Sheila Bair was the chair of the Federal Deposit Insurance Corporation (FDIC), the regulatory body that insures bank deposits, between 2006-2011. As early as early as 2001 she warned of the dangers of subprime lending. Bair told FRONTLINE she was blindsided by some of the decisions made during the crisis. "Just because you're big doesn't mean you should get showered with government money. I want more analysis of why," she said. This is the edited transcript of an interview conducted by correspondent Martin Smith on Nov. 15, 2011.

Sheila Bair

Chair, FDIC (2006-11)

1. **Early concerns about predatory lending in the mortgage market**

Let's go back and begin with you at the Treasury Department in charge of financial institutions. [As] you start to look at the landscape out there, what do you see? What are your concerns?

Then it was really an issue of predatory lending. It was not mainstream banks and thrifts and big mortgage companies that were doing this. It was more the perimeter players in the markets.

We were starting to see a lot of abusive lending. These loans were targeted towards lower-income neighborhoods, and they would have very steep payment resets, very steep payment shock, so that really after a couple of years, the borrower could no longer afford the mortgage. That forced them into another refinancing.

We'd see situations where some of these mortgage originators would actually troll these neighborhoods for people that had equity in their house but also had damaged credit scores. They'd go in and they'd push market and say, "You've got this equity in your house. I'm going to give you 2/28s and 3/27s." They characterized them as fixed-rate loans. Well they were fixed for two or three years, and then there was this huge payment shock.

This is what we were seeing in 2001 and 2002 -- negative amortization features, steep prepayment penalties, so that you'd force them into refinancing and then you'd charge them a really steep prepayment penalty to refinance out of these loans that that had these steep presets.

You're churning the fees all the way along.

Absolutely. ... There had been some real problems in Baltimore, and Sen. [Paul] Sarbanes [D-Md.], who was the chairman of the Senate Banking Committee back then, had sponsored anti-predatory lending legislation.

When I went through my Senate confirmation hearing, in my meetings with him, he was really the one that alerted me to this. Treasury and the HUD [U.S. Department of Housing and Urban Development] had done a recent report on these issues, so there was a real need for legislation.

... [Then] the banks and thrifts started getting in on it too, unfortunately, as competitive pressures created this downward spiral on lending standards.

The [Federal Reserve] had regulatory authority to create rules for everybody, bank and non-bank, but they didn't want to use it. Ned Gramlick, who was at the Fed back then, was very concerned. He had pushed but wasn't getting anywhere, and there wasn't anything that was going to happen on the Hill because there were people making a lot of money off of this.

So we tried to get some of the better players in the industry together, the consumer groups and some of the securitization industry, to agree to a voluntary set of best practices that actually would be enforceable. Under FTC

[Federal Trade Commission] rules, if you make a public statement that you adhere to certain principles and then don't do that, there is an enforcement mechanism that can apply.

That was met with somewhat mixed success because again, it required voluntary buy-in. …

But by and large, the lenders didn't want to go along with it?

They really didn't. I think the lenders were mixed. Some of the lenders did want them. I think they could see what was going on and the kind of pressure this was creating on them. They were losing market share to these predatory lenders.

I think the securitization industry was a real problem. Some of the Wall Street firms who were funding these loans because, I call the perimeter players, they didn't have funding of their own to fund the mortgages. They were getting it through securitization process from Wall Street, and Wall Street was making a lot of money off of it. We couldn't really get any buy-in from them. They wanted nothing to do with it.

So Wall Street is just shoving money down the pike?

Yes. ... They had a saying: I'll be gone, you'll be gone. So it was all volume-driven. Everybody was making their money up front passing off the risk to investors, those who bought these mortgage-backed securities. The investors weren't doing their due diligence. They were relying on the rating agencies.

The rating agencies weren't doing their due diligence either. They were saying: ... "Mortgages are safe, right? Historically [there have been] very low default rates on mortgages. These investments are fine," without looking underneath as to what the poor underwriting standards that were in these loans.

And for years you're complaining about this. ...

I am. This is 2001, 2002, and then I went to teach at the University of Massachusetts for four years and really wasn't that involved in those issues. But then when I came back in 2006, I had been certainly following the raging debate over states passing anti-predatory lending laws, because the federal government clearly wasn't doing anything. ...

When I came back in 2006 to chair the FDIC [Federal Deposit Insurance Corporation], the staff at the FDIC were also getting increasingly worried that the lending standards were deteriorating significantly, and it was not only laying the groundwork for a lot of mortgage defaults but also a huge correction in the housing market.

The problem with all easy lending is it was building the housing bubble. With all this free credit going out, it was creating artificial demand for people buying houses who had no business buying a house. So that fed the asset bubble as well … and as we've seen, that was going to have a huge impact on collateral values for banks and their loans, even with safe loans. ...

Tags:
Subprime Mortgages & the Housing Bubble

2. Why her early push for reform failed

As chairwoman of the FDIC, did you get an opportunity to brief the president on your concerns?

Not in the Bush administration. It was pretty much done at the regulatory level.

So how high could you take your concerns, or who do you talk to?

We talked to other banking regulators at the Fed and the OCC [Office of the Comptroller of the Currency] and the OTS [Office of Thrift Supervision]. We raised our concerns with Treasury. We convened a series of roundtables in the spring of 2007. ...

