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FCIC Transcript of Official Commission Hearing

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THE FINANCIAL CRISIS INQUIRY COMMISSION

Official Transcript

Commission Hearing

Thursday, April 8, 2010

Rayburn House Office Building, Room 2123

Washington, D.C.

9:00 A.M.

COMMISSIONERS

- PHIL ANGELIDES, CHAIRMAN**
- BILL THOMAS, VICE CHAIRMAN**
- BROOKSLEY BORN**
- BYRON GEORGIU**
- DOUGLAS HOLTZ-EAKIN**
- HEATHER MURREN**
- JOHN W. THOMPSON**
- PETER WALLISON**

Reported by: Cassandra E. Ellis, RPR

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P R O C E E D I N G S

1
2 CHAIRMAN ANGELIDES: Good morning. The meeting
3 of the Financial Crisis Inquiry Commission will come to
4 order. As everyone who joined us yesterday knows, we are in
5 the midst of three days of hearings on the issues of
6 subprime lending and securitization and how the subprime
7 origination phenomenon and securitization phenomenon may
8 have impacted our financial and economic crisis with which
9 we are dealing in this country today.

10 Yesterday we heard from Alan Greenspan, from the
11 Federal Reserve, and from officials from Citigroup.

12 Today we are hearing, again, from officials from
13 Citigroup, both Mr. Rubin and Mr. Prince, and later today
14 from officials from the Office of the Comptroller of the
15 Currency. And tomorrow we will continue our hearings in
16 this same cool, not really air-conditioned room, on Fannie
17 Mae and OFHEO.

18 So, with that, I would like to begin our
19 hearing. We have two witnesses today, Mr. Chuck Prince, the
20 former chairman and CEO of Citigroup, and Mr. Robert Rubin,
21 the former treasury-secretary of the United States of
22 America as well as the chairman of the executive -- former
23 chairman of the executive committee of the board of
24 directors of Citigroup. Thank you, gentlemen, for being
25 with us here this morning.

1 What I would like to do, to start off, as we are
2 doing with all witnesses who appear before us in the course
3 of our hearings, both before you and after you, is we are
4 customarily swearing every witness in. So, with that, I
5 would like to ask each of you, both of you, to please stand
6 up so that I can swear you in front of the Commission.
7 Thank you.

8 Do you solemnly swear or affirm, under penalty
9 of perjury, that the testimony you are about to provide the
10 Commission will be the truth, the whole truth and nothing
11 but the truth, to the best of your knowledge?

12 MR. PRINCE: Yes, sir.

13 MR. RUBIN: Yes.

14 CHAIRMAN ANGELIDES: Thank you, very much.

15 Gentlemen, you have provided us with written
16 testimony, which we have in hand. And I'm going to ask each
17 of you, this morning, to provide us with oral testimony
18 of -- not to exceed ten minutes.

19 And so, with really no further ado, Mr. Prince,
20 I will ask you to start this morning. Please turn on the
21 microphones and pull them as closely to you as you can and
22 let's commence.

23 Mr. Prince?

24 MR. PRINCE: Thank you. Chairman Angelides,
25 Vice Chairman Thomas, members of the Commission, let me

1 start by saying I'm sorry. I'm sorry that the financial
2 crisis has had such a devastating impact on our country.
3 I'm sorry for the millions of people, average Americans, who
4 have lost their homes. And I'm sorry that our management
5 team, starting with me, like so many others could not see
6 the unprecedented market collapse that lay before us.

7 I was the CEO of Citigroup from October 2003
8 until November 4, 2007. Before becoming CEO, I held various
9 positions in Citi's senior management. For nearly 30 years
10 until November 4, 2007, when I resigned, Citi and its
11 predecessors was my professional life.

12 I have given a great deal of thought to the
13 unique events that led to the financial crisis and which
14 brings us here today. I wanted to share some of my views,
15 which I believe are important to set the context for the
16 problems that arose at Citi as well as many other financial
17 institutions and eventually led to Citi's receipt of
18 government assistance.

19 The financial crisis resulted from a confluence
20 of several factors, the absence of any of which would likely
21 have caused the crisis to be averted or significantly
22 moderated.

23 First was the unusually long period of low
24 interest rates, stemming from a change in the pattern of
25 global funds flows following the 1998 emerging markets

1 financial crisis, as well as the stimulative actions of the
2 Federal Reserve Board, following the bursting of the tech
3 bubble and the terrorist attacks of 9/11.

4 As a result, investors were reaching for yield,
5 and many people from investors to traders to rating agencies
6 to regulators believed that a new era of generally lower
7 risk had begun.

8 During this period, securitized products, as an
9 asset class, grew dramatically in an effort to satisfy
10 investor demand for products that had higher yields but were
11 still believed to have a high degree of safety.

12 The growth in securitized products also
13 reflected a growing belief in and reliance on financial
14 modeling by traders as a basis for risk decisions and a
15 growing reliance on rating agency determinations by
16 investors.

17 As a result of the rapid growth and demand for
18 assets to be securitized, together with longstanding and
19 bipartisan federal policies encouraging the expansion of
20 home ownership, the asset class of subprime mortgages grew
21 very quickly.

22 The patchwork nature of state regulation of the
23 origination of subprime, indeed of all mortgages, led in
24 hindsight to the origination of more and poorer-quality
25 subprime assets to be securitized.

1 Eventually the rating agencies dramatically
2 downgraded their ratings on the securitized products
3 collateralized by these subprime loans.

4 The precipitous nature of the actions by the
5 rating agencies, together with the widespread holdings of
6 these securities, caused a broad and generalized freezing of
7 the securities markets as investors could no longer be sure
8 what standards and models of risk and safety could be relied
9 upon and who held what levels of risk.

10 This general freezing of the credit markets then
11 precipitated a severe contraction of trade that led to the
12 general recession that still afflicts us.

13 It is against this backdrop that the events at
14 Citi and of many other banks and financial institutions took
15 place. Specifically, on November 4, 2007, Citi announced an
16 estimated 8 billion to 11 billion dollars in write-downs
17 related to subprime-related holdings. That same day, I
18 resigned as CEO.

