YPFS Lessons Learned Oral History Project: An Interview with John Oros

John Oros
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Introduction:

The Yale Program on Financial Stability (YPFS) interviewed John Oros regarding his time as managing director at the private investment firm J.C. Flowers & Co. In the fall of 2008, he worked with Lehman Brothers, Merrill Lynch, and American International Group, advising and negotiating on their behalf with the leading banks, investment companies, and federal regulators to help these firms avoid liquidation. Oros served as chairman of the Federal Savings and Loan Council from 1987–1989 during the savings and loan crisis, when 747 S&Ls failed. Before that, he specialized in investment banking at Goldman Sachs, rising to general partner.

Oros is currently an operating partner at J.C. Flowers & Co. and advises on numerous corporate boards. He has endowed a chair in the business school and established a business speaker series at his alma mater, the University of Wisconsin.

This transcript has been edited for accuracy and clarity.

Transcript

YPFS: You served as chairman of the Federal Savings and Loan Council for two years during the Savings and Loan crisis, when 747 S&Ls failed. When did you see that crisis coming, and what interventions did you take during that crisis?

Oros: That was a matter of interest rate risk that had occurred on the savings and loans. Their basic problem was that they had made a lot of 30-year fixed rate loans, and interest rates went up a lot, and their cost of money exceeded their yields on their portfolios. They tended to solve their problems by issuing things like subordinated ventures as opposed to real equity to recapitalize

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1 The opinions expressed during this interview are those of Mr. Oros, and not those of any of the institutions with which he is or was affiliated.
2 A stylized summary of the key observations and insights gleaned from this interview with Mr. Oros is available here in the Yale Program on Financial Stability’s Journal of Financial Crises.
themselves, and it went to extremes. That was a very different crisis than the financial crisis almost 17 years later.

YPFS: Did you think there were similarities?

Oros: Yes. Basically, borrowing short and lending long was very common in both crises, with some differences in the way it was done. I think mis-matching interest was essentially the problem, once again.

YPFS: In a book called The End of Wall Street, the author, Roger Lowenstein, wrote that as managing director of J.C. Flowers during the crisis, you had just come back to Kennedy Airport after a 22-hour flight from Australia and you went right to AIG that evening. You wanted to know how much cash the company had, and no one seemed to know. Can you describe that weekend—September 12–14, 2008—and the decisions that were made? Did you anticipate what you were heading into?

Oros: No, it was unknown. What I actually did is I came back from Australia from a business trip to go to Lehman Brothers. We went to Lehman Brothers on a Wednesday night and stayed there Wednesday and Thursday, working with Bank of America to buy Lehman Brothers. In the midst of that meeting, we received a phone call from AIG saying that they were going to run out of cash by the following week, so, a part of our team went down to AIG from Lehman Brothers. That was all the same weekend.

The weekend before was the weekend that Hank Paulson put Fannie Mae and Freddie Mac into conservatorship. So, the wheels had started to come off the bus by the time of the conservatorships and the government's stepping in with Freddie and Fannie the weekend before. These events were starting to pile up on each other. Freddie and Fannie led to Lehman, which led to AIG, et cetera. It was a domino effect.

We were looking to make investments, and we basically told the Treasury and the Federal Reserve that to buy Lehman Brothers, we would need to have a big reserve fund with a blind pool of assets, which was yet to be determined, that would have to be set aside and guaranteed by the government, or there was no way that anyone could buy Lehman Brothers without it. They were bound and determined to do it with an industry settlement of $10 billion, for the industry to come up with a reserve pool for whoever it was that bought [Lehman]. They were trying to sell it to Barclay's Bank with a $10 billion reserve, and that deal was quashed by the Financial Services Authority [FSA] of the United Kingdom, the agency that regulated financial services in the United Kingdom. FSA in the UK wouldn't let Barclays do that deal.