First we pushed to strengthen lending standards at least that applied to banks for both subprime loans as well as what they call "nontraditional mortgages," which are mortgages that have negative amortization features. ...

We pushed for that and were not able to get a stronger standard for subprime until early summer of 2007. There was a lot of resistance from the industry as well as from other regulators to do that. There were so many loans that were already made that were bad; we knew they had to be restructured. Especially [with] these steep payment resets, we were going to start having a huge wave of foreclosures.

So we convened a series of roundtables with the other regulators: Treasury as well as the securitization industry, their accountants, the tax lawyers, the underwriters, the servicers. Everyone came in, and [we] were able to establish that there was legal authority to restructure these loans. ...

We thought these loans were going to get restructured, and then it just didn't happen. ... At that point the problem wasn't so much underwater mortgages, ... [it] was really unaffordable mortgages, because some of them couldn't even afford the initial payment, and they certainly couldn't afford the reset.

So we were pushing for interest rate reductions, converting them into fixed 30-year mortgages at low market rates as opposed to these really high basic rates that you would see with the subprime. ...

There was clear authority to lower interest rates. There was less legal authority to do principal write-downs. ...

So they can't change the terms of the contract because it's all tied up in some cluster of other securities?

Yes. You can't put enough emphasis on how the securitization model skewed economic incentives to make creditworthy loans to begin with, because you severed the origination process -- the entity that was actually deciding to make the loan -- from those who would actually own the loan. And because of that severance of economic interest, you ended up with a lot of very bad mortgages being originated.

But on the servicing end too it's been the same problem, because the entities servicing the loans -- those responsible for collecting the payments or working with the borrower if the loan becomes troubled -- those people are not the same people who own the loans. ...

During these roundtables we established that there was lots of legal authority to reduce interest rates, not so much legal authority to reduce the principal amount, so we were pushing very hard for significant interest rate reductions on a long-term, sustainable basis.

But you weren't able to get it done?

We were not. We got a lot of happy talk that they were going to do it and then--

Happy talk from?

From everybody. From the servicers, from the investors, from the Wall Street firms doing the securitizations. Everybody said: "It's going to get done. It's an obvious thing to do, and we're going to do it." And then it didn't.

This is the fall of 2007. The roundtables are in the spring, where we got everybody's buy-in to support loan restructuring. That fall, Moodys.com does a survey and finds out that less than 1 percent of delinquent subprime mortgages are being reworked. The vast majority are just going into foreclosure.

That was when I started going public, because I think there were a variety of reasons why this wasn't happening. The servicers were understaffed and didn't really care. They didn't own it, right? If anything, they had financial incentives to foreclosure. ... If you did a restructuring, whatever money they were owed in terms of fees and things had to be put into the restructured mortgage and it would be paid out over time. You do a foreclosure, they're paid off immediately.

And the investors were pushing back. I think not enough attention has been given to that. What we call the AAA investors -- the investors in the securitization trusts that had the most senior, the most protected interest of these pools of mortgages -- they didn't really care, because if the loans went into foreclosure, what they called the "lower tranches" were going to take the credit losses.

So if you reduced the interest rate, everybody in the securitization pool gets a reduced return. But if you go to foreclosure, for the most part the AAA investors are protected. ... The AAA investors, there's a lot of very powerful institutions. They didn't really see it as in their interest for these interest rates to be reduced. ...

So that was the banks and their clients?

Right. So the big bondholders. Fannie [Mae] and Freddie [Mac] held a tremendous amount of the AAA paper.

Pension funds? Insurance companies?

That's exactly right. ...

... You go forward with speeches. You say, "We have a huge problem on our hands" in one speech. What kind of support are you getting from any other part of the government?

Not much. I think we were getting some lip service.

So you're the skunk in the room?

I was. Somebody called me that actually, said, "Skunk at the picnic." But I didn't feel like I had any other alternative. We had tried internal meetings. We had tried job owning. We'd tried interagency action. Again, these Wall Street firms and a lot of the originators who were funding these mortgages were outside of the insured banks.

We weren't the primary regulator of many of the big banks or thrifts that were doing this kind of lending, number one. And number two, a lot of it was being done completely outside of insured banks. Wall Street, of course, was completely beyond our reach. Those were securities firms.

We didn't really have legal power on our own to force people to do anything, so our only tool was really public advocacy and media pressure and public pressure to try to get it done. That was the strategy we decided to use.

Tags:
Subprime Mortgages & the Housing Bubble

3. **Her relationship with Treasury Secretary Henry Paulson**

... What were your conversations with [Treasury Secretary Henry "Hank"] Paulson about this problem like?

Initially, I had really no interaction with Hank. ... As the crisis unfolded, Hank started becoming more engaged. But what really got their attention on loan modifications was when we started getting action at the state level, and California moved ahead with a loan-modification program -- working with us -- of the kind that we had urged.

That was really the catalyst. When they realized that the states were going to start going ahead in kind of a piecemeal fashion, we did get Treasury more engaged, and they did end up instituting a loan-modification program.

But again, it was half a loaf. It was voluntary and there wasn't accountability. ... I'd had it with people making public commitments to do something and not doing it, so I wanted very detailed disclosure to find out if the loans were actually being restructured, and we didn't get that.

They also allowed the interest terms to be extended only for five years. They still allowed the servicers to do an individual, loan-by-loan negotiation, which we didn't think there was the time or the resources to do. And servicers, as we can see now, didn't have the staff or capability to do this kind of loan-by-loan thing, but that was what was ... permitted in this agreement.

