Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Matthew Kabaker[1] U.S. Treasury Assistant Secretary for Financial Institutions
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Introduction:

The Yale Program on Financial Stability (YPFS) contacted Matthew Kabaker by email to request an interview regarding Kabaker's time as Assistant Secretary for Financial Institutions at the U.S. Treasury during the Global Financial Crisis. [2]

At the Treasury Department, Mr. Kabaker was senior advisor to former U.S. Treasury Secretary Timothy Geithner and the Deputy Assistant Secretary for Capital Markets. While at the Treasury, he established the Office of Capital Markets. He also helped design the Treasury's policy response to the financial crisis, design and implement the Dodd-Frank financial reforms, and address housing finance reform, including the reforms at Fannie Mae and Freddie Mac. Kabaker also served on the Treasury's Financial Stability Policy Council and Housing Policy Council.

Prior to his role at the Treasury, Mr. Kabaker was a managing director at The Blackstone Group L.P., where he focused on investments in the financial services and retail sectors.

He is currently the senior managing partner at the New York-based private equity firm Centerbridge Partners, where he co-heads the company's global private equity investing activities. He focuses on investments in the financial services sector, institutions and assets, in the United States and Europe.

[This transcript of a phone interview has been edited for accuracy and clarity.]

Transcript

YPFS: My first question is, what was your role during the financial crisis?

Kabaker: I was a senior advisor to Secretary Geithner and a deputy assistant secretary at the Treasury.

[1] The opinions expressed during this interview are those of Mr. Alvarez, and not those any of the institutions for which the interview subject is affiliated.
[2] A stylized summary of the key observations and insights gleamed from this interview with Mr. Kabaker is available here in the Yale Program on Financial Stability's Journal of Financial Crises.

YPFS: **During the financial crisis, how did you help fight the crisis?**

Kabaker: I worked on all of the programs that touched housing finance and banks broadly. That would include programs like the stress test, the capital investment into banks, the public-private investment program, and various individual company actions that we took, both under HERA and under TARP, for financial institutions.

YPFS: **At what point was it recognized that there was likely a big solvency problem in the financial system, as a liquidity problem?**

Kabaker: That is an interesting question. I think that it became pretty clear, by late 2008, that we were dealing with a solvency problem. There had been a series of moves to shore up liquidity throughout 2008, and we were left with a situation where both bank CDS prices, bank equity prices, and the constriction in lending was certainly creating evidence, which became even clearer on an ex-post basis, that you had a solvency issue in the system.

Kabaker: The interesting thing is that, the solvency issue was not alleviated by the first capital injections into banks. I think, ex-post, you would have said that the initial TARP capital injections would have been sufficient in quantum to alleviate the solvency issues or, at least, push back on them by a meaningful amount. However, the markets and the banks themselves were not treating that capital injection as necessarily alleviating the solvency test. The theory was that, that capital would be viewed by both markets and banks themselves as debt-like, so there was a problem of design to some degree with that security, the original preferred stock investments in the banks.

Kabaker: When I came into the picture, which was December of 2008, it was increasingly clear, both from market signals and bank behavior, that we had a solvency, not a liquidity crisis, and that the solvency response which had occurred by that point was not having an effect on perception of solvency. So, we set about designing a series of policies that we felt like would, with as little additional capital injection as possible from the government, create a situation where you could have a slightly more self-perpetuating positive cycle of the capital that was in the system from the initial preferred injections. [These initial injections were] being considered more like solvency pressure-alleviating, and then bringing new capital to the table that was, without a doubt, solvency pressure-alleviating, in that it was the form of tangible common equity.

YPFS: **Talking about injections, how was the number of $700 billion arrived at?**

Kabaker: It was, to a large respect, a political outcome. I think there was a desire not to have a number that had $1 trillion in it. Separately, my understanding, and that was done under the Paulson administration, is that number was actually decided when they believed the program was going to be used to potentially purchase troubled assets. I think they thought about it in the context of how many mortgage securities they might have needed to buy to have an impact on the market, before the entire mentality shifted to using that program officially as the solvency backstop. It was either a liquidity or a troubled asset-type program. I was not there for the decision as to size that arrived at 700 [billion Dollars,] but that, I think, was the concept.

