6-1-2010

Agenda for Financial Crisis Inquiry Commission Retreat on Thursday June 3rd and Friday, June 4th 2010

United States: Financial Crisis Inquiry Commission (FCIC)

Agenda for Financial Crisis Inquiry Commission Retreat on
Thursday June 3rd and Friday, June 4th 2010
9:00am-5:45pm ET 8:30am-1:00pm ET
Woodrow Wilson Center, 4th Floor Conference Room
One Woodrow Wilson Plaza
1300 Pennsylvania Ave. NW, Washington, D.C. 20004

Day 1: June 3rd

1. **Overview of Retreat**
   (9:00-9:15am)

2. **Session One:** **Defining the financial and economic crisis**
   (9:15-10:45am)

   Background materials: Commissioners proposed definitions compiled by the staff

3. **Break**
   ***Beverages served at the conference room**
   (10:45-11:00am)

4. **Session Two:** **Discuss hypotheses/potential causes of the crisis**
   (11:00-1:00pm)

   Background materials: Commissioners hypotheses compiled by the staff

5. **Break for Lunch**
   ***Served at the conference room**
   (1:00-1:45pm)

6. **Session Three:** **Identify priorities and areas with agreement/no agreement among the Commissioners on hypotheses**
   (1:45-3:15pm)

7. **Break**
   ***Beverages served at the conference room**
   (3:15-3:30pm)

8. **Session Four:** **Discuss high-priority areas including cross-cutting issues requiring further investigation, research, and analysis**
   (3:30-4:45pm)

9. **Session Five: Discuss outline and writing of the report**
(4:45-5:45pm)

Background materials: Draft outline attached and the document on the process for review and approval of the report is attached

10. **Down Time**
(5:45-7:15pm)

11. **Commission Dinner with Senior Staff**
(7:15-9:30pm)
Location: Kellari Taverna, Wine Room, 1700 K Street, NW, Washington, DC
Site Phone: (202) 535-5274

Day 2: June 4th

1. **Session One: Presentation by the Credit Rating Agencies Working Group**
(8:30-9:30am)

2. **Session Two: Presentation by the Shadow Banking Working Group**
(9:30-10:30am)

3. **Session Three: Presentation by the Housing Working Group**
(10:30-11:30am)

4. **Break**
***Beverages served at the conference room**
(11:30-11:50am)

5. **Session Four: Progress Report by the Derivatives Working Group**
(11:50-12:20pm)

6. **Session Five: Progress Report by the Too Big-To-Fail Working Group**
(12:20-12:30)

7. **Session Six: Progress Report by the Excess Risk and Speculation Working Group**
(12:30-12:40pm)

8. **Session Seven: Progress Report by the Macroeconomics Working Group**
(12:40-12:50pm)

9. **Wrap Up and Adjournment**
(12:50-1:00pm)

Financial Crisis Inquiry Commission

Agenda Item 2 for Retreat on June 3, 2010

Defining the financial and economic crisis – Commissioner Definitions

<u>What is or was the financial crisis?</u>

Chairman Angelides

"The financial and economic crisis refers to a) the freezing up of credit and liquidity and the downward spiral in asset values that began to accelerate in 2007, reached critical mass in 2008 with the collapse or near collapse of major financial institutions, and resulted in the commitment of trillions of dollars of taxpayer assistance to stabilize the financial system and b) the concurrent and related damage to the economy that resulted in millions of Americans losing their jobs, their homes, and their life savings.

A cause would be anything that contributed significantly to the creation, acceleration, or amplification of the crisis."

Vice-Chairman Thomas

"The financial crisis which began in 2007 was characterized by a large decrease in wealth, a credit crunch, and slowing of economic activity above and beyond a normal business cycle. It was prompted by the collapse of the bubble in the housing sector. The crisis was further distinguished by a loss of confidence in financial institutions and freezing of financial intermediation."

Commissioner Born

Proposed paragraph defining the financial and economic crises:

"After an extended period of low interest rates and readily available credit, a real estate bubble and a larger credit bubble deflated, and the credit markets became seriously impaired. The credit crisis fueled the near collapse of numerous financial institutions and cascading losses in the securities markets and other financial markets, resulting in massive government intervention. The crisis spread to the real economy resulting in high unemployment, reduced output and massive foreclosures. The financial and economic crises are continuing. Their causes are the factors described in my hypotheses."

The mandate of the Commission is broad. The statute requires us "to examine the causes, domestic and global, of the <u>current financial and economic crisis</u> in the United States." (Emphasis added.) Thus, we need to look at the causes of both the financial crisis and the economic crisis, and in the view of Congress, these crises were continuing during the Spring of 2009 when the statute was adopted.

Indeed, I believe that both the financial crisis and the economic crisis are continuing today. Many of our financial institutions and financial markets are not functioning properly and are operating only with significant government support. Furthermore, increasing numbers of foreclosures, high unemployment and low economic output haunt our economy. Therefore, I do not think we can limit our examination of the crises and their causes to the period prior to the fall of 2008 as Peter Wallison seems to suggest in his memorandum of March 14, 2010. The crises are still with us, and we should examine the factors contributing to them without an artificial cut-off date.

Commissioner Georgiou

"The financial and economic crisis occurred when America's principal private sector financial institutions and government sponsored enterprises became insolvent or were rapidly careening toward insolvency, leading our public sector leaders, including the current President, his predecessor and leaders of both parties in Congress, to commit trillions of taxpayer dollars to bailouts of private sector financial institutions and government sponsored enterprises, based on their belief that permitting those institutions to fail in the normal course of our free market economic system would result in a crisis of even greater severity, with consequences even more grave than the very punishing consequences Americans have already suffered in losses of jobs, homes, wealth and dignity."

Commissioner Graham

"The financial and economic crisis can be seen in the military phrase: left of boom; right of boom. I would accept the Lehman collapse as the boom – the actions of private and governmental entities which contributed to that boom and the other related financial stresses are relevant. At least equally relevant is how those same entities and others that became involved responded after the Lehman boom.

If the rational for congressional establishment of our commission was a recognition that its role as a primary actor before and after the boom compromised its real or perceived objectivity in diagnosing the reasons for the financial and economic crisis, the rationale is even more persuasive after the boom when congress became more involved and energized than before the boom. Our independent assessment of how the various stimulus, bailout and other legislative actions contributed to lessening, exacerbating or neutrality the ongoing financial and economic crisis could well be our most valuable contribution to congress, executive agencies and the American people as they provide oversight and consider modifications to those actions.