19 After I left, Citi incurred even greater losses,
20 which eventually lead Citi to receive over 45 billion
21 dollars in Federal TARP funds. As the Commissioners are no
22 doubt already aware, the largest losses at Citi emanated
23 from what were perceived at the time to be extremely safe,
24 super senior tranches of CDOs that carried the lowest
25 possible risk of default.

1 It bears emphasis that Citi was by no means
2 alone in this view and that everyone, including our risk
3 managers, government regulators, other banks and CDO
4 structurers, all believed that these securities held
5 virtually no risk, a perception strongly reinforced by the
6 above Triple-A-rating bestowed by the rating agencies.

7 Citi's write-downs on these specific securities
8 totaled some 30 billion dollars over a period of six
9 quarters. And I believe it is fair to say that this factor
10 alone made a substantial part of the difference between
11 Citi's ultimate problems and those of other banks.

12 While I was not aware of the decisions being
13 made on the trading desks to retain these super senior
14 tranches, given the universal perception that these super
15 senior positions were extremely low risk, it is hard for me
16 to fault the traders who made the decisions to retain these
17 positions on Citi's books, having 40 billion dollars of
18 Triple-A-plus-rated paper on the balance sheet of a
19 2-trillion-dollar company would not raise a concern.

20 Moreover, it is important to appreciate that the
21 CDO business, which was a small part of a large and complex
22 financial organization, was being managed by highly
23 experienced traders and risk managers and was fully
24 transparent to our regulators who were embedded across the
25 company.

1 In retrospect it turned out that that risk
2 assessment, while widely held, was dramatically wrong given
3 the wholly unanticipated and significant collapse in
4 residential real estate values across the board in nearly
5 every community and geographic location nationwide and
6 across many parts of the world.

7 In that context, let me say something about
8 risk. I always believed that the risk function at Citi was
9 a critical part of our overall business. After becoming
10 CEO, one of the very first things I did was to name David
11 Bushnell as the chief risk officer of the company and to
12 change the reporting structure so that the risk function was
13 then completely independent of the businesses which it was
14 not before.

15 The risk professionals were not paid on profits,
16 were not paid on volumes or revenues of the business units,
17 and I believe that that was good governance, and I believe
18 that we were ahead of best practices at that time.

19 Mr. Bushnell was known as one of the most
20 sophisticated risk managers in the investment banking
21 community, with a strong hands-on trading background.

22 As serious issues unfolded in the late summer
23 and fall of 2007 relating to the subprime market and our
24 lower-rated CDO holdings as well as certain other
25 businesses, such as leveraged lending, our senior management

1 was fully focused on the unprecedented issues the company
2 faced. We had multiple special board and committee meetings
3 to apprise the board members of the issues as they developed
4 in real time and to solicit their valuable advice and
5 counsel.

6 Regrettably, we were not able to prevent the losses
7 that occurred, but it was not a result of management or
8 board inattention or a lack of proper reporting of
9 information.

10 The lessons learned from this experience are
11 many, but let me address two issues that seem to come up
12 repeatedly when discussing Citigroup. Is Citi too big to
13 fail? And is it too big to manage?

14 These are separate but related questions as you
15 know. Let me start with the latter.

16 I personally do not think Citi was too big to
17 manage, to be sure, it was a challenge, but we made enormous
18 strides during my tenure to improve the way in which the
19 various parts of Citi work together. And I think the
20 company as a whole was much better for it.

21 In any event, I do not think that the broad,
22 multifaceted and diversified nature of Citi's businesses
23 materially contributed to our losses or to the financial
24 crisis more generally. Indeed, smaller, more narrowly
25 focused firms suffered in similar ways.

1 To the contrary, I continue to believe that Citi
2 is a unique institution. It is the only truly international
3 U.S.-based bank, a feature that gives it great advantages in
4 many of its businesses and around the globe.

5 Now, too big to fail is a harder issue. My own
6 view is that we are past the days of exclusively small
7 local-based banks and financial institutions. While these
8 local institutions certainly have a place in the financial
9 landscape, the financial world we live in is complex,
10 interconnected, and global. And I think this demands
11 sophisticated, global, and diversified financial
12 institutions. That said, I certainly do not believe it is
13 good for the United States to have a financial system with a
14 failure or threatened failure of key financial institutions
15 will impose the kind of dramatic and near catastrophic
16 damage on the entire financial system and the national world
17 economy that we saw when Lehman failed and when numerous
18 other financial institutions, including Citi, needed
19 extraordinary government assistance.

20 We must find a solution to this problem, whether
21 through resolution authority, greater regulation, increased
22 capital requirements, or all of the other creative and
23 innovative measures that your Commission has been
24 discussing.

25 Thank you for your time and I'm happy to answer

1 your questions.

2 CHAIRMAN ANGELIDES: Thank you very much,
3 Mr. Prince. Mr. Rubin?

4 MR. RUBIN: Thank you, Mr. Chairman.

5 Mr. Chairman, Mr. Vice Chairman, distinguished members of
6 the Commission, I, too, along with Chuck Prince appreciate
7 the opportunity to testify today.

8 The financial crisis, as we all know, has taken
9 a terrible toll on millions of Americans who have lost their
10 homes, their jobs, their savings, and their confidence in
11 the future of our economy. Better understanding the cause
12 of the crisis is essential to protecting our nation's
13 economic future and to effective financial reform.

14 I hope that my experience at Goldman Sachs, the
15 National Economic Council, the Treasury Department,
16 Citigroup, and this chair of LISC, our nation's largest
17 inner-city development organization can be helpful to this
18 inquiry.

19 Let me make two observations that I believe are
20 relevant to the Commission's work. First, examining
21 problems with the benefit of hindsight can be highly useful.
22 During my time at Treasury, we dealt with the Mexican
23 financial crisis and then later the Asian financial crisis.

24 And while, in both cases, our approaches on
25 balance were successful, we still learned an enormous amount

1 from looking back at what happened.