YPFS: **Would it have been easier if this number was higher? Would it have made your job easier?**

Kabaker: I think the short answer is, with respect to bank solvency, we were able to manage within the budget constraint. Additional budget would have given us an ability to do two things: [firstly] probably some broader programming in and around housing, and [secondly it] would have probably given us an ability to do programs that would look more like traditional bank resolution for very large bank holding companies. You would have had probably the budget to do maybe very, very large resolution procedures for the big four banks, for example, where certainly the budget constraint was a factor in whether we could take on the task of a bankruptcy or resolution of a bank holding company.

I do not know if that would have been the right policy, but the decision not to pursue very large-scale bank resolution was, in part, due to the budget constraint. In hindsight, the policy that we implemented was probably a lot more efficient than full-scale bank resolution, which is what a number of other countries did, such as the U.K. and Ireland. We had, I think, a better outcome with our policy than those full-scale resolution-type policies, but it was in part due to budget constraints that we ended up with what we had.

You could say that the design of the policy or the design of anything, a house, a policy, is more about the constraints. The innovation really happened in designing around the constraints. In this case, we did have, to some degree, a budget constraint that was, relative to the size of the U.S. financial system, relatively modest.

The last thing I would point out is that we knew that the initial $700 billion was, in certain circumstances, where our policy ultimately proved ineffective and we needed to go further towards full resolution. We knew we needed more money. So, we put the placeholder in the Obama initial budget document, which was the executive branch's proposed budget. It is a policy document, it is not an official document that is used by the Congress to guide the appropriations process. We put a placeholder for an additional $700 billion of capital of appropriation into that initial Obama budget. We never actually sought that appropriation from Congress because our policy worked. However, we knew that if our policy did not work and we had to move to this more resolution-intensive approach, we did not have enough money. So, we did put that out there publicly. It was not picked up on at the time to a great degree, but it is there.

YPFS: **What was the significance of government purchasing non-voting preferred stock instead of common stock? You refer to it in your paper, if I do not recall wrongly.**

Kabaker: I addressed this a little bit in my answer to the first question. From a technical bank solvency perspective, preferred stock and common stock serve the same purpose. They insulate liability holders from loss, because you essentially first loss capital ahead of depositors and lenders. So, you would say that those were similar things.

In reality, the way the preferred stock was structured, where it was coming from the government, and it was coming with a set of behavioral restrictions that the bank did not like and it was coming with a meaningful step up in interest rate after a period of time, it was viewed by the banks and by the market as temporary capital at best. It was viewed as capital that would need to be repaid and so, in some ways, [it] was another liability even though it was in the form of preferred stock. If you look at how CDS is traded and how the true common equity is traded, you would see that in the pattern of that trading. It was viewed more as a liability as opposed to anything else.

So, we felt, to really push back on the solvency narrative, that the system was fundamentally insolvent, you needed to have capital injected that was viewed as common equity, and as loss-absorbing, which the preferred [stock] was not by virtue of its design. So, we set about the process of painting a path to how that preferred stock would be converted to common stock and encouraged banks to raise additional common stock through the stress test mechanism, which identified a common stock capitalization target or a so-called "tangible common equity target" and then encouraged the banks to meet that test either through their own efforts or through our efforts at filling that need with common equity, which would be loss-absorbing.

YPFS: **How did you mobilize the private sector, and why was this so crucial?**

Kabaker: Well, the obvious point is that the private sector was much bigger than us, and it had the potential to be self-perpetuating if it were to participate in the process of recapitalization. Our thought experiment was to identify the things that were causing the private sector not to invest in banks' recapitalization.

