" to keep people in their homes and provide access to mortgages for credit-worthy borrowers.

The spring 2008 agreement for OFHEO to remove capital surplus and lift portfolio caps in exchange for the GSEs raising capital

Sec. Paulson continued that, "So then as we got into 2008 and the situation was still not getting better, I became increasingly concerned about capital across the broad section of financial institutions. And I was just totally convinced that regulators were downplaying [the capital situation]… There was a little bit of regulatory capture going on, I think." In response, he said that he started giving speeches, "started jawboning and pushing people as part of that effort" to get financial institutions to raise capital. "No institution ever got into trouble by having too much capital," he said. Sec. Paulson said that starting at least in the spring of 2008, he often checked in with Treasury staff about the efforts underway to push financial institutions to raise capital, but that there was significant push-back from the institutions. With the GSEs, he said that "I asked our people to work with the regulator and with Fannie and Freddie to push them to raise core capital, the idea being that they more than anyone else were the engine we needed to get through the problem. People were applying for mortgages and they had plenty of income [a]nd they weren't getting approved."

Sec. Paulson said that in the wake of the "Bear weekend" and the widespread fear over the consequences of that company's failure, "one of the ideas that had come up [was] that we should do something that increases confidence in the mortgage market with Fannie and Freddie. I said, well we have this effort to urge them to increase capital, so I called Bob Steel and asked where we were – he had been working with the regulators and the institutions and I don't know who conceived of the idea, but [an idea was proposed] to have them have [the GSEs increase their] net capital [in exchange for lifting] the temporary surcharge" levied after the 2006 Consent Order. He said that the idea was that the enterprises would raise in the range of $1-$2 of capital for each dollar that came off of the surcharge, with the intention of raising about $6 billion in additional capital. Sec. Paulson said that he discussed this plan and secured the enterprises' agreement during a call that included Daniel Mudd, Richard Syron, James Lockhart, and Robert Steel. The call was "relatively quick" and "didn't go into a lot of details," according to the Secretary. "I wanted them to say that they'd go raise that capital, and I wanted to hear them say it, and I wanted to hear [that it would happen] soon," he said. The GSEs and their regulator announced the plan several days later, according to Sec. Paulson. He said that Fannie raised the capital, but although "Freddie could have easily [raised capital,] they had lawyers telling them not issue equity – and I learned this much later – and that they would only feel comfortable [raising capital] after they released their audited second quarter earnings," he said.

Regulatory Reform

Sec. Paulson said that simultaneous with his efforts to encourage the GSEs (and other financial institutions) to raise capital, he worked to push GSE regulatory reform through Congress. "I wanted to really drive this home," he said. "I had been trying to work regulatory reform through Congress, the House was not a problem, the Senate was a big problem," and Sec. Paulson said that he felt it was necessary to get the GSEs on board with reform. Sec. Paulson held a meeting with Senators Chris Dodd and Richard Shelby, Bob Steel and David Nason from Treasury, and Daniel Mudd and Richard Syron. "I wanted them [the GSEs] to reiterate in front of the Senators the commitment to raise capital," Sec. Paulson said. "And also, we had figured out that we were not going to get regulatory reform done if they opposed it. They had a lot of contacts on both sides of isle, and were enormously effective, and they had different views – and I mean sincerely – very different views of role of government in housing finance. So they [the GSEs] agreed more or less at that meeting to help get the reform done."

Sec. Paulson said that when he looks back on the situation, "it was inevitable that there was going to be a meltdown and frankly, when you talk about practices - when you do your work, you will find that the problem wasn't beginning in August 07, that they were doing imprudent things and underwriting bad loans or guaranteeing them – now they may have been under pressure to put things in their portfolio – and Treasury did everything we could to stop from them from putting [those mortgages] into the portfolio… I think the march to reform was only important in terms of what it ultimately let us do," he said.

Noting historical experience during the 1980s Savings and Loan crisis, Tom Stanton asked Sec. Paulson what assurances he had that the GSEs would not "bet the bank" once they raised capital. "They weren't accountable to me," he said, "so they weren't giving me assurances. And I think if you talk with Jim Lockhart… I think you will find that if there's anything they did after the crisis began that hurt them financially, it would've been buying previously underwritten securities and holding them in their portfolio. The only reason why I make that statement is that the behavior we saw was pretty interesting – it's a lot more common than betting bank – the horse was already out of barn," and the GSEs apparently decided to "really clamp down and not even make loans to responsible people," he said. He said that there was a big shift to the FHA programs and that FHA was "doing things that Fannie and Freddie had maybe done before." "To the extent we had any influence, we wanted them to make responsible, prudent loans, but we wanted them to be guaranteeing them, not using their capital to take risk from buying things and holding in portfolio," he said.
According to Sec. Paulson, the "march to reform" in 2008 was diverted because of "really what were inconsequential battles" in the House over the Hope for Homeowners legislation, which he

called a “a flash point” in the debate about on one hand, bailing out irresponsible individuals, and on the other hand inflating the number of individuals it would actually help. He said that the legislation was never going to provide a substantial benefit to homeowners, and that the battle over the program delayed GSE regulatory reform from being accomplished.