Commissioner Hennessey

Those events in U.S. housing markets and in both domestic and international financial sectors that resulted in the following outcomes:

- An unprecedented _____% decline in national housing prices;
- An extreme increase in mortgage default rates;
- The failure and near-failure of hundreds of small, medium, and large American financial institutions (and many others in Europe);
- An interbank lending freeze in the fall of 2008;
- The freeze of certain securitization markets in the fall of 2008;
- The severe U.S. recession from Q3 2008 through Q2 2009;
- A U.S. budget deficit near 10% of GDP in FY 2009 and FY 2010.

Commissioner Holtz-Eakin

"The financial crisis was the widespread withdrawal of short-term funding, inability to transact in previously marketable instruments, and broad inability to evaluate the solvency of financial entities."

Commissioner Murren

1. A time of great danger or trouble whose outcome determines possible bad consequences relating to finances, financiers and the production and management of wealth - of the most recent date. (Based on New World Dictionary)

2. The financial crisis may be defined as a sharp transition into a recession as a result of unexpected factors that have created great uncertainty and threatened important goals for economic and financial stability thereby requiring a need for change. (Based on Wikipedia)

These definitions are pretty simple. I think we need to keep it simple in order to keep it accessible to the eventual readers and avoids getting bogged down in detailed technical aspects that we may debate. I appreciate the use of the word 'shock', in some of these definitions, but shocks can be positive (winning the lottery) while ‘crisis’ incorporates elements of danger or risk, so I like definitions not based on the idea of shock.

Commissioner Thompson

“The financial crisis in the US was essentially the freeze in the credit markets, prompted by the collapse of Lehman Brothers, and the resulting impact on business or economic activity across the country. During the initial phase of the crisis, credit was virtually unavailable to businesses, large or small, to finance “normal” activity, much less more strategic activities. Financing terms turned from very favorable (perhaps too much so) to onerous for even the simplest transactions, i.e. inventory financing, payroll, etc. and more strategic activities, i.e. business combinations, geographic expansion, etc, came to a complete halt.”

Commissioner Wallison

“As a prefatory note, I think we have to come to a common definition of what we are talking about when we talk about a financial crisis. I believe that the financial crisis is the freeze-up in lending and the sharp decline in business activity and employment that began in the fall of 2008, after Lehman’s bankruptcy. Everything that happened before that time is a candidate for a cause or an exacerbating factor. What the government did to ameliorate the financial crisis, in my view, was not a cause of the financial crisis. It was a result of the financial crisis. So I would exclude from the hypotheses consideration of any of the actions of the government, including bank bailouts, guaranteeing bank loans, insuring deposits, or guaranteeing money market mutual funds.”

Financial Crisis Inquiry Commission

Agenda Item 3 for Retreat on June 3, 2010

Discuss hypotheses/potential causes of the crisis – Commissioner Hypotheses

Commissioners' Hypotheses on the Causes of the Financial Crisis

FCIC Confidential

The multiple paragraphs below are direct quotes from the hypotheses submitted by various Commissioners. They have been rearranged in rough subject matter order to facilitate your review and discussion, but given the multiple concepts in many of the paragraphs the subject matter divisions are imperfect at best. No textual changes have been made, and no editorial judgment is intended. Formatting has been made uniform.

Regulation

1. Failure of adequate government oversight of financial markets, products and participants played a significant role in causing the financial crisis. It resulted in reduced transparency, weakened banking supervision, inadequate consumer and investor protection, increased speculation and leverage, and regulatory gaps that contributed to the crisis. **BROOKSLEY BORN**

2. The financial services industry used its growing financial and political power to persuade federal policy makers and regulators to adopt deregulatory measures. **BROOKSLEY BORN**

3. Erroneous economic theories that financial markets are self-regulatory and that there is no need for governmental oversight also contributed to weakened financial regulation. **BROOKSLEY BORN**

4. Failures of federal financial regulation include, among other things, the unregulated over-the-counter derivatives market, the Federal Reserve Board's attitude that it should not act to deflate asset bubbles, the Federal Reserve Board's tolerance of predatory and subprime lending, the failure to regulate mortgage origination, inadequate capital requirements for banks and other financial institutions, the undercutting of the Glass-Steagall Act, regulatory arbitrage among banking regulators, international regulatory arbitrage among countries, the preemption of state law, the weakening of private rights of action, and the failure to supervise investment banks and hedge funds. **BROOKSLEY BORN**

5. Bank capital regulation- Bank capital regulation, under Basel I and II, encouraged banks to

concentrate excessively in mortgages and to convert their mortgages to MBS. Under these rules, mortgages have a 50% risk weight (as opposed to a 100% risk weight for C&I loans), and MBS have a 20% risk weight. As a result, banks and others covered by Basel I and II were holding much less capital than they needed when losses from defaulting mortgages began to show up. **PETER WALLISON**

6. Insufficient regulation**-** Insufficient government regulation allowed mortgage originators to produce large numbers of subprime and Alt-A loans and allowed banks to buy and hold these high risk mortgages; changes in Glass-Steagall encouraged banks and bank holding companies to take risks on mortgages **PETER WALLISON**

7. Weak capital regulation of banks coupled with poor risk management practices increased the fragility of the system, while at the same time easy credit fueled a speculative boom in various markets – most concentrated in real estate/housing. **HEATHER MURREN**

8. Predatory lending- Insufficient or lax regulation allowed mortgage originators to sell unwary consumers on subprime and other low quality loans. When the bubble burst, the losses on these loans caused the financial crisis. **PETER WALLISON**

9. Some countries have fared better through the financial crisis than others have as a result of better regulation and management structures. For example, Canada is often cited as a country that has fared better as a result of tighter financial regulation and more consumer protections. **BOB GRAHAM**

10. Insufficient regulation of investment banks- SEC regulation of the largest investment banks allowed them to become overleveraged and dependent on short term financing through repos. They did not have sufficient liquidity to sustain themselves when declining asset prices (primarily MBS) caused creditors to withdraw or reduce support. **PETER WALLISON**

