



August 10, 2010

Via Email & Mail

The Honorable Timothy F. Geithner
c/o George Madison, General Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220-0001

Phil Angelides
Chairman

Hon. Bill Thomas
Vice Chairman

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Commissioner

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Commissioner

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Keith Hennessey
Commissioner

Douglas Holtz-Eakin
Commissioner

Heather H. Murren, CFA
Commissioner

John W. Thompson
Commissioner

Peter J. Wallison
Commissioner

Re: Financial Crisis Inquiry Commission Hearing on May 6, 2010

Dear Secretary Geithner:

Thank you for testifying on May 6, 2010 in front of the Financial Crisis Inquiry Commission and agreeing to provide additional assistance. Toward that end, please provide written responses to the following additional questions and any additional information by August 24, 2010.¹

1. What did you discuss with Mr. Jeffrey Immelt, CEO of General Electric (GE) on or about September 29-30, 2008?
2. During these discussions, which consisted of at least six telephone conversations, did Mr. Immelt express to you his concerns about the disruptions in the commercial paper market and GE's ability to issue commercial paper? If so, what did he say?
3. Did any of the above discussions with Mr. Immelt relate to any of the following areas? And if so, please describe in detail how they related to such subjects:
 - a. GE's ability to enter the Federal Reserve's program (CPFF) designed to support the commercial paper markets;
 - b. The necessity of those programs to support GE's issuance of commercial paper;

¹ The answers you provide to the questions in this letter are a continuation of your testimony and under the same oath you took before testifying on May 6, 2010. Further, please be advised that according to section 1001 of Title 18 of the United States Code, "Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both."

- c. The commercial paper markets as a whole.
4. Please describe the role of over-the-counter derivatives in the financial crisis.
5. Did any of the following factors create systemic risk and if so, how?
 - a. The concentration of derivatives in the hands of the large derivatives dealers;
 - b. The interconnections between those dealers and/or other large financial institutions through derivatives contracts;
 - c. Lack of transparency in the derivatives market.
6. Were derivatives a factor in necessitating the rescue of a number of large institutions? If so, which institutions?
7. Were credit derivatives a factor in fueling the securitization of mortgages and other loans? If so, did this in turn contribute to the housing and credit bubbles?
8. Were credit derivatives the primary cause of AIG's failure and the government's decision to rescue the firm?
9. At the hearing you kindly offered to rank the potential causes of the crisis. Below is a list of the potential causes of the crisis, some of which you mentioned during the hearing. Please rank by importance and/or relevance and explain why or why not you consider these items to have caused the financial crisis. In addition, please comment on which of these are primary causes and which of these potential causes should be removed.

Potential Causes of the Financial Crisis:

Housing

- Assumption that home prices would not decline
- Government housing policy
- Concentration of mortgage-related assets at systematically important institutions
- The extent of bad mortgage assets present in the system

Ratings

- Financing vehicles with very high ratings
- The lack of knowledge of the degree to which the system was reliant on ratings
- Ratings that did not capture the effect of system-wide losses from falling house prices

Regulatory Framework

- Uneven regulation or an absence of regulation

- A balkanized and fragmented regulatory system designed in a different era that lagged far behind changes in financial markets
- Absence of a systemic regulator
- Government's lack of resolution authority
- The Fed's lack of legal authority over investment banks, diversified institutions like AIG, or hundreds of nonbank finance companies
- The SEC's lack of legal authority to set and enforce capital requirements on a consolidated basis across the full range of activities of investment banks
- Inadequate capital requirements that were put in place for the traditional banking system
- Investment banks' lack of access to the lender of last resort
- Lack of constraints on leverage
- Trading of derivatives over-the-counter and a lack of tough prudential standards, including margin and capital requirements across derivatives dealers and major derivatives market participants

Other Features of the Financial System

- Difficulty containing liquidity risk in the shadow banking system
- Global savings glut
- Moral hazard
- Lack of an accounting regime that accurately captured exposure to risks
- Instability of the short-term repo market
- Poor risk management
- Weak credit standards, disclosure and liquidity in the money market-fund industry
- An overall lack of transparency in the financial system
- Short selling and market manipulation

The FCIC appreciates your cooperation in providing the information requested. Please do not hesitate to contact Sarah Knaus at (202) 292-1394 or sknaus@fcic.gov if you have any questions or concerns.

Sincerely,



Wendy Edelberg
Executive Director, Financial Crisis Inquiry Commission

cc: Phil Angelides, Chairman, Financial Crisis Inquiry Commission
Bill Thomas, Vice Chairman, Financial Crisis Inquiry Commission



GENERAL COUNSEL

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

August 27, 2010

Ms. Wendy Edelberg
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, N.W.
Suite 800
Washington, D.C. 20006-4614

Dear Wendy:

I am writing in response to your August 10, 2010 letter to Secretary Geithner. Enclosed please find the Secretary's responses to the questions posed in your letter. Please do not hesitate to contact me if you have any questions or concerns.

Sincerely,

A handwritten signature in black ink, appearing to read "G. W. Madison", with a long horizontal flourish extending to the right.