Sec. Paulson explained that because of the dramatic loss of confidence in the market and the impending meltdown, he was able to persuade Congress that the Federal Reserve should be joined with FHFA in obtaining emergency regulatory powers. After obtaining that authority, Sec. Paulson said that the Treasury worked very quickly with individuals from the Federal Reserve, the OCC, and Morgan Stanley as advisors to assess the financial condition of Fannie Mae and Freddie Mac. Prior to that time, Sec. Paulson said that Treasury did not have a clear idea of the GSEs’ financial situation. It was around August 15 that Sec. Paulson was told that there was significant capital shortfall, he said, acknowledging that it took three weeks for Treasury, Federal Reserve, and OCC examiners working with Morgan Stanley consultants, to convince the FHFA that there was a shortfall.

Sec. Paulson credited himself for two things that made that possible: 1. new powers for regulators which provided the leeway necessary to make judgments regarding the GSEs’ capital position, and 2. the Federal Reserve’s involvement, which Sec. Paulson said enabled the Treasury to take action. If examiners had found a capital shortfall without any “fiscal authority for the government to back the entities, it just would’ve called a colossal meltdown,” he said. “They had $5.4 trillion of securities out there. The difficult thing we needed to do with conservatorship was [find a way] to essential harden the guarantees. We had only temporary authority, which meant nothing because they had 30 year mortgages.” He said that “we figured out through the Keatwell agreement how to harden the guarantees - in terms of averting meltdown… and limiting damage to the economy, I think that Fannie Mae and Freddie Mac having a source of mortgage funding [was among] the most important things we did.”

In terms of the “lever” (conservatorship), Sec. Paulson stated that Treasury was prepared to act but they were “put in a box by Congress,” as they were granted emergency powers but were subject to what Fannie and Freddie would approve, making it important for the companies to sign off on the government’s proposed actions. “So what we needed to do was to do this in a way that worked and protected the taxpayer. So we documented the case [as] accurately as we could. What I said was that no one was looking to blame the management – and I really felt that way – they didn’t create this flawed structure, it was congressionally charted, they didn’t dream up affordable housing and buying subprime… and I had no reason to either defend them or point the finger in terms of their practices and what they’d done – I didn’t go in, I didn’t know,” he said. “I believed the very best way to get them to agree on a friendly basis was to say ‘there’s a hard way and an easy way, and we hope and expect[ed] them to take easy way. Which they did,” he said.

<u>The Market and GSEs</u>

Tom Stanton asked Sec. Paulson to elaborate on a claim made in his book that the market had realized before the GSEs did the degree to which they were in trouble. “Throughout the crisis, the market was ahead of Fannie and Freddie, like they were almost every institution - and they were ahead of regulators, and ahead of all of us,” he said. Sec. Paulson said that after Fannie and Freddie were put in conservatorship, he sincerely believed that would be enough to stabilize the market. But at a lunch hosted by Tim Geithner, he was reminded by another CEO that while during ordinary times, his belief would have been correct, "this was a market driven by fear and panic, so it will get to where the most conservative, fearful, skeptical investor is, and it will get quicker than you think." He used as an example banks' SIVs and conduits, which banks had to "step up and support when they started to unravel so quickly. Well Fannie and Freddie were the government's SIVs and conduit," he said. "I tell this in the book, but I was naïve enough to believe that when Fannie and Freddie were stabilized… that this was all about the housing crisis, and that [stabilizing the GSEs] might put a floor under the housing market decline, which might help out all financial institutions. That it might put out the fire. And as I said, the next day Lehman started to go."

Fannie and Freddie Deal

Mr. Seefer said documents show that in the March 2008 discussions among Mudd, Steel, and Lockhart about raising capital, and that Mr. Lockhart expressed the view that the proposed deal to remove the capital cushion and portfolio caps in exchange for a commitment to raise capital $1-$2 of capital for each dollar removed from the surplus was "perverse." Yet two days later, a press release was issued stating OFHEO would reduce the surplus and remove the portfolio caps, but that the GSEs committed to raise capital without any specific description of how much they would raise. Mr. Seefer asked the Secretary to comment on the dynamic of that situation, if he could.