11. Public Sector Failures to Regulate Systemically Dangerous Private Sector Activity Contributed to the Crisis- During the last four decades, as a result of excessive influence over every level of government by the financial services industry, ideological opposition to public regulation of the private sector, and regulatory fragmentation that enabled market participants to dilute supervision through regulatory arbitrage, federal and state financial regulators inadequately enforced a wide range of laws, including capital requirements, transparent disclosure obligations and fiduciary due diligence obligations, all of which contributed to the crisis. **BYRON GEORGIOU**

12. Public Sector Failures to Regulate Systemically Dangerous Private Sector Activity Contributed to the Crisis- Regulators and law enforcement authorities failed in their obligations to police rampant fraud in mortgage originations, which resulted in extensive pools of mortgages unnecessarily expensive to borrowers and excessively profitable to lenders, leading to massive mortgage failures that contributed to the crisis. **BYRON GEORGIOU**

13. Public Sector Failures to Regulate Systemically Dangerous Private Sector Activity Contributed to the Crisis- Accounting practices, including mark-to-market on the upside and failure to enforce mark-to-market on the downside, a proliferation of off-balance sheet entities that hid liabilities from investors, creditors and regulators and a general regulatory failure to require financial statement clarity and allow opacity, permitted financial institutions to represent themselves as more solvent than they actually were, which left them unnecessarily vulnerable to modest market movements against them. **BYRON GEORGIOU**

14. The Inevitable Collapse of the Unregulated, Speculative Boom- The financial crisis was inevitable given the inadequacy and weakness of the regulatory system. The regulatory framework had not been updated to keep up with the dramatic evolution and growth of the financial sector; the resources and capability of regulators were inadequate for the task at hand; and years of deregulation and desupervision had taken its toll on the reach and effectiveness of regulatory efforts. The weakness of regulatory oversight was compounded by a growing belief in the effectiveness of self regulation and in an efficient, self-correcting market and by the growing power and size of a financial sector which successfully opposed needed oversight. While phenomena such as the real estate asset bubble or credit derivatives may have been proximate causes of the collapse, the lack of an adequate regulatory framework allowed extraordinary risk taking across the board, ensuring a speculative boom and bust of significant magnitude. **PHIL ANGELIDES**

15. Overly Lax Supervision-The failure of many regulatory agencies to execute on their stated mission was astounding. From the banking systems regulators who oversee the capital requirements of our financial system, to the Federal Reserve's role in monitoring credit standards, to the Securities and Exchange Commission's role in monitoring the clarity of the financial reporting of all market participants, to the financial institution's ability to "shop" for the best regulator, the governance and oversight system completely broke down. One might posture that the rate and pace of "financial innovation" out striped the regulators ability to keep up. This might suggest a need to reevaluate our system, particularly the role being played by the SEC, Federal Reserve and the Federal Deposit Insurance Commission, to ensure there is better clarity and accountability for those with important oversight responsibilities. **JOHN THOMPSON**

16. The Alternative Banking System- The creation and growth of the unregulated portion of the US financial system gave rise to unwarranted risk. So much of the overall market liquidity flowed through this system that it allowed its participants to avoid or skirt around the regulatory requirement of capital formation. Therefore, market participants were able to take on unwarranted levels of leverage without being challenged. Only when the bets being placed were proven to be wrong were they "obligated" to show the affects of the risk in their financial statements. **JOHN THOMPSON**

17. Fair value accounting- Accounting policies, particularly the mark-to-market requirement in fair value accounting, caused severe writedowns of MBS assets that were still flowing cash at near their expected rates; the writedowns gave a misleading impression of the real financial condition of the financial institutions holding these assets. **PETER WALLISON**

Asset Bubbles

1. The growth and collapse of a housing bubble was a primary cause of the financial crisis. (The creation and collapse of other asset bubbles, including commercial real estate, the securities market, oil and agricultural commodities, may also have contributed to the crisis.) **BROOKSLEY BORN**

2. Low interest rates maintained by the Federal Reserve Board for an extended period helped to fuel the housing bubble. **BROOKSLEY BORN**

3. Securitization of subprime mortgages and growing investor demand for such securitized instruments played significant roles in fueling the housing bubble. **BROOKSLEY BORN**

4. Predatory lending and the development of subprime mortgage instruments supported the growth of securitization. **BROOKSLEY BORN**

5. The credit rating agencies improperly rated many CDOs as high quality investments and thus encouraged investment in them. **BROOKSLEY BORN**

6. The origination-to-distribute model along with the undue reliance on credit rating agencies and credit default swaps resulted in a lack of responsibility for creditworthiness in the securitization process. **BROOKSLEY BORN**

7. Excess Liquidity Inflated Asset Bubbles, Sowing the Seeds of the Financial Crisis that Occurred when the Bubbles Burst- Excess international demand for dollar denominated assets perceived to be safe havens for dollars accumulated overseas as a result of trade imbalances enabled American market participants to create and sell financial instruments of dubious quality inaccurately characterized as AAA, which contributed to the financial crisis when they failed. **BYRON GEORGIOU**

8. Shocks- I think the underlying shock was the bursting of an essentially world-wide bubble in real assets, residential real estate, commercial real estate, etc. A key feature was world-wide low real interest rates. In the U.S. this was augmented by investor speculation and perhaps fraud. **DOUG HOLTZ EAKIN**

9. International money flows. International imbalances in the flow of funds—high savings rates in emerging economies seeking high returns from supposedly safe assets—produced demand for AAA quality dollar assets such as subprime MBS. **PETER WALLISON**

10. Securitization and credit rating agencies- Securitization and deficient analysis by credit rating agencies encouraged large numbers of financial institutions in the US and around the world to acquire supposedly high quality assets, such as AAA tranches of mortgage backed securities, which ultimately suffered losses **PETER WALLISON**

11. Perfect storm- This is not a 'no-fault' hypothesis, but rather the notion that a number of sweeping big environmental shifts (easy credit, securitization) occurred at the same time, and that several key decision points occurred in the face of this convergence, and bad decisions were made due to greed or negligence (changes in regulation, speculation, failure to supervise, compensation practices). **HEATHER MURREN**

12. Monetary policy- The Fed's monetary policy produced a housing bubble; when the housing bubble collapsed it produced the financial crisis. **PETER WALLISON**