Banks exist really only at the permission of policy. They are fundamentally unstable entities. They would not exist without government liability support, either in the form of deposit insurance or other liability support. As long as you have liability support, banks do not technically need capital. If you have a deposit guarantee, a depositor should be willing to put money in the bank regardless of the capitalization of the bank, for example. So, it is really up to the government to decide at what level of capitalization its own guarantee is at risk, if it wants to fail the bank and essentially have a zero return to private common equity-holders. It is a rules-based system which determines when private equity owners of banks, or owners of common equity in bank, lose all their money.

There was a lot of uncertainty around how the government was going to define that rule set. There was some behavior by the government which caused a lot of confusion around a couple of medium-sized banks, like Washington Mutual (WaMu) for example, where the government ultimately failed the bank but in a manner that it was very difficult to discern what rules-based regime the government was using to determine how to impact different creditors or equity-holders within that bank. Our view was, if you could, one, create some clarity both of disclosure on what exposure the banks themselves had to the different credit assets, and two, create some policy certainty, you had the possibility that the private sector would provide capital for that recapitalization.

The stress test became a mechanism to do both those things. If you think about what that did, you had a policy which was designed to radically increase disclosure around bank losses in different stress scenarios, which they had at that point not published. People just had no idea. Second, it basically said, "Hey banks, if you can raise this amount of money, we are not going to fail you. We are essentially telling you the government is not going to, in a disjointed way or unpredictable way, effectively fail these banks or resolve them or nationalize them." I think the combination of those two things, the private sector understanding that if they met the test, the bank would survive in its current form, and understanding what the bank's losses were in tail [risk] scenarios, made the sector investable.

Once the sector was investable, there was a huge amount of latent demand. We had done a lot of work to size latent demand for bank equities by looking at just how underweight the active mutual fund sector was towards the financial services sector, specifically banks. Then we also looked at the short interest in banks. Obviously, if you have momentum in a direction, you would have a lot of capacity for short covering. We added those numbers together and suggested that there was an upwards of $200 or $300 billion of private capacity that was fairly readily mobilized in the form of short covering and getting mutual funds to move towards an equal weight allocation. We felt like if we could get the right set of circumstances in place, the private sector would show up. That basically ended up playing out. We did not know ahead of time, it was a bet, but that did end up playing out. The stress test provided clarity around those two elements.

I would say you cannot underestimate the fact that the stimulus, which was happening in the background, did have some impact to overall macroeconomic uncertainty. You had the sense that the government was going to use both fiscal and monetary policy weapons to create some overall macroeconomic momentum. I would not underestimate the impact of that happening in the background of this, in the first and second quarter of 2009.

YPFS: **Actually, you did touch upon my next question about how the stress test was structured. Is there anything we should be adding after your explanations to the last question?**

Kabaker: That was the macro structure of it. There is a lot of really interesting questions around the micro structure, where you had to make decisions about how you were going to prepare the stress scenario, what you were going to measure, what was tangible common equity, because it did not really exist as a regulatory definition previously. How much disclosure the banks were going to be required to make? There was a set of really interesting policy questions around that.

There has been some good writing around each of those major choices, most notably in a paper that we had written, that you no doubt have seen. I think a lot of those are really interesting questions. They are very technical, but they are interesting. However, I would say the macro structure of it was how the banks perform in a tail, and use that same information to get regulators to say together, in unison, in one voice with one press release, "If you have enough capital to survive this scenario, we are good, we are not going to fail you." That is essentially what the nature of those joint releases were, because the Treasury Department had no authority to fail banks. We really had to get the regulators to say, "Okay, we are good with this level of capital."

A lot of Treasury's job in that exercise was to corral the bank regulators and say, "Hey, make the steps as hard as you want, because you have got to stand behind this. If a bank can actually raise enough capital to meet the stress [test,] you have got to stop, you have got to leave them alone for a little while and let them do their thing." That was the dynamic of Treasury's role, as well as making sure that all the regulators were saying the same thing and were aligned. Nobody could say, "Oh well, the FDIC's stress test is different than the OTC's stress test, is different than the Federal Reserve's stress test." There is one test. There is one capital “bogey” as we called it and if the banks can meet it, then they will have met it and they can continue to move forward as private companies.