So, Lehman wound up going into bankruptcy, and we made a proposal to buy AIG, along with forbearance. What we were asking for there was direct access to the Federal Reserve's discount window for an insurance company, which is
something they were not prepared to do, and were unwilling to do until after
the Lehman Brothers bankruptcy, and not until after AIG proved that it had
failed. In other words, there was a period of time when Hank Paulson gave a
speech saying we were not going to give any assistance to AIG, and then the
next thing you know, they opened the Fed discount window and gave an $80
billion assistance package, all within 24 hours. But that didn’t happen until
the bankruptcy of Lehman Brothers was announced Sunday night, and this
didn’t happen until Tuesday morning at AIG the following week.

So, I arrived in town on Wednesday and didn’t go home until the following
Wednesday, dealing with AIG.

And in the same weekend, when we were told that Bank of America and we
[J.C. Flowers] could not buy Lehman Brothers because the government
wouldn’t put up the assistance package, Merrill Lynch reached out to Bank of
America and said, "You can buy us this weekend," And Bank of America
completed that transaction, and J.C. Flowers acted as the adviser to Bank of
America, as an investment banking adviser, and we wrote a fairness opinion
on that transaction for Bank of America. It was all at the same time,
simultaneous. Lehman Brothers was first. That was put to rest because they
just said, "It's going to go bankrupt. It's not going to happen." That was
Thursday; Friday and Saturday and Sunday, both Merrill Lynch and AIG were
being dealt with. Merrill Lynch was a successful transaction, meaning it was
completed, and Bank of America did the rescue package for Merrill Lynch.
With AIG, the federal government stepped in the following week.

YPFS: Why do you think they stepped in with AIG and not with Merrill or
Lehman?

Oros: Good question. Hank Paulson is the only one that can answer that question.
Not stepping in at Lehman Brothers may have been the biggest mistake that
was made in the financial crisis. I would say that as much as they deny it, they
wish they had found some way to not let Lehman Brothers go bankrupt.

YPFS: Was that because they had taken so much heat regarding Bear Stearns?

Oros: Well, that's their job to take heat. But letting Lehman Brothers go bankrupt
was the wrong thing.

3 The Fed’s loan to AIG technically wasn’t from the discount window, but it was for $85 billion.
4 Lehman announced its bankruptcy filing in the wee hours of the morning of Monday, September 15, 2008
[LBH Inc Chpt 11 Bankruptcy 9-15-08_0.pdf [windows.net]]. Merrill announced its merger with BofA later
that same day (Bank of America to buy Merrill Lynch for $50 billion – Sep. 15, 2008 [cnn.com]). And the Fed
announced its loan to AIG on Tuesday, September 16 (Federal Reserve Board – Federal Reserve Board, with
full support of the Treasury Department, authorizes the Federal Reserve Bank of New York to lend up to $85
billion to the American International Group (AIG)).
Secretary Paulson and Timothy Geithner were leading that weekend. To what extent were you interacting with them?

They were listening to what we were telling them, and they were telling us what they were and were not prepared to do—Hank Paulson and Tim Geithner—both on the phone and in person at the Federal Reserve Bank of New York that weekend.

When bank rescues are done, what tends to happen is that the bad assets that the government is responsible for when they seize the bank are put into a pool, and reserves are put against them. With Bear Stearns there was a $30 billion pool of bad assets guaranteed by the government, and then J.P. Morgan was able to come in and deal with the rest of the crisis at Bear after that pool of toxic assets was removed.