13. Government housing policies- Government housing policies (Fannie and Freddie, FHA, CRA) produced substantial government demand for large numbers of subprime and Alt-A loans; these loans drove the growth of the housing bubble; when the housing bubble deflated, these loans, totaling half of all outstanding mortgages, defaulted at very high rates, causing the losses at financial institutions that became the housing crisis **PETER WALLISON**

14. The Collapse of the Housing Bubble- The crisis was triggered by the collapse of a housing bubble which was fueled by factors such as low interest rates as well as rapidly escalating subprime lending and securitization, mortgage fraud, and housing market speculation which was unchecked by the regulators and facilitated by participants throughout the business. The collapse of the bubble was accelerated, amplified, and transmitted through the financial system by, among other things, unregulated OTC credit derivatives, the shadow banking system, the interconnection of financial institutions, and a lack of transparency resulting in part from regulatory gaps or failures. **PHIL**

ANGELIDES

15. Excess Liquidity Inflated Asset Bubbles, Sowing the Seeds of the Financial Crisis that Occurred when the Bubbles Burst- Government policies favoring homeownership were inappropriately pursued through creation of government sponsored enterprises that utilized their explicit and implicit government guarantees to raise cheap capital, and originate and guarantee mortgages of dubious quality, adding to an over-concentration of capital in the housing markets and the bubble, which contributed to the crisis when it burst. **BYRON GEORGIOU**

16. Excess Liquidity Inflated Asset Bubbles, Sowing the Seeds of the Financial Crisis that Occurred when the Bubbles Burst- Tax policy favoring home ownership contributed to an over-concentration of capital availability in the housing sector, leading to a housing price bubble that contributed to the financial crisis. **BYRON GEORGIOU**

17. Many investors were heavily exposed to risky mortgage-related assets because they discounted the possibility that home prices could fall at the national level. Investors did not fully account for the housing bubble being driven by national factors rather than regional specific factors. **BOB GRAHAM**

    a. Historically, home prices periodically fell regionally, but these regional declines did not show up as large national declines. As a result, investors apparently assumed that nationally diversified portfolios would fair reasonably well if the housing bubble burst in particular regions. Of course, enough large regions saw price declines as the bubble burst so that prices fell at the national level.

    b. What made this housing cycle more national than previous cycles? Perhaps, previous regional housing booms had been driven by regional economies. When those regional economies felt negative shocks, those regions saw home price declines. In the latest housing boom, as mortgage markets had become increasingly national, national factors such as speculation, loosening underwriting standards and low cost of mortgage credit played a significant role. When these standards were tightened, borrowing costs rose on a national basis, and speculators left the market, large regions saw price declines, which resulted in national price declines.

18. Housing Price Bubble and the Motivation of the Market Participants- The US housing market saw an incredible growth spurt from 1998 through 2007. Housing prices rose at a rate 3X the historical rate of growth and this phenomenon facilitated a combination of events. US home owners thought they had accumulated a substantial and safe level of wealth and were willing to take advantage of it through aggressive mortgage refinancing programs being offered by system-wide players. By refinancing mortgages, many home owners were able to borrow against inflated house valuations to fund a range to items, from college tuition to consumer household expenditures to vacations/holiday excursions, all of which were tax deductible. The mortgage underwriters were able to take advantage of the “originate to distribute” model of financing that almost completely eliminated their risk in underwriting and transferred risk to an opaque securitization market for asset backed securities. And, the home builders were able to initiate new construction projects at an unprecedented rate, which in turn fueled a false sense of economic growth across the entire economy. The “vicious circle of housing price valuation growth” was at the core of the systems growth and eventual collapse. **JOHN THOMPSON**

19. Excess Liquidity Inflated Asset Bubbles, Sowing the Seeds of the Financial Crisis that Occurred

when the Bubbles Burst- Excessively loose Federal Reserve monetary policy enabled flows of cheap credit that produced bubbles in a variety of asset classes, including commercial and residential real estate, and equity securities, among others, the popping of which contributed to the crisis. **BYRON GEORGIOU**

20. The collapse of the housing bubble triggered the crisis. **BILL THOMAS**

21. The nature of the housing bubble and its collapse was unique compared with previous asset bubbles which did not cause financial crises (e.g. the dot-com bubble), because: (a) These were debt assets, as opposed to equity assets; (b) Housing-related assets were used as safe collateral in the "shadow banking" system/interbank lending system; (c) Certain large, systemically important financial institutions held outsized exposures to housing related assets; (d) A large proportion of the wealth of Americans were stored in their homes – thus, the collapse of the bubble led to a massive decrease in the wealth of a large and diverse group of Americans; and (e) The housing bubble was a much larger asset bubble than those experienced in the past. **BILL THOMAS**

22. The causes of the housing bubble:

    1. Macroeconomic factors were a major cause of the housing bubble

        a. Housing is very sensitive to interest rates, and domestic interest rate policy was kept too low for too long
        b. Housing is very sensitive to interest rates, and international investment in the United States depressed domestic interest rates
        c. The international demand for safe investments generated increased demand for U.S. housing-related assets

    2. Government policy was a major cause of the housing bubble
        a. The government subsidized private investment in housing
        b. In response to their affordable housing mission, the GSEs decreased their underwriting standards, increasing the number and decreasing the quality of loans in the housing market
        c. Government policies in favor of homeownership created difficulties for those parties interested in slowing the growth of housing in the U.S.
        d. Quasi-regulatory status was given to credit rating agencies
    3. Private investors were a major cause of the housing bubble
        a. The mortgage finance pipeline (the originate-to-distribute model and securitization) lowered underwriting standards by:
            i. Incentivizing mortgage brokers to originate high-yield (and low quality) loans
            ii. Obscuring the loan quality of mortgages to the final investors, and thus making it more difficult to do due diligence and leading to deterioration in underwriting standards
        b. Complex securities and derivatives increased financing available for housing by expanding the market for investments housing-related assets
        c. New mortgage products increased demand for housing by allowing investors to purchase homes that they had not been able to previously

d. Private demand for housing was driven by investors that were speculating on future increases in home values and otherwise lacked the capacity to meet their mortgage payment obligations
e. Credit rating agencies gave overly optimistic ratings to housing related assets, increasing investor demand. **BILL THOMAS**