2 Second, as policymakers address financial
3 reform, it is important to remember that our national
4 economic policies have enormous effect on all of us. For
5 example, President Clinton undertook deficit reduction and
6 made critical public investments, and those policies, in my
7 view, contributed greatly to the longest economic expansion
8 in American history. Simply put, policy matters.

9 With those thoughts in mind, let me turn to the
10 causes of the financial crisis. While I had thought for
11 some time, prior to the crisis, that markets including the
12 market for credit had gone to excess and that those excesses
13 would at some unpredictable point lead to a cyclical
14 downturn, this is not what happened.

15 Instead, we experienced the most severe
16 financial and economic crisis in 80 years. In my view, that
17 crisis was not the product of a single cause but rather the
18 product of an extraordinary combination of powerful factors
19 operating at the same time and feeding on each other.

20 Let me name just a few of those factors: Market
21 excesses; low interest rates most notably due to large
22 capital inflows from abroad, which contributed to excessive
23 risk taking by lenders and excessive borrowing by businesses
24 and consumers; a sharp rise in housing prices, which also
25 contributed to increased consumer leverage; a subsequent

1 precipitous drop in housing prices; vast increases in the
2 use and complexity of derivatives; misguided Triple-A
3 ratings of subprime mortgage-based instruments; lax and too
4 often abusive mortgage lending practices; shortfalls in
5 regulation; high levels of leverage in financial
6 institutions joined with deteriorating asset quality in
7 asset purchases and much else.

8 There were a few market participants or analysts
9 who saw the broad picture and the potential for a
10 mega-crisis. A larger number saw one or a few of these
11 factors. But almost all of us, including me, who were
12 involved in the financial system, that is to say, financial
13 firms, regulators, rating agencies, analysts, and
14 commentators missed the powerful combination of factors that
15 led to this crisis and the serious possibility of a massive
16 crisis. We all bear responsibility for not recognizing
17 this, and I deeply regret that.

18 Let me now turn to Citigroup more specifically.
19 My role in Citi, defined at the outset, was to engage with
20 clients across the bank's businesses here and abroad, to
21 meet with foreign public officials for bank presence in 102
22 countries, and to serve as a resource to the bank's senior
23 management with respect to strategic and managerial matters.

24 Having spent my career in positions with
25 significant operational responsibility, at Treasury and,

1 prior to that at Goldman Sachs, I no longer wanted such a
2 role at this stage in my life. And my agreement with Citi
3 provided that I'd have no management of personnel or
4 operations.

5 I remained with Citi until January of 2009, and
6 so wasn't present when Citi's problems occurred. In my
7 view, there were two primary causes of these problems.
8 First, Citi, like other financial institutions, suffered
9 large losses due to the financial crisis.

10 I am told that Citi has subsequently analyzed
11 the data made available in connection with the 2009 stress
12 tests and has estimated that the losses of Citi's businesses
13 other than CDOs were roughly comparable to peer firms.

14 Second, Citi suffered distinctively high losses
15 as a result of its retention of so-called super senior
16 tranches of CDOs.

17 I first recall learning of these super senior
18 positions in the fall of 2007 during discussions convened by
19 Chuck Prince with the most senior management of Citi to
20 discuss what by then was considerable turmoil in the
21 fixed-income markets.

22 In a presentation on the fixed-income business,
23 I learned that Citi's exposure included 43 billion dollars
24 of super senior CDO tranches.

25 The business and risk personnel involved advised

1 these CDO tranches, related to Triple-A-plus, and had
2 de minimus risk. My view, which I expressed at the time,
3 was that the CDO business was an arbitrage activity and that
4 I believed, perhaps because of my arbitrage background, that
5 these CDO transactions were not completed until the
6 distribution was fully executed.

7 Having said that, it is important to remember
8 that the view of the securities to be retained was developed
9 at a time when Triple-A securities had always been
10 considered "money good."

11 Moreover, these losses occurred in the context
12 of a massive decline in home sale prices or rather in home
13 real estate market prices that almost no financial models
14 contemplated, including the rating agencies, Citi's, or to
15 the best of my knowledge, the regulators.

16 The board required and received extensive
17 financial and risk reporting but I do not recall knowing
18 before September `07 that these super senior tranches were
19 on our books. I feel confident that the relevant personnel
20 believed in good faith that more senior-level consideration
21 of these particular instruments was unnecessary, because as
22 I said a moment ago, the positions were rated Triple-A and
23 appeared to bear de minimus risk.

24 In October the rating agencies substantially
25 downgraded these securities and subsequently Citi estimated

1 that it would have a loss of 8 to 11 billion dollars.

2 When these losses or estimated losses were
3 announced, Chuck Prince decided to step down, Win Bischoff
4 became CEO, I stepped in as chairman of the board, and I
5 worked with employees, clients and others to stabilize the
6 bank, to assist in raising capital during a very difficult
7 period and served on the CEO search committee that led to
8 the selection of Vikram Pandit.

9 Ultimately, Citi took 30 billion dollars in
10 losses on its super senior CDO positions. These losses were
11 a substantial cause of the bank's financial problems and led
12 to the assistance of the United States government.

13 I believe that the overriding lesson of
14 financial crisis was that financial system is subject to far
15 more severe downside risk than almost anyone had foreseen.
16 I believe, too, that it is imperative in light of that
17 lesson that private institutions and the government act.
18 Citi, first under Chuck Prince and then under Vikram Pandit,
19 implemented major personnel changes, restructured and
20 improved risk management, and raised huge amounts of
21 capital.

22 The private solutions are only part of the
23 answer. Financial reform is imperative and should include,
24 one, substantially increased leverage constraints, with one
25 tier based on risk models and a second tier based on

1 simpler -- simpler metrics, because models cannot capture
2 all of reality.

3 Two, derivatives regulation - I reflected my strong
4 views from my time at Goldman Sachs, that derivatives can
5 create serious systemic risk and that appropriate regulation
6 is needed, a subject I also discussed in my 2003 book.