In each of the other cases that we were involved with, Lehman Brothers and AIG, we made a proposal similar to the Bear Stearns proposal. Our objective was to buy the entire company with government assistance, and with partners. In the case of Lehman Brothers, we were partnered with Bank of America. In the case of AIG, we were partnered with Allianz, the large German insurance company. We were providing capital and expertise and doing workouts. In both cases, those institutions are large financial institutions that have lots of capital but were not particularly familiar with doing large distress transactions, which is the expertise that we had from previous transactions. J.C. Flowers had successfully, in the early 2000s, bought from the Japanese government a bank called Long Term Credit Bank of Japan and turned it around, and turned it into a bank called Shinsei Bank. We had also previously been on Washington Mutual, Inc. We wound up in 2008 buying a bank called IndyMac, and turned it around, along with other partners. J.C. Flowers has some expertise in and some experience with distressed bank purchasing, and the partners that were interested in putting up the bulk of the capital to do the AIG and Lehman Brothers transactions were interested in having us involved with them because of that.

[The government] decided not to assist in either transaction. In the case of Lehman Brothers, there was a bankruptcy. In the case of AIG there was a government bailout, but a purely government bailout, no private sector involvement.

What were the challenges at that time, and what were the successes?

Merrill Lynch was saved, and Bank of America and Merrill Lynch have become a great institution out of that transaction, and there was no government involvement. I say no government involvement, no direct bailout [in connection with the merger]. They [Bank of America], of course, participated
in the capital assistance plan. Every financial institution from Goldman Sachs to JP Morgan to everyone did. Every large institution received, and every bank in the country was eligible to receive an equity infusion from the government, which ultimately was repaid by those institutions. So, I would say that the Bank of America–Merrill Lynch transaction ultimately, as much as it was criticized at the time, was a very successful transaction. AIG has turned into a rescued institution. I think the big failure was Lehman Brothers going bankrupt. That was a terrible error.

AIG is a large, international insurance company today. It survived. It’s functioning. It employs tens of thousands of people. The government assisted it, just like it assisted all the other banks. Determining which banks should fail is really a difficult thing for the government to do. It determined that Lehman Brothers should fail. That was part of the problem; the collateral wasn’t good at Lehman and Merrill. And it determined that the others would be rescued or would be kept alive. The government provides assistance to institutions, and it is the lender of last resort. Determining when sometimes they do it and sometimes they don’t, can be very, very problematic.

YPFS: What were some of the challenges you faced, and what would you have liked to have done differently at that time?

Oros: The size of the originations of subprime mortgages, and the very, very sophisticated instruments that were created to fund those mortgages, and the lack of supervision by people who normally supervise the procedures of originating and securitizing mortgages failed. And the rating agencies all failed in their duties to properly insist upon adequate credit quality. Ultimately, they all failed.

YPFS: Had your analysis of the numbers revealed to you what was really going on, or did you accept the agencies ratings' determinations?

Oros: No. There were many signs that were leading up to the ultimate Lehman Brothers crisis all the way from late 2006, when Ameriquest, the largest subprime mortgage originator, essentially failed, and Citibank took it over. There was First Franklin. There was New Century. These were institutions where, as early as Thanksgiving of 2006, were showing first payment default rates of 10% on subprime mortgages. There were many, many, many signs. I believe there was a failure by those who were intended to bring discipline to

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5 Funded from the TARP, the Capital Purchase Program (CPP) was launched in October 2008 to stabilize the financial system by providing capital to viable financial institutions of all sizes throughout the nation. Beginning with the largest firms, which received the first investments, the program ultimately provided capital to 707 financial institutions in 48 states. [https://home.treasury.gov/data/troubled-assets-relief-program/bank-investment-programs/cap](https://home.treasury.gov/data/troubled-assets-relief-program/bank-investment-programs/cap).
the market to bring that discipline, principally the rating agencies, S&P and Moody's.

Freddie Mac and Fannie Mae also failed to execute their responsibilities. Everyone was worried about market share. If they didn't give the triple-A rating, S&P would. If S&P gave it and Moody's didn't, Moody's lost out. Freddie and Fannie were worried about losing those mortgages and losing that securitization. So, a quest for market share became stronger than the need to provide proper and adequate credit quality requirements and supervision for the structures.

The degree to which subprime mortgages supported triple-A-level securities was mind-boggling. In other words, the large percentage of securities that were backed only by subprime mortgages that were called triple-A was astounding.