George W. Madison
General Counsel

Questions for the Record

Financial Crisis Inquiry Commission

“The Shadow Banking System”

Treasury Secretary Timothy F. Geithner

May 6, 2010

Questions 1-3

In September 2008, the commercial paper market was becoming increasingly strained. In the face of intensifying uncertainty, many investors were reluctant to buy commercial paper from financial institutions and other issuers. The stress on the commercial paper market was evident in the shrinking volume of outstanding commercial paper, rising interest rates on long-term paper, and an increasing percentage of outstanding paper that needed to be financed each day.

Along with my colleagues at the Federal Reserve, I was very concerned about the severe stress in the commercial paper market and the potential impact on the broader economy. As we monitored deteriorating conditions and thought through actions we could take to help issuers access this market, we consulted with a broad range of market participants, including both issuers and investors. We engaged in a detailed examination of the options available to the Federal Reserve to improve the availability of funding for financial institutions and corporations that rely upon the commercial paper market. Ultimately, the Federal Reserve developed, among other programs, the Commercial Paper Funding Facility (CPFF) and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility to help provide liquidity to term funding markets.

You have asked about specific telephone conversations with Mr. Jeffrey Immelt on September 29-30, 2008. In the course of my duties as President of the FRBNY, I spoke regularly with Mr. Immelt, who was a board member of the FRBNY and also Chairman and CEO of GE. In September and October 2008, I remember discussing with Mr. Immelt a number of topics, including the state of the commercial paper market generally and how escalating disruptions might impact GE's ability to access this market. While I do not remember specific conversations, I probably had discussions with Mr. Immelt regarding the CPFF proposal that was being developed by the Federal Reserve at that time. My colleagues at the FRBNY also had conversations with other issuers about the proposed CPFF program around that time, as our goal was to design an effective program that would be utilized by companies and stabilize the commercial paper market. It is worth mentioning that CPFF is now almost entirely wound down with no losses to the government and a considerable profit for taxpayers.

Questions 4-8

In your letter, you asked a series of questions regarding the role of derivatives in the financial crisis. In particular, your questions focused on the role of derivatives in the financial crisis, the role of interconnections between market participants, and the lack of transparency in these markets. You also asked about the role that derivatives played in the securitization markets and in the failure of large institutions during the crisis.

The rapid growth and innovation in the markets for derivatives, especially over-the-counter (OTC) derivatives, has been one of the most significant developments in our financial system during recent decades. The OTC derivative markets grew explosively in the decade leading up to the financial crisis, with the notional amount or face value of the outstanding transactions

rising more than six-fold to almost \$700 trillion at the market peak in 2008. Over this same period, the gross market value of OTC derivatives rose to more than \$20 trillion.

In general, derivatives can play a constructive role in our economy by allowing companies to manage their risk, and even during the crisis many of the derivatives markets continued to function well. However, the complexity and lack of transparency in OTC derivatives allowed risks to build up without capital or oversight, which contributed materially to the financial crisis. These markets were almost entirely unregulated. There was no legal authority to monitor them, constrain risk, or impose standards of conduct. These gaps in regulation were compounded by failures in risk management by market participants. Because OTC derivatives are conducted bilaterally, the market and its regulators have very little visibility into the magnitude of derivatives exposures between firms. Moreover, these bilateral trades create complex networks of exposures to risk – particularly between financial institutions.

For example, Lehman was a major participant in the OTC derivatives markets. As of August 2008, Lehman held over 900,000 derivatives positions worldwide. The market turmoil following Lehman's bankruptcy was in part attributable to uncertainty surrounding the exposure of Lehman's derivatives counterparties.

While derivatives are primarily intended to help manage risk, derivatives exacerbated and concentrated risk, in many cases during the financial crisis. For instance, the growth and distribution of asset-backed securities (particularly mortgage-backed securities) was supported by the provision of guarantees on the risk of these securities. These guarantees were one factor which helped drive demand for mortgage-backed securities and helped fuel the rise in mortgage credit, but also resulted in investors underestimating the risk of the underlying securities.

These guarantees were provided by derivatives dealers and other participants, like AIG, who insured the value of billions of dollars of these securities. At the same time, regulatory requirements and market discipline were both weak and failed to constrain in any meaningful way the exposures of banks to these thinly capitalized firms. For example, banks were able to get substantial regulatory capital relief by buying credit protection on mortgage-backed and other asset-backed securities from monoline insurance companies, which were thinly capitalized, special purpose insurers subject to little or no initial margin requirements. As the financial crisis intensified, and the value of the securities fell sharply, the losses and potential claims both imperiled firms that had sold protection and created significant uncertainty regarding the health of firms that purchased protection from them.

The reforms in the Wall Street Reform and Consumer Protection Act of 2010 address these weaknesses directly. The reforms require that all derivatives dealers and other major market participants are subject to conservative capital and margin requirements and to business conduct standards. The reforms require clearing and transparent trading for standardized contracts and provide both market transparency and full enforcement authority across derivatives markets. These reforms also protect the ability of corporate, agricultural, and other non-financial companies to hedge their risks through an appropriately narrow exemption from the clearing and trading requirements.