<u>Interconnectedness</u>

1. The interconnectedness of financial institutions through over-the-counter derivatives transactions exacerbated the financial crisis by spreading counterparty risk throughout the financial system, multiplying risk through speculation and leverage, and fueling panic and suspicion through lack of transparency. **BROOKSLEY BORN**

2. CDS- Credit default swaps created nontransparent interconnections among large financial companies that caused all of them to weaken when some began to suffer losses. Naked CDS created incentives for some CDS counterparties to cause the losses they had insured themselves against. **PETER WALLISON**

3. Propagation Mechanism- The physical assets were backed by financial assets – equity and debt instruments. The latter experienced a decline in underwriting standards due to: Ready buyers (notably Fannie/Freddie) of low-quality mortgages, Ready buyers of the securitized mortgages (notably international investors looking for "safe" assets,) perhaps fraud (I am agnostic.) When the physical asset bubble burst, these financial claims were doomed. **DOUG HOLTZ EAKIN**

4. The interconnectedness of large financial institutions contributed to systemic risk. Thus, the failure of one institution, such as Lehman Brothers or AIG, threatened the stability of others and contributed to a freeze of the credit markets. **BROOKSLEY BORN**

5. Moral hazard- The rescue of Bear Stearns led the financial markets to believe that all financial firms larger than Bear would be rescued. This created moral hazard, so that other market participants (like the Reserve Fund) did not believe that they had to protect themselves against the failure of Lehman. Lehman's failure caused a common shock that created the financial crisis. **PETER WALLISON**

6. Interconnectedness- Large financial institutions are interconnected, so that Lehman's bankruptcy caused a systemic breakdown. If the government had the authority to take over companies like Lehman and wind them down, this would not have occurred. **PETER WALLISON**

<u>Transparency</u>

1. The lack of transparency resulting from the use of off-balance sheet vehicles and products and other accounting problems added fuel to the crisis. **BROOKSLEY BORN**

2. Transparency of losses- Lack of transparency in the balance sheets of financial institutions, or the inability of the markets to understand where the losses on complex CDOs had actually been incurred, led to an investor panic that became the financial crisis. **PETER WALLISON**

3. Opaqueness of credit derivatives- The absence of netting, inability to identify those that were genuinely AAA versus not, etc. fed the widespread panic. I don't know what I believe about the credit

rating agencies today! **DOUNG HOLTZ EAKIN**

4. Lack of transparency and disclosure across broad segments of the economy, coupled with poor compensation practices and lack of personal accountability, led to imperfect information and poor decision making by corporate managers, investors and in individual households. **HEATHER MURREN**

5. Lack of Transparency of Systemic Risk- Much has been and will be written about the opaqueness of the US financial system with its many levers to amplify the returns of market participants. But, the complexity of today's financial markets, with its many interconnected global players, makes the system both robust and fragile. By creating unique products to off-set risk, the system is able to grow and prosper. But, the lack of visibility into the aggregate level of risk or the concentration of risk by a single player or sector, makes the system quite fragile. In no single place is there a clear view of the aggregate risk being taken by all the players within the system itself. The growth in derivative instruments, particularly credit based instruments, was a significant driver of the overall market and the aggregate risk undertaken within the system. The significant level of activity driven by derivatives or options trading coupled with the almost total lack of transparency into this important market element was a major contributor to and amplifier of the financial crisis. **JOHN THOMPSON**

Risk

1. Risk management- Risk management at financial institutions was ineffective, allowing these institutions to take unnecessary risks. **PETER WALLISON**

2. Poor risk management practices by financial institutions including the use of inadequate models contributed to the crisis. **BROOKSLEY BORN**

3. Executive and employee compensation designed to reward short-term risk taking over long-term performance contributed to the crisis. **BROOKSLEY BORN**

4. Inadequate capital requirements for commercial banks and other financial entities permitted too much leverage and liquidity problems. **BROOKSLEY BORN**

5. Compensation- Badly designed compensation systems at financial institutions encouraged employees to take substantial risks without regard to the long-term effect of these risks on the firm's viability. **PETER WALLISON**

6. Failure of risk-management in our largest institutions. In the end the large financial institutions had too little diversification and suffered. The question is why? This is of particular importance, I think, with regard to Fannie/Freddie because their failure is so expensive and was so shocking. The moral hazard of too-big-to-fail fits here. I can't decide how important it is. **DOUG HOLTZ EAKIN**

7. Compensation was structured in such a way as to create excessively risky behavior, both in the chain of mortgage origination and securitization and in executive behavior. **BOB GRAHAM**

    a. Did mortgage brokers get paid to encourage borrowers to take loans they couldn't afford? Did these incentives to increase the supply of "toxic" mortgages exist all the way up the chain to investment houses selling mortgage-related structured products?

b. Did executive compensation structures, which include limited liability for losses, create a mismatch between incentives for gain and the desire to avoid losses?

8. Misalignment of Private Market Incentives and Abdication of Responsibility and Accountability Contributed to the Crisis- Corporation compensation structures enabled management to profit from taking on excessive risk, earning short term bonuses based on the achievement of financial targets that turned out to be illusory over the long haul, thereby undermining the capital base of the corporation, and contributing to the financial crisis by rendering the company incapable of withstanding losses suffered when the excessively risky bets went bad. **BYRON GEORGIOU**

9. A Tilted Playing Field- The boom and ultimate bust was driven by a range of incentives and conflicts of interest that resulted in significant risk taking and speculation without strong countervailing forces. Enormous sums of money could be made by the financial industry through financial engineering and the creation and sale of financial products with the risk of failure being shifted to others and ultimately the American public. Among the examples: the originate to distribute model pushed risk down the chain while providing current compensation to originators and securitizers; asymmetric compensation practices at financial institutions rewarded the taking of big short term risks to the detriment of long term sustained performance; the issuer pays model for credit rating agencies undermined rating agency independence, as structured products grew as a significant revenue source ; housing speculators could get no recourse, no doc, no down payment loans: and implicit (which became explicit) government guarantees encouraged big financial institutions to take outsized risks. The sheer scale of the financial sector in relation to the real economy amplified the effect of risk shifting and failure. Against this array of incentives stood only internal corporate controls which were outmatched by the power of enormous short term profits and a regulatory and supervisory system weakened by deregulation and desupervision. **PHIL ANGELIDES**