7 Three, resolution authority to avoid the moral
8 hazard of too big to fail.

9 And four, consumer protection, primarily and
10 very importantly to protect American consumers but also to
11 protect the financial system.

12 With that, I appreciate the opportunity to share
13 my views and would be happy to respond to your questions.

14 Thank you.

15 CHAIRMAN ANGELIDES: Thank you, Mr. Rubin and
16 Mr. Prince. And let me just reiterate again, we appreciate
17 you being here today; we appreciate your willingness to help
18 us in our endeavor. And Mr. Rubin, let me also just say to
19 you, thank you for your years of service to the country.

20 So, with that, we are now going to begin a
21 period of questioning by Commissioners, and, as Chairman, I
22 will start off with some questions for both of you and each
23 of you.

24 So I want to pick up on your comment,
25 Mr. Prince, about whether or not this institution was too

1 big to manage, too complex to understand, perhaps too big to
2 regulate.

3 Really, for the benefit of people watching
4 today, it appears as though that there are about 51 billion
5 dollars in write-offs related to subprime lending. The
6 institution, as I understand it, is one that went from about
7 670 billion dollars in assets in about 1998 to 2.2 trillion
8 dollars on balance sheet, another 1.2 trillion dollars
9 off-balance-sheet by 2007. By 2008, the tangible common
10 equity-to-assets ratio we estimate at 61 to 1, with
11 off-balance-sheet 97 to 1.

12 I really want to ask both of you some very
13 specific questions that get to the heart of the management,
14 the risk of the organization, particularly around subprime
15 lending. Mr. Rubin, I'm going to start with you.

16 On November 17th of 2007, there was a meeting
17 between executives of Citigroup, including yourself, and you
18 were there briefly, I believe, at the meeting, and then
19 Mr. Bushnell was at the balance of the meeting. This was a
20 meeting with the senior supervisors from the Federal Reserve
21 Bank of New York, the Federal Reserve board, the OCC, the
22 SEC, the UK FSA.

23 And at that meeting, there are notes about Mr.
24 Bushnell's assessment of what he thought had gone wrong.
25 And he mentioned, among other things, and I might add these

1 are notes, not his exact words, poor communication across
2 businesses, decentralized nature of firm, senior management
3 business line and risk management did not fully appreciate
4 the market risk of the leverage loan pipeline to the
5 retained super senior CDOs.

6 Corporate-wide stress testing scenario analysis
7 was insufficient. The firm did not have adequate firm-wide
8 consolidated understanding of its risk sensitivity factors.
9 The nature and origin and size of the CDO exposure was
10 surprising to many in senior management.

11 So as you look at some of those comments, do you
12 think those are a fair reflection? Do you believe that the
13 organization did become too big to manage, the internal
14 controls did break down, Mr. Rubin?

15 MR. RUBIN: I think, Mr. Chairman, that if you
16 look at Citi prior to the crisis erupting, that David
17 Bushnell ran, at least my impression, ran a very effective,
18 independent risk management capability.

19 But what David did, as I understand it, and I do
20 remember being a part of that meeting; I don't think I was
21 there for the whole meeting. What David did, and rightly,
22 it seems to me, is after the crisis emerged -- and when I
23 ran Goldman Sachs, we did this every time we had trouble --
24 he looked back on what he could learn from the circumstances
25 that existed.

1 And while I don't remember the specific comments
2 that you just made I do remember that there was a conclusion
3 that Citi could do a better job bringing together the risk
4 exposures across the various product areas and David's
5 obsessive function focused more on that.

6 Well, I guess my answer, Mr. Chairman, is I
7 don't believe that Citi is too big to manage. But I do
8 think that every time you go through, in this case it was a
9 crisis at Citi, but when I was running Goldman Sachs or
10 involved in co-managing Goldman Sachs, we had times we had
11 very, very difficult developments in the trading areas. And
12 every time that happened, we would look back and we would
13 learn how to try to do things better. And I think that was
14 what David was doing in the comments or, rather, was
15 reflecting in the comments that you just repeated.

16 CHAIRMAN ANGELIDES: All right. Let me ask you
17 a related question, Mr. Prince. For the sake of efficiency,
18 I'll try to move back and forth between the two of you.

19 On October 30th Mr. Bushnell made a
20 presentation, I believe to the board, of course I'll verify
21 that, but the essence of this is he had a timeline of key
22 events in the subprime market. In fact, I believe it was to
23 certainly senior management. He noted that on February 27th
24 of 2007, that HSBC had announced major mortgage
25 delinquencies and losses related to that; on 6/12, June

1 12th, my birthday, 2007, Bear Stearns' outside management,
2 it was announced that their funds were in significant
3 problems.

4 I knew you would want to know my birthday,
5 Mr. Vice Chairman, so you could note it on your tickler.

6 On July 10th, S&P and Moody's announced
7 significant CDO ratings changes and major downgrades.

8 On August 10th, BNP Paribas froze its funds, and
9 for the first time Countrywide announced significant
10 problems.

11 Mr. Prince, I would ask you, because both you
12 and Mr. Rubin have said you really became aware, and
13 Mr. Rubin did in September and I think you said the same
14 thing, of problems in the CDO desk. When all these things
15 happened, why didn't the potential of problems rise to the
16 top in the wake of these major announcements? Why didn't it
17 bubble up?

18 MR. PRINCE: Well, Mr. Chairman, I think you
19 have to go back to the time in question. So much has
20 happened since then that it's a little hard to put yourself
21 back in the timeframe of what just happened. And I can only
22 speak for what people must have been thinking, because I
23 obviously didn't know about the CDO positions and the
24 timeframes that you're talking about. But I believe in
25 hindsight that people believed, and they believed with a

1 level of certainty that it's hard to appreciate today, that
2 the super senior tranches would never be touched by these
3 problems. So the various rating changes you talked about
4 were for the lower level, the not super senior tranches.

5 Now again, sitting here today, that belief looks
6 pretty unwise, but I think at the time, Moody's was quoted
7 as saying that these problems would never reach the super
8 seniors. And I think people believed that the structuring
9 process had gotten to a point where that top level would be
10 immune from the problems that were being seen at the lower
11 levels.