So it helped. I think we probably got several hundred thousand more loan [modifications] done with that than without it, but it wasn't the really aggressive response that we thought was needed.

Tags:
Henry Paulson

4. **Roots of the meltdown**

Then 2008 and the meltdown begins. Had you envisioned that this was going to bring down a couple of big investment banks?

We thought it was going to be bad.

You thought it was going to be bad when?

We thought it was going to be bad in 2006. ...

But did you imagine that these problems that you were seeing at the sort of ground level were going to infect Bear Stearns or other investment banks on Wall Street?

Yes, because of a different issue on capital. Another battle we were fighting with other regulators was on what was called the Basel II capital standards. Basically this was an international agreement to let banks, large financial institutions, pretty much decide for themselves what kind of capital they had to hold. ...

This is all about the banks juicing up their returns by taking out a lot of leverage so they can, with a little money down, get a lot of action?

That’s exactly right, can get a lot of big, big returns on equity. So we stopped Basel II for FDIC-insured banks. We successfully blocked it.

But the SEC [Securities and Exchange Commission] implemented it for securities firms. ... They were operating on very thin levels of leverage and they [had] high-risk balance sheets, so we were very aware that they were very thinly capitalized because of the Basel II debate. ...

You’re watching a meltdown begin. You're seeing all these homeowners in trouble. ... Then you're being told at the same time that your banks ought to be able to take out more loans in order to keep this machine going?

That's exactly right. It was crazy. Basel II was birthed during this so-called golden age of banking, when everybody got enamored with the idea of self-regulating, self-correcting markets. You didn't need regulation. Banks knew better than regulators how much leverage they should take on and what their risk was.

So it was delusional. But the golden age of banking was because of an asset bubble that popped. It wasn't a sustainable model.

... Nobody saw that there was a bubble building in housing except for a few people.

They didn't, and the irony was that the Fed … had regulatory tools at their disposal to reign it back. They could have set lending standards across the board for everybody. They didn't do that. …

Did you see this then playing out in the failure of major investment banks?

Absolutely.

But did you ever go to the Treasury and say, "You guys are going to watch these banks that are over-leveraged melt down in a matter of a month or a year from now"?

No, we never had that kind of a pointed discussion. They were really more general discussions about Basel II and the kind of leverage that large financial institutions -- and this is going on in Europe too. …

We didn't regulate investment banks. It was the SEC's responsibility, and you're always doing this delicate dance in terms of encroaching on other people's jurisdiction. ...

Tags:

Roots of the CrisisSubprime Mortgages & the Housing Bubble

5. **What Bair knew about the decision to rescue Bear Stearns**

So as Bear Stearns melts down, what position did you take on what to do about it?

We, being the FDIC and my peers, were not involved.

I got a call on Friday, early in the morning, from one of my staff. He had been notified by somebody at the Fed that [Bear Stearns was] going to go into bankruptcy, and then when I got into the office the narrative had changed. Now there was going to be this government-assisted acquisition by JPMorgan Chase of Bear Stearns.

My reaction when he called me that morning and said they were going into bankruptcy was, "Well, investment banks fail." Because they do. That's the traditional model. Insured banks are supposed to take deposits.

I was surprised that the government had to assist with the acquisition and had taken on risk exposure to assist with the acquisition of an investment bank. It amazed me because the FDIC is the only agency with express legal authority to wind down financial institutions other than Fannie and Freddie. Their regulator has control, and of course ours only extends to insured banks.

So we have ... rules and procedures that we have to go through, and we are really forbidden from doing anything to help shareholders. … Our rules say if the place is going down, they go into receivership, which is just like a bankruptcy, and the shareholders and the unsecured creditors absorb the losses associated with that. ...

So I was very surprised that the New York Fed had found legal authority to go in there and arrange a deal. We auction things too. We never just call up an entity and say, "Will you buy this place?" We might call several entities and say, "Would you be interested," to get an auction going, but we never kind of just arrange marriages. ...

... Did you call up Tim [Geithner] and say, "What's going on?"

Again, it was an investment bank. I did not have any authority over Bear Stearns.

But you knew more than anybody else in the government about what it meant to take down a bank?

We did, and it would have been nice I think if we had been consulted at least on some of these issues.

You were never consulted?

Not outside insured banks, absolutely not. We had nothing to do with Bear Stearns, Lehman Brothers, AIG, none of that. ... We were consulted on Fannie and Freddie, but not the other ones. ...

I think that's regrettable, because I think there're some things where our insights and rules could have maybe helped with perhaps making the bailouts not so generous at least. Granted, government had to take some action. ...

It would have been at least nice for there to be some publicly available analysis. ... Why was it necessary for the government? What did the New York Fed see about Bear Stearns failing that convinced it that it was going to be systematic. Who was going to take losses? What would the knock impact of that been?

Throughout the crisis I was very frustrated that I just kept getting these arguments when we started being asked to participate in bailouts. When institutions like Citi got into trouble, I got very frustrated with these categorical statements: "Because they're big. They're systematic. And we've got to bail them out." That wasn't enough for me. Just because you're big doesn't mean you should get showered with government money.

I want more analysis of why. If I'm going to go in there and give exposure for the FDIC, which is a government agency, why am I doing that? Who am I protecting? I don't want to protect this institution. They were badly managed. They should fail. So who am I protecting? ...