10. Misaligned or Misguided Federal Government Housing Agenda: The role that Fannie Mae and Freddie Mac played in the creation and eventual propagation of the securitization market was important in supporting the government mandate to assist more US citizens in acquiring a home. However, as time progresses, the risk being taken by Fannie and Freddie and the implicit government guarantee of that risk was inappropriate. To create entities with implied government guarantees, but left to act is free-market participants in their actions and incentive systems, was inconsistent with or counter to the overall mission on which these entities were established. While programmatic initiatives such as the Community Reinvestment Act appear to have had no material impact on the crisis, its mere existence should call into question the role of the government in acting as a stimulus to what might be considered normal free market activity, i.e. the creation of demand for housing. **JOHN THOMPSON**

11. The increase in leverage and risk taking by financial institutions contributed significantly to the financial crisis. **BROOKSLEY BORN**

12. The use of over-the-counter derivatives to engage in highly leveraged speculation about the failure of the housing market and the failure of individual financial institutions, combined with other strategies such as short-selling, exacerbated the crisis. **BROOKSLEY BORN**

<u>Corporate Governance and Accountability</u>

1. Abdication of personal responsibility at every level including the failure of regulators to act in the face of clear data demonstrating increased risk in the system, corporate actions to avoid disclosure of

risks held and sold, lowered lending standards, individual mortgage holders taking on debt they could not afford. **HEATHER MURREN**

2. Poor Corporate Risk Management and Governance- Members of the management teams and board of directors of the largest financial institutions failed to follow simple, but tried and true, principles of good governance, i.e. challenging overly optimistic views of market growth, demanding balanced scenario planning, matching compensation/reward systems to long-term, sustainable growth, etc, etc. To assume the US housing market would continue to grow at such an astounding rate, particularly when compared with historical norms, would suggest a naïve, at best, view of market planning. To allow compensation systems to evolve that disconnects the current period rewards for performance from the long term consequences of the risk being assumed borders on negligence. And, to fail to adjust the risk management models to keep up with the pace of innovation or the introduction of new products was a tremendous lapse in sound management practices. **JOHN TOHMPSON**

3. Misalignment of Private Market Incentives and Abdication of Responsibility and Accountability Contributed to the Crisis- Overly permissive lending practices, combined with the originate-to-distribute model for extending credit and, through securitization, transfer of the risk of default away from all of the parties who profited from the origination and securitization to the investors who purchased the securities, resulted in a deterioration of underwriting standards, and a lack of accountability for the consequences of risk creation that contributed to the failure of the originated securities and the financial crisis. **BYRON GEORGIOU**

4. Lending standards- A decline in lending standards, facilitated by the originate-to-distribute system of securitization and lax rating agency standards induced by conflicts of interest, caused banks and other financial institutions to acquire and hold, or acquire and redistribute as MBS, low quality or high risk mortgages **PETER WALLISON**

5. Misalignment of Private Market Incentives and Abdication of Responsibility and Accountability Contributed to the Crisis- The quality of due diligence undertaken by financial institutions deteriorated as a result of risk shifting practices that insulated the originators of financial products from the consequences of the failure of those financial products to perform as represented, thereby enabling originators to continue to collect fees for creating ever riskier financial products for which they evaded accountability, contributing to the crisis when the financial products failed to perform in accordance with assurances they made to investors to induce purchase of the securities. **BYRON GEORGIOU**

6. Misalignment of Private Market Incentives and Abdication of Responsibility and Accountability Contributed to the Crisis- Deficiencies in the governance of corporations by their shareowners and boards of directors enabled managers to benefit personally by engaging in excessively risky practices that endangered the very existence of the corporations they led at enormous costs to all stakeholders in the corporations, equity holders, creditors and employees, contributing to the financial crisis. **BYRON GEORGIOU**

7. Misalignment of Private Market Incentives and Abdication of Responsibility and Accountability Contributed to the Crisis- Over-reliance on numerical risk models and credit ratings, which are by their nature backward looking and frequently fail to identify future risk during long periods of relative stability, lulled financial institutions into a sense of complacency that facilitated the accumulation of excessive risk which contributed to the financial crisis. **BYRON GEORGIOU**

Leverage

1. Inadequate Capital Requirements and Excessive Leverage Caused and Amplified the Crisis- In light of the levels of risk, capital requirements were inadequate and permitted leverage was excessive at many financial institutions, rendering them vulnerable to solvency concerns after minor market movements against them, thereby contributing to the financial crisis and the conundrum faced by regulators as to whether to rescue them or let them fail in the normal course. **BYRON GEORGIOU**

2. Misalignment of Private Market Incentives and Abdication of Responsibility and Accountability Contributed to the Crisis-The unregulated derivatives market masked the creation of risk through inadequately capitalized positions taken by market participants using excessive leverage and contributed to interdependencies among large complex financial institutions that rendered them too-big-to-fail in the view of market regulators. **BYRON GEORGIOU**

3. Too Much Liquidity/Leverage. The US market was awash with very inexpensive capital, driven in large part by the Federal Reserve's monetary policy to maintain low interest rates … post the dot com bubble collapse and the 9/11 crisis … to stimulate economic growth. The low Fed funds rate was complimented by significant inflows of cash from sovereign wealth funds and the Chinese government in their desire to invest in a "safe haven" such as the US market for returns that were reasonably assured and where the principle was safe. This significant in-flow of liquidity was amplified by the amount of leverage the financial market players were allowed to take on in order to attract additional capital and invest in a burgeoning asset valuation bubble, i.e. the US housing market and the global real estate market. **JOHN THOMPSON**

4. Credit default swaps and synthetic CDOs fueled the securitization market and added a large amount of leverage and speculation to it, multiplying the losses when the bubble collapsed. **BROOKSLEY BORN**

Overarching Hypotheses

1. Misalignment of Private Market Incentives and Abdication of Responsibility and Accountability Contributed to the Crisis- The issuer pay model for credit rating agencies and the statutory and policy requirements applicable to many market participants that permitted them to invest only in AAA rated securities created financial conflicts of interest on the part of credit rating agencies that led them to overrate the safety of hundreds of billions, perhaps trillions of dollars of securities and also enabled financial institutions rated AAA to extend their rating to cover credit default protections they sold which cumulatively exceeded their capital, leading to the collapse of those institutions and the default of a variety of financial instruments, all of which contributed to the crisis. **BYRON GEORGIOU**

