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Henry M. Paulson Jr.

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Testimony by Henry M. Paulson, Jr.
Before the Financial Crisis Inquiry Commission
May 6, 2010

Chairman Angelides, Vice Chairman Thomas, and members of the Commission, thank you for the opportunity to testify today.

I served as Secretary of the Treasury during the recent financial crisis. I am proud of the work we in government did to save our nation's financial system from collapse and chaos, and our economy from disaster. Even so, the crisis caused human suffering that simply cannot be measured. The American people deserve—and policymakers will benefit from—an understanding of the broad and diverse causes of the crisis. The job of providing that explanation falls to this Commission, and it is an awesome responsibility.

Many mistakes were made by all market participants, including financial institutions, investors, regulators, and the rating agencies, as well as by policy makers. Most of these are well understood, and, importantly, policymakers are currently addressing some major regulatory structure and authority issues that either allowed the pre-2007 excesses in our system or made it difficult to address the crisis. Nonetheless a number of the root causes are not being addressed and remain sources of danger to our country.

I fully support your important mission, and I hope that my testimony today can assist it. I will start by giving my views on the fundamental causes of the financial crisis, and then turn to the specific topic of today's hearing—the so-called "shadow banking" system. My views are based on my long experience in the financial markets, my time as Secretary of the Treasury during the financial crisis, and the consideration I have given to these issues in the year-and-a-half since I left government.

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The roots of the financial crisis trace back to several factors, including housing policy, global capital flows, over-leveraged financial institutions, poor consumer protection, and an archaic and outmoded financial regulatory system—among many other causes.

Underlying the crisis was the housing bubble, and it is clear that several policy decisions shaped the home mortgage market. Excesses in that market eventually led to a significant decline in home prices and a surge of loan defaults which caused tremendous losses in the financial system, triggered a contraction of credit, and put many Americans—quite literally—out on the street. These excesses were driven in large part by housing policy. From 1994 to 2006, home ownership soared from an already spectacular 64 percent of U.S. households to a staggering 69 percent due to the combined weight of a number of government policies and programs. Fannie Mae and Freddie Mac, the government sponsored enterprises (GSEs) comprised a central part of U.S. housing policy. The GSEs operated under an inherently flawed model of private profit backed by

public support, which encouraged risky revenue seeking and ultimately led to significant taxpayer losses.

The United States has always encouraged home ownership, and rightly so. Home ownership builds wealth, stabilizes neighborhoods, creates jobs, and promotes economic growth. But it must be pursued responsibly. The right person must be matched to the right house (and consequently the right home loan), and in the years before the crisis we lost that discipline.

The overstimulation of the housing market caused by government policy was exacerbated by other problems in that market. Subprime mortgages went from accounting for 5 percent of total mortgages in 1994 to 20 percent by 2006. Consumer protection, including state regulation of mortgage originations, was spotty, inconsistent, and, in some cases, nonexistent. Speculation on rising home prices led to increasingly risky loans, including far too many home loans made with no money down. Securitization separated originators from the risk of the products they originated. Mortgage fraud increased, and predatory lenders and unscrupulous brokers pushed increasingly complex mortgages onto unsuspecting borrowers. The result was a housing bubble that eventually burst in far more spectacular fashion than most previous bubbles.

Global forces also played a significant role in causing the crisis. Imbalances in the world's economies led to massive and destabilizing cross-border capital flows. While other nations save, Americans spend. Consumption in this country is the norm, spurred on by low interest rates aided by capital flowing from countries, notably China and Japan, which have high savings and low shares of domestic consumption, and further encouraged by U.S. tax laws that discourage saving. We were living beyond our means, on borrowed money and borrowed time. Consumers, businesses, and financial institutions all overextended and overleveraged themselves with inevitably disastrous results while our federal and state governments continued to borrow heavily, jeopardizing their long-term fiscal flexibility.

Our financial institutions—including commercial and investment banks—were notable examples of this overleveraging. In general, these institutions did not maintain sufficient, high-quality capital, which left them unable to absorb the significant losses they incurred as the housing bubble burst. Many of them did not understand their liquidity positions fully. They held insufficient cash and cash equivalents, and instead relied overly on short term funding sources that ran dry as the credit markets contracted. These leverage problems were further exacerbated by a lack of transparency, which caused problems in subprime to infect other classes of assets. Like a tainted food scare, a relatively small batch of deadly products—securitized subprime mortgages—led to fear and panic in the markets for many mortgage securitizations, driving down the price of assets, which triggered huge losses and severe liquidity problems. Derivative contracts, including excessively complex financial products, exacerbated the problem. These instruments embedded leverage in institutions' balances sheets along with risks which were so obscured that at times they were not fully understood by investors, creditors, rating agencies, regulators, or the management themselves. Very importantly, a number of

financial institutions had woefully inadequate risk management and liquidity management practices that allowed these problems to grow and intensify, in a number of cases leading to failure of the institution.