Tags:
The Bear Stearns RescueBailing Out the BanksTim Geithner

6. **Why the FDIC should have been consulted on the bailouts**

So then you have Lehman Brothers coming in the fall. Are you getting any closer to getting any real information on or analysis put forward?

No. ...

Why should you be consulted?

Because we had expertise in resolving financial institutions. And we have resolved institutions with cross-border operations. There were a couple during the crisis that were resolved.

One of the things we always do very early on is we notify the foreign regulator that we have a troubled institution, that it may have to go into an FDIC resolution, that we may have to sell it very quickly. And we find out in advance, what are your regulatory requirements to approve mergers and acquisitions? And we walk them through it and we make sure they're comfortable when we get to that point where the institution actually has to be sold.

How many people worked under you at the FDIC?

About 8,200.

You had procedures and methods in place.

We did.

You drilled these things.

Right.

You do simulations.

We did.

You're sitting there like a firehouse ready to take down a bank and do it in an orderly fashion?

Right. That's exactly what we do.

So the United States gets into a financial crisis with a couple of Wall Street banks that are teetering, with some big commercial banks that are teetering. And you're not consulted?

Not with the investment banks, no, and a very poor consultation with the commercial banks.

As the commercial banks started getting into trouble, we were given a very short timeframes. In one situation with Wachovia, ... were told on Friday by the primary regulator that they were stable. And the next day, we were told that they were going to fail if something didn't happen.

So even with commercial banks we were given very short timeframes, and I think that also limited our ability to pursue different options other than bailouts.

Why are you not consulted?

Because I don't think regulators work as well together as they should. I think a lot of it is turf. I think a lot of it was fear. I think they know our process is a harsh one, and I think there was some desire to protect these big banks and their shareholders and creditors, especially their bondholders. I think that was absolutely part of it. ...

Tags:
Bailing Out the BanksHow Do You Break up a Superbank?

7. **Was the AIG bailout necessary?**

Was the AIG bailout necessary in your view?

I still to this day question why they paid off all of those counterparties in full at par with government money. ...

Did you ask Geithner?

No. Again, we were not involved in that at all. ...

We have rules in terms of derivatives. We have the power to accept or repudiate derivatives contracts. And typically if they have enough collateral or more collateral than necessary, the counterparty, to protect their position, then we'll ask for continued performance.

But if they're under-collateralized, we tell them, "Fine, take your collateral and go and take your haircut and go." That's kind of the rule we follow, and they could have done that. ... They could have used that same kind of approach I think.

Because not only was it the right thing to do, but the optics of this, I think the insensitivity of how people on Main Street would view of all this was always troubling to me. ...

The argument would be that there was no time for that. At this point the world's financial markets were going to melt down on Monday morning if Lehman Brothers or if Bear Stearns failed.

That was the argument. But even if you had to make a decision in a nanosecond, require them to take a 10 percent haircut. Just tell them, "We're going to pay you off at 90 percent. If you don't like it, too bad."

But the government had no legal obligation to put money into AIG to bail it out. If the government hadn't intervened, those counterparties would have taken huge losses, so there was some leverage there. But at least tell them, "You're going to take 10 percent." That would have helped.

But there was just willingness to kind of throw lots of money at the problem. I think we threw more money at the problem than we needed to, absolutely. ...

Tags:
AIGBailing Out the Banks

8. **Geithner, Paulson, Bernanke: We want the FDIC to guarantee the whole financial sector**

You're watching all [the Troubled Asset Relief Program negotiations] from the sidelines?

Pretty much. We were not really involved in their first attempt to get TARP passed. We got brought in later because they couldn't get the votes, and so one of the things they decided to do to get the votes was to increase the deposit insurance limit to $250,000. ...

So you had to agree to that?

Right. We had to buy in. They needed us to get the votes, so we got brought in at that point.

And that was throwing something out to Main Street?

That was the Main Street benefit. ...

I was summoned to a meeting. ... It was at Hank Paulson's office. I kept asking him what it was about. Nobody would tell me what it was about. I thought it was about TARP and how to spend the TARP money. ...

I go into the room, and there's Hank sitting there, Ben [Bernanke] sitting there, and Tim Geithner's on the phone. And they basically hand me a piece of paper that would have the FDIC announcing that they're going to guarantee pretty much all of the liabilities in the financial sector. So all the debt we're going to guarantee for banks and bank holding companies.

That was quite a thing, and I didn't want to do that. ... So I told them that I would have to think about that.

On the one hand, it's hard for the chairman of the FDIC to go in a meeting and be pointedly asked by the secretary of the Treasury and the chairman of the Fed to do something and to say no. But I bought for time. I played for time. ...

Was that a tense meeting?

I don't know if it was tense. I was so flabbergasted. At that point I didn't even have the wherewithal to fight back. I just played for time. I said, "I have to go talk to my board about it." ...

So anyway, I went back, talked to the board, my internal directors. They had the same reaction I did. They were incredulous.

What is that they're asking you to do?

... I didn't bring the text with me, but it basically said the FDIC would guarantee all the creditors of banks and bank holding companies, including the investment banks.

So they want your budget?

They want my budget. They wanted my legal authority ... to guarantee debt, guarantee bondholders. It's all about the bondholders.

Where was that money going to come from?

... That what was one of my questions.

One of the criticisms I got during the crisis was that all I cared about was the FDIC, and I didn't care about broader financial stability.