2. Large Complex Financial Institutions Regarded as Too Big to Fail Cost Taxpayers Trillions and Continue to Present Major Systemic Risk- American taxpayers were victimized by the notion that certain large complex financial institutions were regarded as too-big-to-fail, leading to inexplicably anomalous results like the extensive taxpayer guarantees that enabled the shotgun mergers of Bear Stearns with JP Morgan Chase and Merrill Lynch with Bank of America, as compared with the failure to rescue Lehman Brothers, the permitted conversion of Goldman Sachs and Morgan Stanley to bank holding companies and direct taxpayer bailouts of AIG, Citigroup and other institutions, all of which added to the burden of the enormous and growing U.S. deficit on future generations and its associated drag on the economy as it attempts to recover from the crisis. **BYRON GEORGIOU**

3. A Systemic Breakdown of Responsibility- The crisis in our financial system was a result of a breakdown of responsibility at all levels – lenders making irresponsible loans; investment banks creating and selling toxic mortgage securities; financial institutions abandoning common sense risk management in pursuit of current earnings and compensation without regard to external consequences; investors making speculative bets; consumers speculating and/or taking on debt they could not afford; widespread mortgage fraud; and regulators and public leadership who stood aside or enabled practices that proved to be detrimental. **PHIL ANGELIDES**

4. A Man Made Storm- Significant changes in underlying conditions – such as cheap money, excess liquidity, households' need/desire to borrow, weakened regulation and supervision, and the explosive growth in the size and complexity of the financial sector - set the plate for potential financial instability. In that context, the financial industry created home mortgage and commercial real estate lending practices and products which fueled a borrowing spree and a speculative real estate boom. That speculative cycle was accelerated and amplified by factors such as high leverage, compensation programs which incentivized short term risk taking without regard to external consequences, new complex and opaque financial products like CDOs and CDS, as well as human traits such as the herd mentality, avarice, and hubris. At each step along the way, human choices compounded the growing storm. Despite warning signs, the entities charged with oversight – from the regulators and policy makers to the senior management of financial institutions to the credit rating agencies – did not act to contain the speculative cycle or put in place the safety net to guard against or to cushion a collapse. When the bubble peaked and burst, the collapse was accelerated by a number of factors such as the interconnection of financial institutions, a lack of transparency, downgrades by credit rating agencies, and the freezing up of the shadow banking system – resulting in a financial panic that led to the Great Recession. **PHIL ANGELIDES**

5. Risky Financial Practices with Lack of Oversight- The financial crisis was caused by the growth and pervasiveness of risky financial practices such as high leverage, irresponsible lending, and the creation, sale and purchase of toxic mortgage securities coupled with the breakdown of responsible corporate management practices and the systemic failure of financial regulation and oversight, including deregulation, desupervision, regulatory arbitrage, and a lack of transparency. **PHIL ANGELIDES**

6. How the Collapse of the Housing Bubble Caused the Financial Crisis:

    1. Housing-related exposure was concentrated in systemically important firms. Caused by: (a) Opacity in the market caused by credit derivatives; (b) Failure of both regulatory supervision at regulated firms and macroprudential regulation at the Federal Reserve; (c) Risk management and corporate governance failures at systemically important firms; (d) Regulatory policies (especially regulatory capital requirements and credit ratings) that encouraged outsized investment in housing-related assets.
    2. Housing-related exposure was very large (and perhaps larger than expected), and thus was unable to be contained. Caused by: (a) Magnification of housing-related exposure caused by synthetic positions on housing; (b) Expansion of housing market and market opacity caused by GSEs; (c)The magnitude of (existence of) the housing bubble was badly misunderstood (ignored) in markets and by regulators.

3. The rapid collapse of the housing bubble and then firms that had significant exposure to housing caused panic in financial markets (relates to #4)
    a. Interbank lending, which relies on trust, froze when counterparty risk exposures became less certain
    b. Lack of clarity about future government interventions generated uncertainty in the markets
    c. Procyclicality in regulatory capital requirements and accounting standards exacerbated funding runs
    d. Speculation (and perhaps associated market manipulation) accelerated the collapse of the housing bubble and firms with exposure to housing-related assets
4. The modern financial system was inherently fragile
    a. Financial institutions were highly levered, making them unable to sustain the shock to asset values caused by the collapse of the housing bubble
    b. The migration of financial intermediation away from regulated and insured banks left system vulnerable to runs
    c. There was general fragility in financial markets caused by opacity and interconnectedness in "shadow banking" and derivative markets
    d. There was misplaced trust by financial market participants and the government in the efficiency of markets
    e. Changes in Wall Street's traditional role in financial intermediation (i.e. increased leverage speculation, and risk taking on the part of Wall Street banks) created market instability **BILL THOMAS**

Additional Text from the Commissioners' Hypothesis

1. The financial markets and the economy are exceedingly complicated and fluid. The notion that one single piece of legislation or one single enterprise was responsible for the crisis strikes me as unrealistic. Any hypothesis about the cause of the crisis will need to have several component parts, and potentially several sequential related events or actions, that describe the critical factors. Another possibility is a thematic hypothesis: underlying issues that cut across the various segments of the financial markets that contributed to failure. **HEATHER MURREN**

2. On a separate note I wanted to comment briefly on recent communications with regard to the behaviors of Fannie Mae. I know that there is some speculation that the reason that Fannie Mae engaged in an increasing volume of participation in the subprime mortgage markets might be linked to pressure from the government.

One aspect of this behavior that has been advanced as evidence that FNMA was directed to participate in sub-prime lending is the notion that if we find that the subprime mortgage market can be proven to be less profitable or have lower margins than the existing portfolio of mortgage activity, that this would in some way suggest that Fannie Mae had been pressured to participate in these markets for reasons other than those that would be explained by regular business principles. I am not sure we can make that jump.

It has been a normal course of the evolution of various financial products that margins fall over time, and that certain financial products are much more profitable when there are fewer participants. As there are increasing number of participants in any kind of financial product or activity - for example regular stock trading and brokerage activities - that the profit margins declined over time. This in turn leads management and companies to increase their participation in these markets (fight for market share) because these businesses and their managements are often paid on percent growth in revenues/earnings not necessarily on the relative profitability of different market segments. Therefore, participation in a variety of financial products and activities are driven by a desire to continue to grow, not necessarily seeking out the most profitable lines of business but rather seeking a variety of businesses that can in aggregate grow at a certain pace.