12 And I'm not saying that's right; it obviously
13 turned out to be wrong, but I believe that's what they
14 believed at the time.

15 CHAIRMAN ANGELIDES: Well, let me probe that a
16 little, because Mr. Georgiou raised this yesterday. The
17 very nature of the CDOs, which is they were a, essentially,
18 a collection of the lower tranches of the residential
19 mortgage-backed securities.

20 And I -- I want to attribute this to
21 Mr. Georgiou that there was an element here of taking lead
22 and turning it into gold. You had a number of lower-rated
23 tranches that if you add a pile of stuff, and that's
24 probably a charitable description, you take the lower stuff,
25 now you put it at the top, and all of a sudden, that's

1 highly rated.

2 Interestingly enough, by the fourth quarter of '07,
3 housing prices had only fallen 5 percent. And just for
4 reflection, in '90, '91, on a cumulative basis in this
5 country, housing prices had fallen 3 percent, of course
6 particularly driven by places where I lived, California,
7 Florida, Texas. But by that fourth quarter, you had already
8 written down 18 billion. So clearly those super
9 senior tranches were touched fairly quickly because, in
10 essence, they weren't truly the Triple-A. They were
11 elevated in that structure.

12 So I guess the related question is, to what extent
13 did you ever do any at the board level, and I know you said
14 at one point, which I think reflects on the scale of the
15 institution, that putting on a 2-trillion-dollar balance
16 sheet 40 billion dollars of a Triple-A-rated zero risk paper
17 that that would not have in any way excited my attention.

18 At any point did either of you gentlemen look at
19 the nature of these instruments and say, I'm troubled about
20 the nature of taking this subpar stuff and rating it at the
21 top? Did you ever do the analysis, essentially, the hard
22 analysis of the underlying collateral? Mr. Rubin?

23 MR. RUBIN: Mr. Chairman, and I'll reflect back,
24 if I may, just in response to your question, for a moment,
25 on the days when I ran Goldman Sachs.

1 When you're running a large organization, or I'd
2 say even a medium-sized organization, what you can do is you
3 can look at the people you have in place, you can look at
4 the aggregations of risk, which the Citi had done very well
5 by David Bushnell, but there isn't a way in an institution
6 that has hundreds of thousands of transactions a day and
7 probably something over a trillion dollars a day running
8 through it, that you're going to know what's in those
9 position books.

10 And I didn't know it when I was running Goldman
11 Sachs, and you wouldn't know it sitting on the board of Citi
12 either. You really are depending on the people who are
13 there to bring you problems when they -- when they exist.

14 In this case you're talking about a level of
15 granularity that no board will ever have with respect to the
16 positions that are in -- that are in its books, which is why
17 a board has such a strong responsibility to make sure that
18 they have the right people in the right places.

19 CHAIRMAN ANGELIDES: Not to interrupt, you did
20 have weekly business meetings, which you both attended, of
21 the business heads.

22 MR. RUBIN: Yeah, but the business heads --
23 absolutely correct.

24 CHAIRMAN ANGELIDES: And it does seem to me, I
25 know that 40 billion dollars may sound like chump change in

1 this organization, but it seems to me like a fairly
2 significant initiative to have 40 billion dollars of
3 exposure.

4 I mean, it's not that it's so -- and I might
5 add, you know, in the RMBS arena, I think you guys were
6 doing about 90 billion dollars' worth of securitization, you
7 weren't light in this arena. So I'm just curious about the
8 depth of strategic discussion around the positions and
9 mortgage-backed security and the underlying collateral.

10 MR. RUBIN: Yeah, but if I may say something,
11 Mr. Chairman?

12 CHAIRMAN ANGELIDES: Yeah.

13 MR. RUBIN: We had the strategic discussions
14 about, at the business heads meetings, about P&Ls and the
15 operation of the business one thing or another. But
16 individual positions only came to that meeting when either
17 independent risk management or the people running the
18 businesses felt that there were problems.

19 And in this case, they were dealing with, as we
20 now discussed many times, Triple-A securities that were
21 deemed to be de minimus in risk. And these simply were not
22 brought to that meeting.

23 If I had to make a guess, and I do not know, my
24 guess is that the people who structured these did a
25 probabilistic analysis and determined that even though as

1 you correctly say, the individual securities within them
2 were not of the quality of the totality if you will, that
3 with the structures that they had, that the risk became
4 de minimus.

5 I seem to remember, because they not only depend
6 on the Triple-A as you know, they did a lot of their own
7 independent work. And I seem to remember seeing someplace,
8 much more recently, that they calculated the risk for
9 something like one in 10,000.

10 CHAIRMAN ANGELIDES: Well, that's what their
11 models showed. Yeah.

12 MR. RUBIN: Yeah, what their models shows, and
13 it's sort of --

14 CHAIRMAN ANGELIDES: But I really question the
15 models if you only have a 5 percent price drop, you write
16 off 18 billion.

17 MR. RUBIN: Look, there's no question,
18 Mr. Chairman, that once developments became or started to
19 become adverse the -- these securities got -- incurred
20 considerable difficulty. And, in hindsight, obviously,
21 there were real problems. But I was trying to speak of them
22 as of the time that these positions were taken and as they
23 were seen at that time.

24 CHAIRMAN ANGELIDES: Let me ask you a couple of
25 quick yes-or-no questions to move along here.

1 You had, Mr. Prince, you -- you indicated you
2 had about 11 billion dollars' worth of warehouse lines out
3 to subprime originators.

4 MR. PRINCE: I'm sorry?

5 CHAIRMAN ANGELIDES: Eleven, you had about
6 11 billion dollars, you've acknowledged in your interview
7 with us that you became aware fairly late in the game, you
8 said, I found out at the end of my tenure -- this is about
9 the 11 billion dollars in warehouse lines that supported
10 some very aggressive subprime lenders, about 26 of them, and
11 you said, I did not know before, I think getting that close
12 to the origination function, being that involved in the
13 deracination of some of these products is something I wasn't
14 comfortable with.