Well the FDIC was holding things together. … If people had lost confidence in the FDIC and started pulling their money out of banks, we would have been back in the Stone Ages. It would have been cataclysmic. I don't even want to think about what would have happened.

So this idea that by caring about the FDIC I wasn't caring about system stability I thought was ludicrous. I was very concerned about the credibility of the FDIC doing what it was supposed to do, which was insure deposits.

Now if I go out and insure all the debt and $13 trillion financial system, what kind of credibility was I going to have? Insured depositors are going to be saying, "They can't do all that."

So I told them that, and that was one of the many arguments I used subsequently to tell them we weren't going to do that. ...

So you're insuring, at the FDIC, Main Street?

Right.

But you're being asked by these three guys to insure Wall Street?

Pretty much. To insure the bondholders, and these are big Wall Street firms, pension funds, big bondholders, mutual funds.

Which props up Wall Street, but this is not your mandate?

... It's not anywhere close to our mandate. It was a real stretch in terms of legal authority, and it was a huge stretch in terms of our financial capability to make good on this. ...

So did you say no?

... We entered into a negotiation. Throughout the crisis ... another criticism was that I wasn't a team player, I was always difficult. I tried very hard to meet these folks halfway, even though I didn't agree with a lot of what was going on. ...

The markets were freezing up. Nobody wanted to lend to anybody after the Lehman failure, and I agreed there was a problem with the ability of financial institutions to roll expiring debt. ...

So ... we said we'll guarantee new debt. We will not guarantee the existing debt. That's there for loss absorption if these institutions go down. And then we're also going to charge money for it."

You wanted some moral hazard?

Yeah. Actually our original proposal was we'd only guarantee 90 percent of it. We wanted them to take 10 percent, and that was just a non-starter with both the Fed and the Treasury. They said that wouldn't work. They just refused. ...

So you signed?

We did. I think at the peak of the program it was about $330 billion worth of debt. Have not taken any losses on it so far. I don't think we will. And we did make money off of it.

I don't think that justifies that. There's so much of this, "Oh, we made money off of the bailout." I'm not sure overall we did make money off the bailouts because you have to look at Fannie and Freddie and AIG and GM and some of the other places where the government's still in pretty deep.

We also printed a lot of money, which could come back to bite us.

That’s true. This could have tremendous inflationary pressures down the road. ...

Tags:
Moral HazardTARPBailing Out the BanksTim Geithner

9. ## Forcing the banks to take capital injections "took my breath away"

Tell me the mood as you go into that [Monday] meeting [with Hank Paulson].

We had meetings over the weekend. It was at that point we learned that they were going to do these capital investments to these nine big banks. We were not involved with selecting the nine big banks. We were not involved with the dollar amount that they would get.

What did you think of that idea?

It took my breath away. I was also very surprised that they were going to basically force all of them to take it. The clear message at that meeting when they were all called in was, "You have to take this money." And a lot of them, probably most of them, didn't really need the money. ...

But the idea here was to get lending going again?

That was the stated idea. And we certainly emphasized that in terms of our debt guarantee program. I put this in my speeches and public statements and our guidelines for the program, that this money was to be used to support lending.

So are you on board at that point? Do you think it's a good idea?

No, I never thought any of this was a good idea. I think you do what you need to do.

So you're trying to be a team player even though you're considered not.

I'm trying to be a team player. There was action that was needed to stabilize the system. [If] I was a dictator, would I have done it differently? Yes, but that's really not the point. ... We did what we did and it did, in the short-term, work. It did stabilize the system, and you have to give Hank credit for that.

Longer-term did it meet expectations in terms of these big banks lending? No. Throughout the crisis we consistently saw the smaller banks, who didn't get all this money, were doing a lot better job of lending than the bigger banks. I think it prevented a worse credit contraction, but we still had a credit contraction. ...

It was tense. The weaker banks were happy to take it. The stronger ones, like [Wells Fargo Chair] Dick Kovacevich, didn't want it. I don't think Wells Fargo needed it.

What about Vikram Pandit?

Citi definitely needed it. ...

Tags:
Henry PaulsonTARPBailing Out the Banks

10. **A second bailout for Citigroup**

I think in the last quarter of 2008, [Citi] lost between $30 and $40 billion.

It was a very large number. They also had very unstable funding, so they used foreign deposits to fund a lot of their bad loans and other toxic assets that they had. ... But they were losing foreign deposits, and so they funded short-term too. They didn't have a lot of long-term debt that would have been stable, and their capital was low as well. They were in very bad shape at that point.

Just a few weeks later, Citi continues to be a problem. ... You have another crisis.

... They needed another bailout. ...

Another weekend.

... Got the call on Friday. We were playing catch up, but we had started paying a lot more attention to these large institutions, so we had a little bit of better sense.

But again, we weren't notified until Friday that the Fed and the Treasury wanted to do another bailout. They felt another bailout was necessary, and it had to be done that weekend.

Again, not much [time] to plan or look at alternatives, and so they got another very generous bailout, another $20 billion in capital. And the government agreed to guarantee losses above a certain point and about $306 billion of toxic assets that they had.

You commented that basically you had no real feel for whether or not Citi's failure at that point would have been systemic.

I think Hank and Tim Geithner have said that. ... What I did say was, can we at least explore putting the insured banks, the Citigroup structure, the bulk of the assets -- I think it was around 67, 65 percent of the assets -- can we explore running that through a receivership, creating a good bank, bad bank structure?