Compounding the problems at these financial institutions was a financial regulatory system that was archaic and outmoded. Our regulatory framework was built at a different time for a different system, and it has not kept pace with the rapid changes in the financial industry. I noted during my time at Treasury the enormous gaps in authority, duplication of responsibility, and unhealthy jurisdictional competition. No single regulator had responsibility for overseeing the stability of the system. The result was that regulators were often unable to supervise the firms they oversaw adequately, they did not see the impending systemic problems that progressed towards a crisis, and they did not have the tools to contain all the harms that unfolded as institutions began to collapse. In March of 2008, this led me to recommend a blueprint for major reform of our financial regulatory system after a year-long comprehensive review.

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I will turn now to the specific topic of today's hearing: the "shadow banking" system, a term that refers to the large capital and credit markets outside the traditional banking system that provide credit for municipal governments, corporations, and individuals for short, intermediate, and long term funding needs. Before the crisis, these markets satisfied at least half of consumer and business credit needs and are one of the hallmarks of our advanced and highly developed capital markets. They have greatly benefited our nation, spurring growth and prosperity at all levels of our economy. They have enabled more people to receive higher education, more people to purchase homes, more people to start new businesses, and more people to plan effectively for their children's future. They have increased consumer choice, stimulated job creation, and allowed our system to diversify away from the large, concentrated banks found in other capital markets.

But like all activities in the financial sector, these markets were fueled by the global excesses and regulatory flaws I have already discussed. Inside and outside the traditional banking system, financial institutions overreached, financial services were misused, and financial products were misunderstood. In addition, our regulatory system was balkanized, outdated, and lacked the infrastructure to oversee these markets, something I had observed and attempted to reform throughout my tenure at Treasury. When the crisis hit, the stress it placed on these markets exposed many of these flaws, and these flaws in turn extended and exacerbated some of the effects of the crisis.

These problems must be addressed. Our financial system cannot move forward without fortifying the weak parts of its infrastructure. But in addressing these problems, we must make sure we retain the benefits of the underlying financial innovations. In our haste to deal with the flaws in the non-bank financial system, we should not move ourselves back to a system of consolidated, monolithic commercial banks. I am confident that a thoughtful process can achieve this.

I will provide a few examples of areas in the non-bank financial system where flaws were exposed by the recent crisis, but that can, in my view, continue to function productively with appropriate regulation and oversight. Some of these suggestions I put forward while I was at Treasury—both before and after the crisis. Others are based on my study and reflection in the time since I left government.

Securitization: Securitization is the process by which a collection of assets—for example, mortgages, car loans, or credit card receivables—are packaged together by an underwriter and then sold to a large group of diversified investors. Because securitization separated mortgage originators and underwriters from holding the risk of the loans they originate, it enabled subprime lenders to stop focusing on the creditworthiness of the loans they made, and instead focus solely on their ability to sell those loans upstream to underwriters. Underwriters in turn relaxed their underwriting criteria, relying on their ability to sell their securities into a booming market. Investors did not do due diligence on these investments, instead allowing their judgment to be guided by exuberant ratings agencies and risk sensibilities dulled by the benign market conditions and the complexity of novel financial instruments.

But securitization is not, in and of itself a bad thing. Proper securitization has greatly expanded the credit available to responsible consumers, by allowing loans that large commercial banks find unprofitable to be diversified among numerous financial institutions. A large amount of the credit available to consumers comes from this important market, including such useful products as credit cards, student loans, and small business loans. And, as we saw in the recent crisis, the functioning of these markets is critical to our economic success. In 2008, when the problems in the mortgage securitization market caused other securitization markets to grind to a halt, consumers and business found themselves choked off from funds, and productivity and prosperity soon declined.

That being said, reforms are unquestionably required. Better disclosure is necessary. Underwriters and originators should be required to retain some portion of what they sell. Requiring underwriters to keep some "skin in the game" will properly align their incentives with those of investors who end up holding the bulk of the risk. In addition, we must reform and strengthen oversight of rating agencies and eliminate those areas of our securities regulations and laws that reference third-party ratings, which have tended to serve as a crutch or an excuse, discouraging investors and regulators from doing the necessary credit analysis. These changes will provide the securitization market with powerful incentives to focus on creditworthiness and will lead to more responsible lending practices.

Repurchase Agreements: The repurchase agreement market is a major source of funding for financial institutions. A repurchase agreement—or "repo"—is essentially a form of short term secured lending. One institution sells a security—such as a Treasury bond, agency debt, or mortgage-backed security—to a counterparty for cash, and agrees to buy it back later, typically the following day, at the same price, plus interest. Institutions may engage in repos directly with one another or through a third-party intermediary who

administers the transaction and serves as custodian of the securities being transacted—a so-called “tri-party repo” transaction.