15 Mr. Rubin, did you know that the bank had a very
16 significant 11-billion-dollar extension of credit to very
17 aggressive subprime lenders? Is that something of which you
18 had awareness?

19 MR. RUBIN: I certainly don't remember today
20 whether I knew at the time or not. I honest -- I truly
21 don't, Mr. Chairman.

22 CHAIRMAN ANGELIDES: Let me ask you, Mr. Rubin,
23 one more question specifically, and I want to go to one
24 final issue before I, at least at this point, turn to the
25 other members.

1 Yesterday we had before us Mr. Bowen, who was, I
2 believe, chief risk officer, his title, he was in the
3 business underwriting unit in the risk function.

4 He had -- had tried unsuccessfully to get his
5 superiors to move on some concerns he had, and then on
6 November 3rd, '07, sent you an e-mail. He was concerned
7 about the inaccurate adequacy of the sampling size for loans
8 that Citi was buying and then selling to Fannie and Freddie.

9 The sample size, according to your policy,
10 should have been 5 percent. It was consistently less than
11 2 percent. But in addition to that, he found that 40 to 60
12 percent of the sample files failed to meet the minimum
13 contractual underwriting criteria of the originator or had
14 information missing and a fail rate that was not accurately
15 being reported. He also found that that failure rate rose
16 to 80 percent.

17 Did you ever act -- that was sent to you,
18 Mr. Bushnell, and I believe some other individuals. Did you
19 ever -- it was sent to, yes, you, by Mr. Bushnell,
20 Mr. Crittendon, and Ms. Howard. Did you ever act on that?

21 MR. RUBIN: Mr. Chairman, I do recollect this
22 and that either I or somebody else, and I truly do not
23 remember who, but either I or somebody else sent it to the
24 appropriate people, and I do know factually that that was
25 acted on promptly and actions were taken in response to it.

1 CHAIRMAN ANGELIDES: All right. Could you
2 please get us, back to us, perhaps, you know, you and/or the
3 people existing at the company today, back to the Commission
4 exactly how Citi responded and when it responded and what it
5 did?

6 MR. RUBIN: I would be very happy to, and I
7 believe legal counsel at Citi has -- in fact, I know they
8 do, has that information.

9 CHAIRMAN ANGELIDES: All right, last set of
10 questions for you before I yield the right to go on to other
11 members, and I will come back at the very tail end, but I
12 want to ask you about sequence of events, and here they are.

13 Both of you have said that you didn't become
14 aware of the CDO exposures until September, I believe. And
15 as I understand by looking at documents, by looking at the
16 interviews you did with our staff, that you learned in early
17 September, which point you started, Mr. Prince, a series of
18 meetings and, later, nightly calls that became known as the
19 Defcon calls.

20 And I think the first meeting was on September 9th.
21 Mr. Rubin was in Korea, but he was in touch by e-mail. And
22 then, Mr. Rubin, you joined these I guess very extensive
23 calls that happened over time.

24 And I think you said, Mr. Rubin, on September
25 12th, when the CD -- CDOs really become a focus of your

1 discussions, but here's -- I want to just ask you about a
2 sequence here.

3 On October 1st, Citigroup preannounces its
4 third-quarter earnings, and I believe indicates a
5 13-billion-dollar exposure to subprime, including a
6 billion-dollar write-down related to subprime-related CDOs.
7 On October 11th, there's some rating agency downgrades.

8 MR. RUBIN: What was that date, Mr. Chairman?

9 CHAIRMAN ANGELIDES: I believe October 11th, the
10 second date. But then here's what I want to ask you about.
11 Apparently you became aware mid-September; October 1st, you
12 announce that you are announcing your exposure's 13 billion,
13 but here's what happens, at least according to records I've
14 seen, and I certainly will give an opportunity for you and
15 your folks to review these to make sure we have the
16 chronology right, and maybe I should ask the question.

17 It appears that on October 15th, two things
18 happened. The first is that there is a call with analysts
19 in which Mr. Crittendon tells analysts and the public that
20 Citigroup has a 13-billion-dollar subprime exposure.

21 However, on the same day, a presentation is made
22 to the corporate audit and risk management committee and
23 then to the board of directors, and as part of that there's
24 a presentation on risk management, and it says, quote, the
25 total subprime exposure in markets and banking was

1 13 billion dollars, with an additional 16 billion dollars in
2 direct super senior, and 27 billion dollars in liquidity and
3 par puts.

4 So on the same day that the public's being
5 informed it's 13 billion, the board and the audit committee
6 are being told that this adds up to, frankly, more than 50
7 billion, I believe 55 is the total math here roughly, at
8 which point, on November 3rd, you have an emergency board of
9 directors, and on November 4th you announce the 55 billion
10 dollar exposure, and Mr. Prince, I believe that's the day in
11 which you announce your resignation.

12 I guess what I want to ask is, why is there an
13 announcement made to the public that it's 13 billion at the
14 same time that that board and the audit, risk and audit
15 committee, are being told that it's substantially more? And
16 I think, Mr. Prince, I'll ask you and then Mr. Rubin.

17 MR. PRINCE: Well, Mr. Chairman, I think that
18 you've asked a very detailed factual question referring to
19 documents and presentations and so forth, and I would have
20 to look at those and compare them pretty carefully to answer
21 it in the level of detail in which you've asked it. But I
22 think that at the time, the financial people were working
23 very intensely with the fixed-income people to try to
24 determine exposures in this area.

25 This was an unprecedented time in which markets

1 were crashing and rating agencies were pulling supports out
2 of longstanding structures. And I think that the -- that
3 their view of what the exposure was to subprime changed
4 during that period of time as these events happened.

5 Now, you just quoted from a presentation. And
6 it sounds to me as if, just listening to what you read, that
7 the presentation was structured in a way to say that our
8 subprime exposure was X, but don't forget we have these
9 other things. And perhaps that reflects their thinking at
10 the time.