So you keep the bad assets back in what we call the bad bank. The current shareholders and unsecured debtors have to take whatever losses are associated with that. The good stuff, the good part of the franchise, you spin off. You sell or you recapitalize.

I wanted to explore doing that. I didn't want to do just another kind of one-off bailout. ... Obviously we needed to take action. We needed to do something to Citi, but I still think that would have been a better model to use. ...

You said again to the inspector general looking into this, "I don't think that additional assistance is going to fix Citi." So this was a patch-up job in your opinion?

It was a patch-up job. ...

I had a very tense conversation with [Former Comptroller of the Currency] John Dugan, their primary regulator. I said: "What is your supervisory plan? How are you going to fix this institution, because it's still sick? What are you going to do?"

He had no answers for me whatsoever. And the CAMEL rating, ... they had capped at a CAMEL 3.

CAMEL?

That's a supervisory rating. So 1, you're a very healthy bank; 5, you're a failing bank; 3, you're kind of an in-the-middle bank.

And Citi was?

Citi had failed twice and it required two government bailouts. It should have been a 5, right? If it had been a little bank. But they still had it as a 3.

When I asked him on that, his rationale was well, because it was getting all this government bailout money, it was a 3. So here we go. Now we're going to be rating the health of institutions based on how much government money they get.

After the fact.

So the fact that they were big and connected and can get a lot of government money, then we're going to give them a nice supervisory rating.

Like I would be less insolvent if you gave me a few million dollars.

It amazed me. And there was no plan and no sense of developing a plan to right the ship. ...

The criticism of the inspector general in looking at these deals was that these were ad-hoc assessments, sort of seat-of-the-pants, instinctual kinds of things.

They were. ... There is no question. ...

Tags:
Citigroup Bailing Out the Banks

11. **"Blindsided" by the decision not to give the FDIC resolution authority**

... June 2009, the president is going to announce a package of reforms that eventually becomes the Dodd-Frank [Wall Street Reform and Consumer Protection] Act. Coming up to that point, you believe the

FDIC is going to have resolution authority.

Yes.

What happened there?

We got blindsided.

Again?

It was the story of my life.

Actually, the president asked me to come to a meeting with him and Tim and Larry to talk about the AIG bonuses. This was probably a couple months before. There was all this adverse publicity about these huge bonuses being paid out.

What was the president saying in the meeting?

He was clearly upset. He was really concerned that this had happened. ...

I think the whole country was upset about that.

Yeah, and rightfully so. So I told him at that meeting, "You need resolution authority for non-banks like AIG because with our resolution authority, we can repudiate these employment contracts. ... You can fire them. You can pay what you want to pay. You can figure out who you need to keep and who you don't, but you have no legal obligation to give them their jobs or pay them their bonuses."

The president liked that, and I think that was really the start of serious decisions about including resolution authority as part of the package of reforms that the White House would request.

Where were Geithner and Summers on that?

They were agreeing, and the early iterations of the white paper had basically an FDIC resolution mechanism in it.

It got changed. We didn't see the final draft until that meeting. We got it basically when the press got it.

In June?

Yeah, and I was flabbergasted when I saw it was not the FDIC process. It was a bailout process.

I was being put on the spot. I was asked to appear with all the regulators at a big press conference unveiling this thing. I had not seen it beforehand. I didn't agree with what was in it.

What was in it that upset you?

First of all, it didn't make the FDIC the resolution entity. Basically the Treasury Department would run it and decide who was going to be the resolver and all that. And I didn't really care for the non-banks, but for the banks and the bank holding company, it was really important for us to get that.

Because what good does it do me to have Citibank if somebody else has got the Citi holding company? It doesn't. They're all intertwined. So that was a problem.

But it was more. We had pushed for very tight prohibitions on bailouts. We didn't want any more one-off bailouts, and that language was lost. And there was a lot of flexibility to do what we thought were essentially bailouts in capital investments and all the things that we think in retrospect would have been better to do something else.

So they got unhappy with me. Tim got unhappy with me. I didn't say anything at that point, but when Barney Frank asked me to testify later about the bill, I gave him my honest views.

I thought there was too much flexibility for bailout authority, and both the House and the Senate ended up rewriting the resolution authority to make it more aligned with what we had suggested. So we ended up winning that battle.

But I was just blindsided. The president didn't know. The president thought that everybody had seen this thing and signed off on it. I talked to Rahm Emanuel afterwards. They had no idea that Treasury hadn't shown it to us until that meeting. ...

As far as you could tell, the president understood the issues?

That's right. I think he wanted to end bailouts. He wanted a bankruptcy-like resolution process that would impose accountability. I think that's what he wanted. I don't think that's what he got in the white paper that was unveiled that day.

But you'd have to get into the weeds to really pick up on how the thing had been restructured to really allow continued bailouts, which was unfortunate. It was not what the president wanted. ...

Tags:
Obama's Handling of the CrisisHow Do You Break up a Superbank?

12. "I don't understand" why Lehman was allowed to fail

Not so many months after Bear Stearns had been bought at a bargain price, why was Lehman Brothers allowed to fail?

I don't understand that. ... I think they thought they were going to do a sale to Barclays, and there really wasn't a plan B. … I think they felt there were legal constraints, and why they didn't have those with Bear Stearns but did have them with Lehman, I don't know. …

That's remarkable to me. As chairwoman of the FDIC at the time, you still don't know why they allowed that to happen?