YPFS: **Was it difficult to get that collaboration between the different parts, different offices?**

Kabaker: Yes. We had and still have a tremendously balkanized regulatory system relative to any other major economy. It is a highly balkanized structure with a tremendous amount of distrust and lack of collaboration among the different regulators.

YPFS: I would imagine that it would be much easier to fight a crisis if the collaboration is established. Are there any ways that we can do this?

Kabaker: There were attempts to create bodies like the Financial Stability Oversight Council. There were a variety of working groups that survived for a period of time, because the annual stress test became really, to some degree, a joint exercise for a period of time between the OTC, the FDIC, and the Fed. That has all largely failed. All the regulators have gone back to their own silos, and the stress test, which was a joint exercise, has become basically just a Federal Reserve exercise. To some degree the OTC and the FDIC do their own thing. My perception would be that, while there were some attempts in the immediate aftermath of the crisis to bring some forums for collaboration, those attempts have largely failed over time. We are as balkanized as we were prior to the crisis.

YPFS: What do you say to those who criticize the government for not requiring creditors to take haircuts?

Kabaker: Well, I guess I would say, "To what end?" My response would be [to ask] "What is the precise policy argument?" If the argument is that the government lost money in the manner in which it intervened and therefore creditors got a great deal, that is not true. We made money. I think the evidence is that, it would have been far more costly and with a worse macro result to do resolution of large bank holding companies and create the dynamic where creditors did have to take losses. I think you can see that to some degree in the experience of other countries.

Having creditors take losses in that scenario imposes a another set of policy requirements, but you [would need to] do that in a way that is easily understood and is predictable. If, in the middle of a crisis you are going to impose losses on someone without creating a broader run dynamic, you have to be able to have a very clear and crisp explanation of who is losing, and how you can differentiate between different creditors and the losses that they take. That was basically an impossible task, because the type of creditors in banks, from derivative counterparties to senior lenders, were essentially undifferentiated. You would have almost had to create a new legal regime in the midst of the crisis, publish it in a way that was easily understood, and be able to do that in a way that was not run-accelerating.

I think we all thought that task was highly impossible relative to the alternative, which was the policy that we pursued. My reaction [to that criticism] would be, if you could explain to me how you would do that, and there would [be] a feel-good element in that policy… However, in 10 years no one has explained to me a credible mechanism for achieving it that was consistent with the budget constraints that we had and would not lead to a run dynamic across broad liability markets that would accelerate the crisis as opposed to alleviate it.

No one has been able to point out to me another country where they were able to meet that task. If you think about it, the U.S. financial crisis response was budget-positive, meaning it was not only costless, but it also actually contributed a positive surplus. There is no other country that did that. Ireland pursued creditor losses. Their response was much more expensive from a fiscal standpoint and had a worse macroeconomic outcome. No one has been able to point me to an example, either in this crisis or in prior financial crises, whether they are in Asia, or Latin America, or elsewhere, where this idea of just have creditors take all the losses... I am yet to see a practical example of how that exactly works and achieves the same outcome that we achieved.

YPFS: **You mentioned in a number of places, also during our talk, uncertainty, fear, panic, a cycle of worry as elements that contributed to the crisis. Could you elaborate on the necessity to establish certainty, predictability, and credibility to fight the crisis?**

Kabaker: The track record here is imperfect, because the nature of having a... One of the things that Secretary Geithner has said before is that, one of the first recommendations he had for a financial crisis response was not to have a presidential transition in the midst of your financial crisis. We had the unfortunate circumstance of, literally at the most acute moment of our financial crisis, a change of power in the government, including, unhelpfully, a party change-over. It was not even the same party. It was a complete change in government.