11 But, again, I would have to look very carefully
12 at the comparisons you're making to be able to answer the
13 question in as detailed a way as you've asked it.

14 CHAIRMAN ANGELIDES: All right. Well, we will
15 provide this to you. Actually, let me just say it's on
16 page 1. This is called Risk Management Review, an update to
17 the corporate audit and risk committee, and it says the
18 total subprime exposure in markets and banking was
19 13 billion dollars. It's right in the executive summary.
20 It's right at the top, under the heading Subprime.

21 It says, the total subprime exposure markets and
22 banking was 13 billion with an additional 16 billion in
23 direct super senior and 27 billion in liquidity and power
24 puts. All right, Mr. Rubin, and then we'll move on to other
25 members.

1 MR. RUBIN: Yeah. Mr. Chairman, I don't
2 remember the presentation, but I could give you what I
3 suspect was the case, if I may, and you can confirm this for
4 yourself.

5 I might, as I say, I don't remember the
6 presentation, but it strikes me as understandable in the
7 context of how those positions were then being seen, which
8 is to say that the 13 billion, I would guess, was subprime
9 exposure below the Triple-A super seniors that we've now
10 discussed a number of times.

11 And if that was viewed as subprime exposure,
12 that the 43 billion, which is exactly the number that we
13 referred to as the super senior number, wasn't viewed as a
14 subprime exposure, it was viewed as a Triple-A security.

15 CHAIRMAN ANGELIDES: I will just note, you can
16 look, I don't want to surprise you, I will have you look at
17 the document. It's right up top. It's under subprime.

18 MR. RUBIN: Oh, it may have been listed under
19 subprime, but I don't think, and, again, I don't remember
20 the meeting and the discussion and I certainly was not part of
21 the formulation of these documents. I think you can find
22 out other ways exactly what these people were thinking.

23 But my guess would be that they reviewed as two
24 different classes of exposure: One being subprime exposure
25 and the other being because of all of the structuring

1 Triple-A super seniors.

2 CHAIRMAN ANGELIDES: All right, let me do this,
3 I may have one or two other questions, but I want to stop
4 now and move on to the vice chair. Thank you very much for
5 your answers to these questions.

6 Mr. Thomas.

7 VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

8 EXAMINATION BY VICE CHAIRMAN THOMAS

9 VICE CHAIRMAN THOMAS: Thank both of you for
10 coming. We appreciate it. As you know, given our charge of
11 trying to understand what happened so that we can convey to
12 the American people what happened is an exceedingly
13 difficult and complex job in which we have a very short
14 period of time.

15 I want to ask you, we obviously know more today
16 than we did yesterday in this very narrow area, and we're
17 going to know more tomorrow. These hearings are not
18 designed to be exhaustive. And if I ask you, if we had
19 questions, not only relating to the topic that we have
20 before us but other concerns based upon your position and
21 experiences, some very in-depth, others very broad, would
22 you be willing to respond in a timely way to written
23 questions that we might submit to you between now and the
24 end of our statutory journey? Is that an appropriate -- do
25 you have a --

1 MR. PRINCE: Well, I'm not sure how we could say
2 no, Vice Chairman, so I guess the answer is yes.

3 CHAIRMAN ANGELIDES: Well --

4 VICE CHAIRMAN THOMAS: Well, I don't understand
5 how you can explain what you did and how you did it, but
6 it's really easy, because all you do is say yes.

7 MR. RUBIN: The answer, Mr. Chairman, I agree,
8 Chuck, the answer is yes, we would be delighted to, and that
9 is -- and I'll interpret Mr. --

10 VICE CHAIRMAN THOMAS: Is that "we" as part of
11 your responsibility at Citi to advise senior or former
12 senior management?

13 MR. RUBIN: I was expressing my view and
14 interpreting Mr. Prince's view.

15 VICE CHAIRMAN THOMAS: Could I have your view,
16 Mr. Prince?

17 MR. PRINCE: Indeed, yes, I would be greatly
18 pleased to do that.

19 VICE CHAIRMAN THOMAS: Thank you very much.
20 Yesterday's panel, and we spent some time with Mr. Murray
21 Barnes, former managing director, independent risk officer
22 of Citigroup, David Bushnell, as you mentioned, chief risk
23 officer, Nestor Dominguez, former co-head of the Global
24 Collateralization Debt Obligations, Citi Markets & Banking,
25 and Thomas Maheras, who is the former chairman and co-chief

1 executive officer, Citi Markets & Banking.

2 I woke up this morning, my alarm was set at
3 5:00, and I have my radio on CSPAN. And I woke up to the
4 voice of Brooksley Born, the Commissioner who was inquiring
5 about, as we began our journey yesterday into this garden of
6 good and evil, about synthetic CDOs and what were they.

7 And, of course, if you listen to that
8 discussion, it led into Commissioner Byron Georgiou's trying
9 to comprehend how you take a bunch of Triple Bs, slice them
10 and dice them and turn them into Triple-A and Triple-A-plus,
11 the super senior tranches that somehow were never supposed
12 to go bad.

13 And then I listened to Commissioner Wallison's
14 excellent questioning of the panel leading us to a better
15 understanding of these products that were created to be
16 sold, which meant -- generated millions of dollars, in some
17 years tens of millions of dollars, to then-Citi management,
18 on the way up, but never resulted at any time even in a
19 dollar of clawback on the way down.

20 So that I finally woke up realizing that, if I
21 had a chance to start my life over, I may very well choose a
22 different path because apparently you get to the top without
23 ever having experienced any of these things that people
24 underneath you do; you don't have a comprehension; you're
25 not informed, but you get to make all this money on the

1 upside and there's no downside.

2 You folks had an opportunity to submit written
3 testimony, which you did. I don't believe, correct me,
4 Mr. Chairman, there's no limit on the pages of written
5 testimony.

6 CHAIRMAN ANGELIDES: Not that I'm aware of.

7 VICE CHAIRMAN THOMAS: There's a limit on the
8 verbal which you can express as you see fit. So what we
9 have in front of us is your written test- -- testimony, that
10 started with a blank sheet of paper and that you were
11 willing to inform us, more or less.