Again, we were consulted when there was a major insured bank involved. We really were out of the loop when you dealt with all these big non-banks. …

Tags:
Lehman WeekendThe Fallout from Lehman

13. Why were AIG's creditors bailed out?

So when the AIG creditors are bailed, what's Geithner thinking?

I don't know. Thumbing through the GAO report that was done on this I think, again, it was they didn't feel like they had enough time to figure it out. And so when time is pressed and information is imperfect, I guess the tendency is to be more generous not less generous. ...

Tags:
AIG

14. "Hank's a pretty forceful person"

In the Oct. 13, 2008, when the bankers are all handed this $125 billion in various amounts, what kind of conditions were put on that money?

There were really not much. We had asked for commitments on loan restructurings for residential mortgages. There was a general commitment. There was no specific commitment.

But you had asked for this in your meetings prior when you talked to Paulson.

We had asked for that. ... But in fairness, I think here was the problem: They wanted everybody to take the money, and probably most of the banks around that table didn't need the money, right? ...

So Hank Paulson is worried that they're not going to take the money.

So they had to make it generous. And the reason they needed everybody to buy off was because there were a few institutions like Citi, Merrill Lynch, I think, Morgan and Goldman, they had at least been able to access private capital, but they were having some troubles too. But the rest of them probably didn't need it.

So to use your words just now, they were buying them off?

Well, buying them off in the sense that if they didn't get ... all the major institutions to take it, then the weak ones would have a big target on their forehead. ...

They didn't want the market to differentiate. They wanted to lump everybody in together, but that meant that they had to force the stronger banks who didn't need the money to take it. And that meant that they couldn't put many conditions or restrictions on it or otherwise the strong banks wouldn't take it.

So the federal government, essentially, the Treasury is begging?

Hank's a pretty forceful person. I would say he was pressuring. He was significantly pressuring.

But he had a weak hand in a sense?

He absolutely had a weak hand. ...

Tags:
Bailing Out the BanksTARPHenry Paulson

15. The power of the Wall Street lobby

So the white paper comes out, and this launches the Dodd-Frank process. The banks gear up and are busy lobbying at this point. Do they find friends on the Hill? Do they affect that legislation?

They've got a lot of friends on the Hill. They did impact that legislation, absolutely.

This is one of the most powerful lobbies that Washington has ever seen.

It is, and they got too big as part of the market; they got too big as part of the political process.

Gretchen Morgenson's book *Reckless Endangerment* chronicles what Fannie did, how Fannie got its tentacles everywhere through not just lobbying and campaign contributions and hiring staff and all of that, but also through funded research with academics, with contributions to some community groups.

I think a lot of the big banks took a page from that same playbook. So it wasn't just the PAC contributions which are significant, but it's hiring former members of Congress and staff. It's funding research that supports your position. It kind of comes from you at all directions.

So even in their weakened position with this horrible financial crisis, they still had a lot of influence. And I think also this ideological dogma of self-correcting markets had taken hold and it was very, very difficult to dislodge, even with all these problems that were clearly related to just basic fundamental regulatory shortfalls. ...

If we'd just had higher capital standards for banks and they had mortgage lending standards that applied to everybody, so much of this could have been avoided. ...

Give us a sense of the power of the banking lobby and what it puts you as regulators up against. How does it work? How do they operate?

Well, it is tremendous. First of all, there are these ongoing relationships. Regulators aren't supposed to lobby, and we shouldn't lobby. We provide tactical assistance. We respond when asked our views.

And Congress generally very freely asks for our views, so it gives the opportunity to have a robust dialogue. But there are actual legal restrictions against lobbying by regulatory agencies, so it needs to be weighed into the balance.

Then [there is] also regulatory agency. The only thing we have are the force of our policy arguments. We don't have campaign contributions. We don't have big paying jobs to hire staff and former members of Congress. We don't have any of that.

So if we can't make our policy case -- and that was one of the reasons why I interacted so frequently with the media -- we needed public help on this, because we didn't have money, and we shouldn't, to counter all this lobbying. ... And these lobbying people don't have to disclose their relationships with the banks. …

... The notion out there on the street ... is that the banks have us over a barrel. That the bank lobbyists buy favor in Washington and that regulators like yourself really are at a tremendous disadvantage in terms of making any progress. ...

They have more influence than they should.

The optics are bad, as you would say.

Well, you can't not talk to them. ... And the fact that you meet with them or talk with them doesn't mean that there's something bad going on. You need to get input from a variety of sources to make rules.

But you do need to make sure that it's balanced input, that you're hearing from everybody, not just big banks, and that your decision is based on what's good public policy, not what some big bank lobbyist wants.

So do the big banks have too much influence? Yes. Is it as bad as people think with the regulators? No, I don't think it is. ...

Tags:
Wall Street LobbyingCan Dodd-Frank Work?
Fannie & Freddie

16. **What progress have we made?**

We still haven't seen results in the economy even though the banks have been given billions of dollars to loan. We still have banks that are too big to fail, that are systematically risky institutions. What progress have we made?

There has been progress in raising bank capital levels and requiring that they rely more on long-term funding, so they are more stable from that standpoint. ...

Europe hasn't done much of anything to stabilize their banks.

But we're tied to this banking system. It's all one banking system.