That added a meaningful amount of uncertainty at exactly the wrong time. Part of our job was try to manage the uncertainty that our own transition was creating. In some ways, we took a number of steps backward before we were able to finally take some steps forward. It was front and center of every discussion. Our principal job, as a policy matter, is to have the private sector understand that the job of the government is to assume tail risk in financial crises, explain how that would work from a practical standpoint, and, in the process, have a predictable and clear government response that would ultimately reduce uncertainty and worry. We had that as a clear goal of policy, but you have to acknowledge that we initially added to uncertainty by virtue of the policy change-over.

There were a lot of voices during that period, from political voices in the White House, to some of the bank regulators, to Treasury, where you got a very disjointed set of public statements around the financial crisis response. The stress test, in some ways, was just a device that allowed us to achieve a bunch of other policy objectives, as I said, including reducing uncertainty and increasing coordination between balkanized regulators. Part of the nature of the "stress test," or the series of policies that surrounded the stress test, were designed so that we could get back control of that narrative, where there would be one set of policies and it would be clear.

You could argue that it is somewhat self-serving, but you went from a place where you had literally a completely new administration that was elected in November. By February, we basically had gotten the entire thing corralled into a unified statement and by March, a detailed set of policies that the entire regulatory community had agreed on, and the entire administration had agreed on and offered a predictable and complete way forward. I would say that is pretty good for a pretty complicated country to pull that off in four months.

YPFS: **Why is certainty so important?**

Kabaker: It is by far the cheapest way, from a fiscal standpoint, to create a response. Reducing uncertainty, if you can achieve it, is incredibly cheap and is the gift that keeps on giving. It is sort of a positive externality in and of itself.

The question is, how do you do it? As finance people, we would talk about uncertainty in a more quantitative or series-structured way. Another way of saying uncertainty is "volatility," from a financial point of view. If you think about volatility, how do you reduce volatility? Well, the financial way to express that is, you either sell a lot of put options or you buy a lot of call options. We looked at every policy to the left of "is this effectively selling a put option? If it is, great. That should reduce volatility. That should reduce uncertainty." If you think about things like providing an unlimited backstop to the purchase of common equity post-stress test, there is no bigger volatility-reducing exercise than that. That is a very large put that was written by the federal government. We tried to really hit tail risk where we thought it was probably priced most inefficiently.

YPFS: **Are we better off under DFA?**

Kabaker: In certain respects, [yes.] It was a product of political compromise and, even then, only addressed a series of problems but it did solve some very important issues. First was the lack of a resolution procedure for bank holding companies and [second was that it] clarified the ability of regulators to force banks to raise capital really at their discretion, which was largely in law but was not as clear as it became law after Dodd-Frank. Those, to me, were the two primary benefits. To some degree, the strengthened regulatory power and forced capital raising created a resolution mechanism for bank holding companies. Also, the designation authority, the Financial Stability Oversight Council (FSOC), was important in terms of taking non-bank entities and forcing them into a regulatory regime at the regulator's election as opposed to the firm's election. Those I would say, were the most important three [outcomes].

There were other things as well. The other category being, things that did not get touched at all. Going in the other direction were the constraints on the tools that were used in the financial crisis response. That was clearly a negative of Dodd-Frank that I think makes things worse, not better. It did not address regulatory balkanization, which as I said before, is a significant problem in the U.S. system. It did not go far enough in addressing the issues in the so-called “shadow banking” more broadly. In an ideal world, you would move to a more principals-based regime, where you would look at the nature of liabilities and try to treat all demand liabilities similarly. So, in that way a deposit or a daily liquidity money fund asset would be more similar than they are different. Right now they are treated completely differently from a regulatory perspective.

Then there were some other things that were not really related to financial stability but were more political, like the Consumer Financial Protection Bureau (CFPB) and others.