By the time the crisis hit, the repo market had grown to an enormous size at an astonishing speed. Architecture, infrastructure, and regulation had not kept up. Lending practices had become sloppy, lenders vastly expanded the collateral they would lend against, without demanding sufficient protection, and no single regulator had the necessary information and the authority for dealing with the attendant problems. Partly as a result, many firms placed too much faith in the market’s seemingly constant supply of easy liquidity. When the crisis hit, these problems came home to roost as the markets declined. Lenders became increasingly strict about the types of collateral they would accept, and borrowers consequently found their access to liquidity evaporating. Bear Stearns, for example, which relied heavily on tri-party repo to meet short term funding needs, saw its cash on hand drop from $18 billion to $2 billion in the few days before its rescue, due in part to its loss of access to the repo markets. The crisis of 2008 was characterized by a run on the secured borrowing of a number of financial institutions.

I believe the repo market can, and should, be able to function efficiently while serving us better during future periods of market stress. It makes sense for firms to be able to use their securities as collateral to fulfill certain short term funding needs, rather than being required to always obtain wholesale credit from large banks. For this to work, however, the market must be well supported by a robust infrastructure, appropriate technology, and intelligent oversight. For example, the Federal Reserve has sponsored an industry-led task for to develop enhancements to the policies, procedures, and systems that support the tri-party repo market, and I look forward to the results of those efforts, some of which should also be applicable to the broader repo market. In addition, the crisis has underscored the point that, even in a well functioning market, firms cannot rely on short-term funding in place of proper liquidity management.

Commercial Paper: Commercial paper refers to unsecured notes sold to investors outside of the banking system. These notes are very short term, with maturities from one day to not more than a few months. A variety of institutions relied on commercial paper for their funding. For example, large businesses used it as a means of obtaining short term financing based on their credit ratings. Financial institutions used it as a means to fund securitizations, so-called “asset backed commercial paper,” sometimes off balance sheet. The financial crisis exposed weaknesses in this market. As the financial industry came under stress, investors pulled back from the market, and when Lehman collapsed, even major industrial corporations found it difficult to sell their paper. The resulting liquidity crunch, showed that firms had overly relied on this short term funding and had failed to anticipate how restricted the commercial paper market could become in times of stress.

That said, the commercial paper market remains tremendously valuable. It has functioned effectively and transparently for a long time, proving a useful source of short term funding to many major industrial and financial firms and a stable, relatively liquid investment for money market funds and other large investors. But financial institutions and their regulators must be aware of the risks associated with its use. It should be used

to fund short-term requirements only and even then not be a disproportionate part of a firm's liability profile. Importantly, all commercial paper issuance should be backed up by bank lines of credit to provide greater stability to the market in times of stress.

Derivatives: Derivative contracts—including credit default swaps—serve a useful function in mitigating risk and making the capital markets more efficient. They did not cause the crisis, but they did introduce greater interconnectedness as well as embedded and hidden leverage into financial institutions' balance sheets, and, in many instances, they magnified the effects of other risks. For example, AIG, by serving as a counterparty to numerous credit default swap contracts, exposed itself to tremendous risk in the mortgage market and threatened the entire financial system with its potential failure, all while escaping the notice of regulators.

Better regulation of these products is clearly needed. Standardized derivatives should be traded on a public exchange, and nonstandardized contracts should be centrally cleared and should be subject to more regulatory scrutiny, transparency, and greater capital charges. Such regulations will encourage standardization, promote transparency, and penalize excessive complexity with capital charges, thereby restoring these products to their proper function—mitigating, not enhancing, risk.

Money Market Mutual Funds: Money market funds are an enormous industry, managing nearly $4 trillion in assets for over 30 million customers. These funds invest primarily in government securities and top rated commercial paper. Before the crisis, investors had come to believe that investing in these funds guaranteed them their principal back and complete liquidity, because the funds would always maintain a net asset value (NAV) of at least $1.00. In the immediate aftermath of the Lehman failure, money market mutual funds came under intense pressure, eroding investor confidence and causing redemption requests to soar. The money market funds in turn began to pull back on their commercial paper investments causing funding to dry up for those institutions that relied on that market for liquidity needs. Disaster was averted when we stepped in and guaranteed the funds in order to prevent the crisis from worsening.

I continue to think that these funds are great products and have the ability to offer consumers attractive returns, liquidity, and very low volatility and principal risk. But the expectation that these funds can provide better yields than Treasury bills or insured deposits, and at the same time provide complete liquidity and no loss of principal, is unrealistic. Consumers must be disabused of that notion for the market to thrive. To that end, the SEC has recently enacted new rules governing disclosure in this industry. I suggest that the SEC also explore whether fund managers should move from a fixed NAV, which makes money market funds resemble insured bank accounts, to a floating NAV. The funds would still provide great value, but as clients saw slight variations in principal, they would have a tangible indication that they were not investing in a bank account.

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The innovations of our modern financial system should be a source of pride. They are expressions of American ingenuity and inventiveness, and they will help secure our rightful place as a leader in the global economy. They also deserve thoughtful scrutiny and appropriate regulation, as they must be well understood and properly used. I am confident that the Commission, as it examines these issues in light of the recent crisis, will properly balance these important considerations.

Thank you, and I would be pleased to answer any questions.