We are. That is true. ... I have done as much as I can -- and probably made myself unpopular with a lot of people in Europe -- to try to bring more public attention to that. Because I don't think the problem with regulatory capture is much worse in Europe in that there is just no separation between the big banks and their regulators. It is a very close relationship and one that I wish the political leadership in Europe would look more closely at, because I think that's a real problem.

But we have made progress. I think the lending standards are better. The Fed did finally move ahead, at least with the high-risk mortgages, and have lending standards across the board.

But we still have "too big to fail."

But there has been progress there too. There are tools to resolve these institutions now. There's been internal planning at the FDIC to be able to put them in a resolution should one of them get into trouble. They are now required to do plans to show how they can be disassembled. ...

... But we still have a system that looks to me [like] we could be back where we were in 2008.

That it could change on a dime? You're right. We absolutely could be.

I think the lack of tangible progress is frustrating to people. I'm not going to say what's happened is near enough. It's not near enough. But in fairness to the regulators, capital is much higher. Liquidity, the funding of banks is much more stable. I think there has been significant improvement there.

We need to be vigilant. They're backsliding already on their funding structure and funding with long-term debt, but there have been improvements there.

Tags:
Can Dodd-Frank Work?Are We Safer?Too Big to Fail

17. **The "one single thing" that could have helped during the crisis**

In your opinion, if all the banks were required to have 25 percent capital levels, would it hurt anybody?

They will tell you that they can't make their return on equity, that nobody would invest in them if they had capital that high because the higher capital required, the more shareholder equity you require. [The more] shareholders are put in your bank, the lower their returns are going to be. That is what they will tell you. I don't know that the analysis bears that out.

Certainly non-financial institutions operate quite profitably with much less leverage; some with zero leverage. So I think more analysis needs to be done at that.

We're up to 9.5 percent for the very largest institutions, which is a huge improvement. And that's tangible common equity, which was 2 percent under Basel II. ...

But even at that level, they're fighting it tooth and nail, which is why people like yourself in the media and the public in general needs to focus on this and exert counter pressure, because we need to get those capital levels up.

If there's one single thing we could do that would have helped during this crisis and will help make sure it doesn't happen again, it's higher capital.

When will banks be required to meet those capital 9 percent requirements?

It doesn’t kick in until the end of 2018, but my guess is they will get there earlier. ...

So what you're saying is that we're a little bit safer but we're not safe enough?

That's exactly what I'm saying. We can get there, but the only way this is going to happen [is] to counter all the lobbying pressure, is political understanding and support of what regulators need to do. [If] there's not popular pressure on the other side, it's just not going to get done.

18. **Was Obama well served by Tim Geithner?**

Do you think there's real support for that by the president?

I hope so. I think he is, but I think he needs to make sure he's got an economic team that's also committed to that same agenda.

Geithner … is really the last man standing in the Obama economic team. What is it about him that makes him a permanent fixture of this administration?

I think he and the president have a very good working relationship. I think the president values his advice, and it's his job to pick his own advisers.

Do you think the president's been well served by Geithner?

I think you need to look at the objective effects about what's going on with our fiscal situation and our economy and make that decision based on that.

Well, that would--

Not say good things. No, it wouldn't.

The presumption was that if the banks get this money, they will lend it. Small businessmen will get the money. They will hire people. And the economy, which is dependent on consumer spending, will pick up.

Right.

It didn't happened.

It didn't happen. Not only that, but I think with the bailouts we propped up a bloated sector, and I think that they're a drag on the economy right now. ...

Other people raise the issue that they drain the best and brightest from our schools?

Now that's true. I'll give you an anecdote: When I was still a chairman at the FDIC, I went to an Ivy League school to give a presentation, and there was a nice reception afterwards for some students. There were five young women standing around me talking, and they were wonderful, bright, ambitious, optimistic young people. And three of the five we're going to go work for Goldman Sachs.

You've got to credit Goldman; they recruit very smart people. But it is that siren song of money and prestige and power. I would like those smart people to go find the next cure for cancer or more ways to do renewable energy, or increase our manufacturing base.

I want the smart people to go into the real economy and do all the things that we need smart people to do there too. It's hurt us. We didn't have a sustainable model. We had a hyperdrive model based on a juiced-up housing market and a juiced-up financial sector. ...

Tags:
Obama's Economic TeamTim Geithner

19. ## Why has no one gone to jail?

Why has no one gone to jail?

I'll even take just paying money.

Paying a fine?

Paying out of your personal pocket, yes. That's another adverse outcome of the bailouts. When a bank fails we, the FDIC, sue the executives. We sue the internal board members. We sue a couple people and we go after personal assets. You don't have that when you bail them out. ...

... How do you account for the fact that hundreds went to jail in the previous banking scandal in the '80s and no one has gone to jail here?

> I don't know. I think it's a combination of things. I think the line between fraud and just cluelessness or looking the other way -- it's sometimes hard to figure out where to draw that line.
>
> I think clearly with the original level there was a lot of fraud. There was a lot of dressing up of documents. ... The question is, as you go higher and higher up the management chain, did they know what was going on, or were they just looking the other way? Or were they just being lax in terms of checking, as opposed to actually know it?
>
> [If] they were just being lax in terms of checking, that's not necessarily criminal behavior. It's negligent behavior and could be subject to civil fines and penalties, but not necessarily criminal. ...

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