YPFS: **I read a sentence by you that I thought was really striking and thought-provoking. It read that, "To engineer a sustainable economy it was necessary to fix the machine that provided credit to families and businesses, to resuscitate the very markets and institutions that brought us the global financial crisis." Could you please elaborate on that?**

Kabaker: In an economy that is levered, in an economy where you have chosen to use a financial sector for intermediation as opposed to just having it all be done by a central bank or a similar institution, and leverage the savings of the economy to drive credit formation and therefore drive macroeconomic activity and create kind of a multiplier effect (that is literally what we call it in monetary policy,) you are kind of stuck. Unfortunately, when you enter a financial crisis, you are stuck with the intermediation system that you have. You do not get to create a new financial intermediation system in the midst of a crisis.

The only thing that gets you out of the crisis is some macroeconomic momentum. The only way to create the macroeconomic momentum is not to allow massive financial intermediation de-leveraging or multiplier-reducing activity to occur at the moment of the financial crisis. We had this problem, where half of our financial intermediation system was occurring outside the banking sector. Essentially, it was occurring in securities markets and things that we really did not have a lot of policy influence over. It was essentially the market deciding whether or not it wanted to engage in financial intermediation activity. It was not stable intermediation activity; it was fair-weather remediation activity.

The nice thing about banks is that they are designed, by virtue of accrual accounting and the fact that they do not have to worry about liability runs, to be able to intermediate in rainy weather and sunny weather. Your challenge is how to maintain some level of credit intermediation or lending to families and businesses when half of your entire intermediation sector just went on strike. They are gone and all you are left with are these banks. Your issue is that these are the very institutions whose mistakes caused the financial crisis, and yet, now that your markets-based intermediation is gone, all you have are these institutions.

I have to figure out a way to use what I have, which is the banking institutions that exist and which are designed to be able to create credit intermediation in sunny and rainy weather. So, my best strategy, absolutely, as politically unpopular and noxious as it is, is to make those institutions work. The need of the many, which is the need for credit intermediation activity, ends up causing you to have to "bail out" or support these institutions. You could let them all fail, but then you have nothing. You have no system. You cannot recreate financial intermediation in the middle of a crisis, so you have to work with what you have.

It is even worse in the sense that it is oftentimes the financial intermediary who did the worst who is going to be the one that is in the worst trouble. If you need to support the financial sector as a whole, by definition, the greatest amount of your support is going to go to the institution that did the worst deeds leading into the crisis. It is like some terrible cycle of political pain, where the most efficient, best financial crisis response becomes assisting the worst offender. A lot of the challenge of financial crisis management is managing the politics of that basic reality. I think that would have been true of our response, too.

YPFS: **In lesson four of The Mortgage Giants, you write that, conservatorship was not designed as a Government-Sponsored Enterprise (GSE) reform plan, and was meant to be temporary, and that they still remain under conservatorship. In fact, in July this year, it became apparent that they will remain under conservatorship until 2024. In retrospect, do you think that it would have been more efficient to design their conservatorship differently to avoid this?**

Kabaker: The one-word answer would be: "absolutely." In hindsight, we sort of erred on the side of financial stability, which was to say there were not necessarily explicit trigger points which would create a moment of crisis, so to speak, where policy would have to intervene. That would have been relatively easy to do. You could have designed a mechanism where certain of these authorities or instruments would have had a maturity, or would have expired, or would have created effectively a catalyst for policy action.

We ultimately concluded that any catalyst for policy action would, by definition, put a time stop on the assistance, which would be on the margin less financially stabilizing than assistance which was deemed as permanent in nature. Our judgment, which was, honestly, terribly wrong... The policymakers in Congress would be so unhappy with the regime that resulted, which was the nationalization of these two large entities, that they would no doubt act in some way. The flaws in the system that existed prior to the financial crisis would be so obvious, in terms of the balance of government risk versus reward, that policymakers would no doubt intervene to solve what we viewed as a completely faulty mortgage finance market. We did not anticipate, to some degree, the nature of interest group alignment against it for the status quo, ultimately preventing any changes from Congress in the basic regime. In hindsight, we would have almost certainly designed a forcing function.

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