Sec. Paulson said he did not recall any conversation with Mr. Lockhart regarding this except when they spoke on the phone to "cut the deal." Sec. Paulson stated the he believed that Fannie raised $7 billion in capital. He explained with Fannie it was successful but with Freddie it was not. Sec. Paulson stated that either Freddie reneged by permission of the regulator or, the more benign explanation, when Syron got ready to issue a general counsel decided that they were not going to take the legal risk of issuing equity. Sec. Paulson stated that he wanted them to have more capital and continue the role he thought was essential.

From Sec. Paulson's statements, Chris Seefer summarized that it was clear that there were concerns both about the GSEs' safety and soundness, and on providing liquidity to the housing market, and that Fannie and Freddie were the only game in town to provide that liquidity. He continued to explain that everyone recognized there was a trade off. But Lockhart, who also recognized the trade off, was still uncomfortable with the deal. Mr. Seefer described to Sec. Paulson what was said of Lockhart's depiction of the deal. He said that he did not recall the conversation when Lockhart finally "cut the deal," and that he never heard from Lockhart that the deal was perverse. He said that "from my perspective, it was a no-brainer. My frustration came later when Mudd raised it and Freddie didn't."

Chris Seefer then asked Sec. Paulson if there were similar conversations at Fannie regarding trouble raising stock. Sec. Paulson stated no and that he had never heard of an issue.

Business Model

Mr. Seefer asked Sec. Paulson to comment on the GSE business model. "Let me tell you what I do believe," he said. "Homeownership is great. Having it be [an aspiration] is great. But homeownership is not for everyone, in every situation… So if you look at the combined weight of Fannie and Freddie and FHA and state programs and the mortgage interest rate deduction – and this is something that the Bush administration, the Clinton administration, that everyone supported. But for laudable goals, we over-stimulated homeownership and homeownership got pushed up – it was at 64% and by god we pushed it 69 percent. So I think you need to look at Fannie and Freddie and how that fits into the overall homeownership [system]. The model is so perverse it's really hard to believe when you stop and think about it." He said that they had a "very bad model with very bad incentives… it's not just that the elephant was too big for the tent – the elephant was ugly!" he said.

Sec. Paulson said that the enterprises had "flimsy capital" and "bullshit capital," (the deferred tax asset, for example), and that the regulator had no discretion to use its judgment with respect to the level of capital. Added to that, the country promoted a policy where the companies were chartered by Congress, "try to go around the world and explain to one leader after another what this implicit-not-explicit government guarantee was about. To me, if there's a guarantee, they should be a utility – why should people get wealthy off of a government guarantee?" The argument that was made that entities needed to buy securities and hold them in their portfolios to prop up the market did not make sense to him, he said. "Why [should] they be able to borrow money cheaply on the back of U.S. taxpayers and use it to buy securities," he said, noting that "if I were Dan Mudd and I have a board and a fiduciary responsibility to shareholder – to say this is dangerous financially and I want to do away with holding securities in my portfolio which generate two-thirds of my earnings – well I couldn't say that."

Sec. Paulson said that he did not have enough knowledge to know if the motive for buying subprime backed securities and holding them in their portfolios was to make more money but his bet was that the biggest losses resulted from the worst products placed in the portfolios. In the end, Sec. Paulson said that he does not believe management can be blamed for Congress's creation of this structure by specifically stating, "I don't think you can blame management for having Congress say 'go make money.'"

<u>Value of Portfolios</u>

Tom Stanton then asked Sec. Paulson his insights on Congress's perspective on why the GSEs considered portfolios valuable. He answered that it was his guess that the GSEs told Congress that the portfolio was valuable by arguing that it enabled the GSEs to play a role in making a stronger, more orderly market. He added that most individuals in Congress do not posses enough knowledge about markets to analyze the argument. He stated that he thought the sheer size of portfolios caused huge dislocations in the market place as they were difficult to manage. Sec. Paulson then said that he believed the GSEs' structure contributed to the crisis in terms of stimulating housing by buying and guaranteeing mortgages.