One of our portfolio companies had a large business in creating securities, and we saw early indications of difficulties, and we, as early as March of 2007, exited those businesses, a year and a half before the Lehman Brothers crisis.

**YPFS:** At one point Secretary Paulson wanted to establish a Resolution Trust Corporation, similar to what was done after the S&L crisis, but it was not done. What do you think of that idea? Do you think it would have been helpful?

**Oros:** I have no idea what Hank Paulson wanted to do. The Resolution Trust Corporation was used to take pools of assets off the balance sheets of failed institutions and to put government guarantees on them and sell them. This crisis was much bigger than that. In this situation, we're talking about tens of trillions of dollars of losses. I have no idea what type of Resolution Trust Corporation Hank Paulson might have had in mind.

They wound up doing the Troubled Asset Relief Program [TARP], which provided direct equity infusions into the institutions, rather than taking the assets. In other words, the Resolution Trust Corporation took the assets of failed institutions and re-securitized them in government securities. In this situation, very, very few institutions failed. Most of them were kept alive with equity infusions by the government called TARP. They made direct equity investments to keep the institutions alive, which I believe was smart. Ultimately, it worked. We have had great financial success in this country since the financial crisis, and I don't know that there would have been the ability to close all the institutions and put their assets into government securities. I'm guessing this problem was much too big to simply governmentalize all the financial institutions in the United States and reissue their assets in the form of government securities.
YPFS: **What do you see as the major lesson learned from the Global Financial Crisis?**

Oros: Institutions have got to have adequate capital. They have to have an adequate stake in the decisions that are made. The major problem with the financial crisis, the mortgage crisis, was that there was the ability to originate mortgages at a very high price and risk and sell that mortgage and that risk on. Ultimately, it didn’t work, because everyone went to excess—Freddie Mac, Fannie Mae, the rating agencies, mortgage originators—all felt that they could originate the mortgage, sell the mortgage, and be done with it.

What we’ve come up with is a recapitalization of financial institutions, adequate capital standards, the Dodd-Frank Act, and the qualifying mortgage test, that all have been very, very important aspects of providing financial incentives, proper credit-taking, and taking credit responsibility for the types of assets that are originated, whether they’re held on the balance sheet, or whether they’re ultimately sold. Creating a higher standard of equity and creating a stake in the mortgages or securities, creating a responsibility for the creditworthiness of the mortgages and the assets of various types that are created was, I think, important.

YPFS: **Do you think there are sufficient regulations now, or do you see vulnerabilities?**

Oros: I’m sure a situation exists, no matter how many regulations there are, for individuals to find ways to take advantage of the situation. But, I believe that with the degree of equity that is required, our financial institutions have never been better capitalized, and we are rich in high-quality mortgages, high-quality assets of various kinds, auto loans, credit cards, et cetera. So, on balance, I think yes, the regulations are adequate.

YPFS: **What similarities do you see between the global financial crisis and the COVID-19 pandemic in terms of the economy?**

Oros: Both caused great disruption. I think the systems are functioning, and it’s probably due for a correction both in some cooling off in price and activity. There was so little activity for so long that we created an artificial shortage of housing, and there’s some heating up in pricing, and bringing up higher interest rates will tend to cool that down. Like a pendulum, it swings back and forth. I do not predict a housing crisis or a financial crisis.

Interest rates are going up and the Federal Reserve is using its authority to address inflation, that should cool things down.

Oros: I think what they’re doing now makes pretty good sense. We are not in a financial crisis.
Oros: The financial system is in great health today. The US system is particularly strong as a result of steps taken after the financial crisis, I believe, to a great extent. Specifically, important lessons were learned—to increase the equity of financial institutions, to increase the risk sharing and responsibility for assets originated by those financial institutions, and to maintain good credit standards by originating institutions. That’s what they did after the financial crisis. Those are good things.