Therefore in my mind, there is no direct correlation between the relative profitability of the subprime lending business and pressure from the federal government and the associated activities that would arise from either one of those. If in fact we wish to continue to test this theory, it would be useful to determine the relative profitability of a variety of different products and activities of different firms. We can then determine if in fact companies regularly engage in increased volumes of lower margin activities that ultimately contribute to revenue and earnings per share growth, perhaps associated with a particular growth hurdle that the companies themselves have set as their goals. I am guessing that the comparison will validate the notion that this is a regular occurrence across many firms. **HEATHER MURREN**

Financial Crisis Inquiry Commission

Agenda Item 9 for Retreat on June 3, 2010

Outline for FCIC Report

As of May 26, 2010

This is for discussion purposes only. It is a set of pieces, or building blocks, that can be reconsidered and rearranged as the FCIC comes to its findings.

Commission Members

Staff and Acknowledgements

Letter of Transmittal to the President and Congress

Preface

Note to Commissioners: Findings and conclusions will be included in the appropriate place(s) in the report. In addition, timeline(s) and key graphics will be included throughout the report.

THE FINANCIAL AND ECONOMIC CRISIS

ONE **On the Edge**

1.1 The Financial Markets in Crisis

A. 2007
B. 2008
C. 2009

1.2 The American and International Response

TWO **The Financial Crisis and the Economy**

2.1 The Crisis in the Financial System and the American Economy

2.2 Comparison of this Financial and Economic Crisis to Previous Crises

BACKGROUND TO THE FINANCIAL CRISIS

THREE **The American Economy**

3.1 The Growth of Public and Private Debt

3.2 Liquidity, Monetary Policy and Global Savings

3.3 Tax Policy and Its Effects

3.4 Wealth, Income

3.5 Homeownership in America

3.6 The Financial Services Industry and the Economy

3.7 Other Aspects of the Economy

Perspectives

FOUR **Traditional Financial Institutions**

4.1 Financial Institutions: 19th Century Panics to the Depression

4.2 Financial Institutions: The Depression to 2007

4.3 Structures and Practices (e.g. Transparency, Ownership, Compensation, Other Practices)

LEADING UP TO THE FINANCIAL CRISIS

Perspectives

TEN	**Ratings Agencies**
10.1	The Purpose of Rating Agencies
10.2	How the Ratings Agencies Evolved
10.3	Ratings Agencies in the Financial Crisis

Perspectives

ELEVEN	**Complex Securities and the Financial Crisis**
11.1	The World of Derivatives
11.2	The Regulatory Environment for Complex Securities
11.3	Structured Credit Products
11.4	Synthetic Products
11.5	Transparency
11.6	Contagion

Perspectives

TWELVE	**Excess Risk and Speculation**
12.1	What is Excess Risk and Speculation?
12.2	Excess Risk and Speculation in Mortgage Markets
12.3	Opacity of Exposure to Risk
12.4	Concentration of Risk
12.5	The Market Reaction to Investors' Positions in the Crisis

THE REGULATORS

CURRENT SITUATION

Financial Crisis Inquiry Commission

Agenda Item 9 for Retreat on June 3, 2010
Process for Review and Approval of the Report by the Commission
As of May 31, 2010

For discussion purposes only

Below is an outline of a suggested process for the preparation and consideration of the report by the commission. The report preparation and consideration will move in parallel with the commission's consideration of findings and conclusions to be incorporated into the report. In that vein, commission meetings will be scheduled as needed in addition to the regularly scheduled business meetings and the meetings indicated below. The Executive Director, under the direction of the Chair and Vice Chair, will be responsible for preparing sections of the report and the full report for consideration by the commission.

It is important to note that, by statute, the report must be approved 30 days prior to its release – assuming a release date of December 15th, the report must be approved by Monday, November 15. In that vein, commission members should block the period from October 25 to November 15 on their schedules for full commission consideration of the report.

- **Review of Initial Drafts of Sections of the Report –** The staff will start to draft sections of the report that can be written now, recognizing that they will contain language/provisions that will be changed or added as the research and investigation continues and that findings and conclusions will be added as the Commission's deliberative process proceeds.

  - Section 1 (4 chapters)
    - 1st draft to commissioners **Due: July 2nd**
    - Written comments by commissioners **Due: July 16th**
    - 2nd draft to commissioners with track changes, identification of comments made and disposition of comments (including listing of comments still sought but not yet incorporated) **Due: July 30th**

- Section 2 (4 chapters)
  - 1st draft to commissioners — **Due: July 16th**
  - Written comments by commissioners — **Due: July 30th**
  - 2nd draft to commissioners with track changes, identification of comments made and disposition of comments (including listing of comments still sought but not yet incorporated) — **Due: August 13th**

- Section 3 (4 chapters)
  - 1st draft to commissioners — **Due: August 6th**
  - Written comments by commissioners — **Due: August 16th**
  - 2nd draft to commissioners with track changes, identification of comments made and disposition of comments (including listing of comments still sought but not yet incorporated) — **Due: August 27th**

- Section 4 (4 chapters)
  - 1st draft to commissioners — **Due: August 16th**
  - Written comments by commissioners — **Due: August 23rd**
  - 2nd draft to commissioners with track changes, identification of comments made and disposition of comments (including listing of comments still sought but not yet incorporated) — **Due: August 30th**

Commission retreat to discuss report Sep 3rd

- **Review of Full Report -** Based on the drafts produced above, additional information received, during the research and investigation process, and deliberations to date on findings and conclusions, staff will produce a 1st draft of full report for commission review and comment.

  - 1st draft of full report to commissioners with tracked changes against final drafts of sections — **Due: September 17th**
  - Written comments by commissioners on 1st draft — **Due: September 30th**
  - 2nd draft to commissioners with track changes, identification of comments made and disposition

of comments (including listing of comments still sought but not yet incorporated) **Due: October 15th**

- **Meetings of commission as a whole to consider and approve report** **Due: Oct 25 to Nov 12**

- **Approval of Commission Report**
  This will be the formal approval required under the statute. **Due: Nov 15**