Testimony before Senate Committee on Agriculture, Nutrition and Forestry on OTC Derivatives Reform and Addressing Systemic Risk: <http://www.treas.gov/press/releases/tg425.htm>

Remarks on Reducing Systemic Risk in a Dynamic Financial System:

<http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html>

Testimony before the House Committee on Oversight and Government Reform on AIG:

<http://www.treas.gov/press/releases/tg514.htm>

Testimony before the House Financial Services Committee on Lehman Brothers:

<http://www.treas.gov/press/releases/tg645.htm>

Question 9

The financial crisis we have just experienced was the result of a complex combination of conditions and actions. As a result, any ordinal ranking of individual factors would likely be more misleading than helpful.

Among the factors that you list, some did play a larger role than others—a fact that this Commission’s work has revealed over the past year. To try to assist you in ranking the importance of those factors, I would divide them broadly into three tiers.

The first tier includes factors that, in combination, were the primary drivers of the crisis. Within this tier are elements that began to set the stage decades before the crisis hit. They made the system more vulnerable over time and, if left unchecked, were likely to eventually lead to a crisis.

- Unusual macroeconomic stability since the early 1980s encouraged risk taking. Meanwhile, accommodative monetary policy contributed to an environment of ample liquidity. In a low interest rate environment, many investors were willing to take on more risk to boost nominal returns. Institutions and investors looked for higher returns by taking on greater exposure to the risk of infrequent but severe losses. Underwriting standards eased, most notably for mortgages.
- Risk management systems did not keep pace with the growing complexity of the system, in particular how to identify and hedge potential losses in extreme circumstances and counterparty exposures.
- Capital at banks was inadequate to support the risks they were taking on, and increasing reliance on short-term sources of funding left the banking system susceptible to a disruption to the liquidity of key markets. The wave of losses that began in 2007 quickly depleted common equity, requiring government intervention to prevent a system-wide collapse.
- Meanwhile, a parallel banking system emerged outside of regulatory oversight to meet the growing demand for credit. The capital inadequacies, duration mismatches, and poor risk management present in the banking industry were magnified in this parallel system.
- The regulatory regime failed to curb increasingly risky behavior and compensate for deteriorating market discipline. There was no systemic regulator to monitor non-bank

financial institutions, where it was easier to increase leverage and take advantage of unwary consumers. No resolution regime existed to wind down large financial institutions without threatening the system. Many risky derivatives were traded off exchanges and beyond regulatory scrutiny. Financial institutions took advantage of differences between economic function and legal form, cherry-picking among competing regulators and shifting risk to where they faced the lowest standards and constraints. Consumer protection was inadequate, in particular for increasingly complex mortgage products. And capital requirements were too low at banks and very weak or nonexistent at nonbank financial firms. Many of these failings occurred because regulators lacked adequate authority over nonbanks, but in part the authority they did have was not rigorously used.

The second tier of importance includes misaligned incentives.

- Managers in financial institutions faced incentives to increase leverage and boost short-term performance, without taking sufficient account of risk and what was needed to maximize the long-term value of their firms.
- Ratings agencies proved susceptible to conflicts of interest and unable to keep pace with many of the institutions and instruments they were rating. Ratings also failed to reflect the possibility of system-wide losses. Yet, many investors placed blind faith in the agencies' stamp of approval.

The third tier of factors includes deficiencies in the tax, accounting, and regulatory reporting systems.

- The tax code created incentives for households to take on mortgage debt and for businesses to issue debt, instead of equity to raise funds.
- Accounting standards failed to adequately capture risks and in some cases exacerbated the crisis, in particular fair value requirements for certain tradable assets.
- More broadly, firms did not report their activities to regulators or investors in a way that allowed them to accurately gauge risks. This lack of transparency contributed to widespread fear in the fall of 2008.

Included in your list are short selling and market manipulation. Although in certain periods over the past three years such activity may have contributed to volatility, I do not believe they were significant causes of the crisis.

Finally, in assessing the most severe financial crisis in 70 years it is important to keep a number of things in mind. First, nothing as broad and consequential as the recent financial crisis has a single or a simple set of causes. In order to learn the right lessons from the recent crisis, we must reject overly simplistic explanations of what happened. Second, while the financial system suffered from deep flaws that led to a major crisis for our economy, we must recognize the essential constructive role that financial intermediation plays in our economy. This Administration and the Congress have worked hard to strike a balance between regulation that

addresses what I believe are the primary causes of the crisis and the need for our private financial markets and institutions to innovate and provide credit to homeowners, consumers, and businesses. We continue to do so as we implement the recently enacted reforms and in addressing housing finance. Finally, financial crises are a recurring phenomenon, reflecting certain fundamental aspects of economic behavior and market structure. But at the same time, each financial crisis is unique in its details. Although the details of recent events are important to record, the Commission should seek to draw attention to the broad principles that contributed to this crisis, and may contribute to the next one. That will provide a significant service to future policymakers and the American people.