<u>OHFEO</u>

Mr. Seefer then asked Sec. Paulson to elaborate on his earlier point that OFHEO was a weak regulator. Sec. Paulson answered that it is very hard to be a strong regulator without regulatory power. He also mentioned that there was a very ugly relationship between regulators and GSEs and that they lacked the mutual respect that he would have ideally liked to see. He said that he gives FHFA a lot of credit, "because it was a big step for them to be able to say, 'this entity that we've been regulating – and we *haven't* been pointing to a capital shortfall – in fact has a shortfall.' So I talked in the book about them wanting to go after [the GSEs] on all sorts of procedural items. I wanted the truth, this wasn't part of some holy war, it's not like the Treasury of a Republican administration and this was the last blow to try to punish these guys. I wanted to be clear that there was a capital problem, and OFHEO got there and I was pleased and produc of them – and at the time it seemed to me that it took Lockhart some time to get him there, but looking back, I think – by gosh, it was only three weeks." Sec. Paulson also stated it was difficult for any regulator to do the job and get the right individuals as there was big difference between quality and sophistication.

Chris Seefer then asked Sec. Paulson about dealing with various holders of agency debt. Sec. Paulson responded that when looking at the collective $5.4 trillion, $1.7 trillion was outside of the country while $3.7 trillion was within the U.S. According to Sec. Paulson, when individuals assert that the Treasury bailed out foreigners, he reiterates that "these were our mortgage markets and that U.S. investors held two thirds of it." He said the U.S. government encouraged the Chinese to buy securities but the Chinese wanted to see U.S. invests in these as well. After Bear Stearns collapsed in 2008, questions came from all over the world. Sec. Paulson said as many top leaders focused on this issue and there was a lot of nervousness and uncertainty, he had to explain to individuals like Merkel Sarkozy and Hu Jintao that these were not explicit guarantees. Sec. Paulson stated when he initially announced his proposal of TARP and Congress did not immediately state they were going to pass it he was on the telephone almost every night reassuring individuals that this legislation would get passed. He criticized that Congress does not act on anything big or important unless there is an impending crisis. After TARP was passed, Sec. Paulson said the climate calmed down a bit but the questions continued. According to Sec. Paulson, people still wanted to know what it meant and that the U.S. was adequately capitalized.

Sec. Paulson said he had to figure out how to keep foreigners buying securities to keep interest rates low. But he claims that it was a market driven by fear and that people were not buying. He stated the Treasury bought securities as a sign of confidence and then the Federal Reserve made the decision to come in and bought a boat load of them.

Chris Seefer stated that back in April 2008, Sec. Paulson met with several investors Chinese investors in GSE debt, including Wu Yee, and they were concerned about whether or not the U.S. would stand behind the debt. He said that he spoke generally with those investors, who were "respectful, but like many people, skeptical," but that they acknowledged that "neither of us know what's going to happen." He continued to state that GSE debt was "like quasi-treasuries. The flowed through capital markets like water, like treasuries. They were liquid. I just don't know how to explain to someone what would have happened if the debt had gone down… there would have been no mortgage market, and there wouldn't have been much else. Because if you don't take care of this [the GSEs], you're not going to take care of your banks or anything. Can you imagine $3.7 trillion of losses? In a market driven by panic… they would say that there's nothing we would do to put out the fire. They were essential," he said.

<u>Sec. Paulson's Opinion of GSEs Chances of Survival During Crisis</u>

Tom Stanton stated once in hundred years there is a flood. He asked Sec. Paulson about Fannie and Freddie and if in his opinion they would have survived a one in fifty year flood. Sec. Paulson stated that he does not know if they could have survived but also stated that there is a lot of blame to go around. He says that when he looks at the housing crisis he asks himself why he missed it, not that he knew there were excess that were so significant, but also why so many experts and economists missed it. Sec. Paulson stated that if we studied residential housing in America during WWII, we would see that there were declines in one area or another but generally housing in America increased since then. He stated that people felt that residential mortgages were secure and safe investments and all models never envisioned that we could get the kind of decline we received in residential housing. Sec. Paulson also stated that he knew that they were not structured to withstand the storm and that he would not structure them in that fashion to withstand that type of storm.

Sec. Paulson's Evaluation of Root Causes of Crisis

Sec. Paulson stated that the root causes of the crisis were housing policy in addition to the lack of regulation. He explained that many mortgages had big regulatory gaps and many mortgages issued in many number of stated did not have an adequate regulator. Sec. Paulson recommended including in a regulatory blue print a consumer agency that focuses on consumer protection and a mortgage origination commission that evaluates the training and regulation that goes on a state level and will be able to evaluate the different programs so investors would be informed. Sec. Paulson closed by reemphasizing that a root cause of the crisis was housing policy.

Chris Seefer thanked Sec. Paulson for his participation in the interview.

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