12 Now, Mr. Prince, I'm looking on page 2 and you
13 say, in the middle of page 2, the patchwork -- quote, the
14 patchwork nature of state regulation of the origination of
15 subprime, indeed, of all mortgages, led in hindsight, to the
16 origination of more and poorer quality subprime assets to be
17 securitized.

18 Was there a requirement that they be
19 securitized?

20 MR. PRINCE: Well, I'm not sure I understand
21 your question, Mr. Vice Chairman.

22 VICE CHAIRMAN THOMAS: Well, there was a demand,
23 as you say a sentence above it, in dealing with this growth
24 of securitized products that you obviously, given your
25 business, wanted to produce securitized assets that had low

1 risk and high yield. Who wouldn't? To the point that you
2 create so-called synthetic products.

3 But it sounds like you're saying the fault was
4 the state regulation of the origination of subprime because
5 they -- they gave us poor quality subprime assets to be
6 securitized.

7 You didn't have to do that but you did. And --
8 and, please, we heard enough yesterday about you starting
9 along a line of argument that others, third parties, gave
10 you assurance that they were okay, rating agencies, others.

11 Again, how do you get to the top if you don't
12 have any experiential experience, whatsoever, or your
13 argument is, at that point, and you don't pay any attention
14 to it?

15 What do you get paid for if it isn't having some
16 intuition, understanding, knowledge, or do you just do what
17 everybody else is doing because everybody else is doing it,
18 and if you don't do it, then you won't make money? Because
19 I do think it's all about money. And it was big money on
20 the way up. But never at any point is it on the way back
21 down.

22 What I'm saying is that when we get this -- when
23 I get, and I'll speak for myself, this kind of an argument
24 as to what happened, in hindsight, it's listening to someone
25 blame the inferior quality of leather in a pair of shoes

1 based on the feed that some person supplied to a FINRA
2 feeding the cattle that produced the leather.

3 I have to tell you, listening to the radio this
4 morning explain what it was that you did with products makes
5 it very, very difficult, notwithstanding a beginning
6 paragraph or two in which I do believe was sincere in terms
7 of your concern about what happened, but in this entire
8 process, not one dollar of clawback.

9 Mr. Rubin?

10 MR. RUBIN: Well, there were a lot of pieces --

11 VICE CHAIRMAN THOMAS: I -- I -- I have a
12 question.

13 MR. RUBIN: Oh, I'm sorry. I apologize.

14 VICE CHAIRMAN THOMAS: That was a statement but
15 if anybody wants to turn it into a question, they can.

16 MR. RUBIN: Okay.

17 VICE CHAIRMAN THOMAS: You have -- you started
18 with a blank sheet of paper as well. I do like the latter
19 pages where you go into that analysis of some things that we
20 need to work on. I think you've got some core stuff that I
21 think we're all talking about.

22 And you know as well as I do that when you talk
23 about financial services legislation moving through the
24 Congress that committee jurisdictions limit what they can
25 look at and it's going to be a long and difficult process.

1 What I want to focus on is that for the first
2 time in these hearings, someone has introduced of their own
3 volition, in the comments that they've offered to the
4 Commission, some partisan comments.

5 In one, two, three, in the fourth paragraph, you
6 state, it's important to remember, quote, it's important to
7 remember that our national economic policies enormously
8 affect all of us. For example, President Clinton undertook
9 deficit reduction and made critical public investments. And
10 those policies contributed to the longest economic expansion
11 in American history, simply put, policy matters.

12 Well, so does the truth. I -- you came in at
13 the beginning of the Clinton Administration and actually
14 before the President was sworn in, in December of '92, and
15 the President was sworn in, in January of '93, and he became
16 President with a democratic Congress and a democratic
17 majority in the House of Representatives.

18 The House of Representatives is that branch of
19 the legislature, the national legislature, which in
20 Article 1, Section 8, has sole responsibility for the
21 generation of revenue legislation. It is the place that
22 controls the nation's purse strings.

23 Just before you were sworn in as Secretary of
24 the Treasury, January 11th, 1995, for your three years of
25 experience as Treasurer, on January 3rd I was sworn in for

1 the ninth time into the House of Representatives and for the
2 first time in four decades as part of a Republican majority
3 in the House of Representatives.

4 And so I guess I'm a -- I'm a little -- I'm a
5 little personally concerned that if anybody looks at the
6 election of November of 1944 it was over the tax and spend
7 policies of the Democratic administration and the Democratic
8 majority, principally, those who controlled the purse
9 strings in the House of Representatives.

10 And the American voters in that election, just
11 prior to your becoming Treasurer, rejected those policies
12 and voted out as a majority those members of the Democratic
13 party.

14 So if there was deficit reduction, as a policy, and
15 critical public investments for six of the eight years of
16 the Clinton Administration, three-quarters of that
17 administration's policymaking, it was with a Republican
18 majority in the House of Representatives that controls the
19 purse strings.

20 And you know the punch line. I was on the
21 committee that controls the purse strings, and so I guess
22 I'm a little concerned that the continued representation of
23 what I would call a half truth doesn't serve our needs
24 today.

25 And I -- and I -- I know this is a partisan

1 statement surprisingly, that the fact that it became
2 bipartisan to have to make public policy, I believe worked
3 to the benefit of the American people.

4 There's been great criticism by the current
5 majority, both in the administration and the Congress, about
6 the unilateral control of the Presidency and the Congress
7 for a period of time by the Republicans. And I'm concerned
8 about the current return of structure of the current
9 non-bipartisan arrangement.

10 So if you would, just as you were writing there,
11 uncharacteristically, given a little bit of credit to the
12 fact that just prior to your signing in, you knew you were
13 going to have to work with a House of Representatives
14 controlled by another party, which I think ultimately, in
15 the American political tradition of accommodation and
16 compromise, moved some pretty good policy.

17 And, yes, the President signed it, but he would
18 have had nothing to sign if it hadn't been advanced by a
19 Congress with a House of Representatives controlling the
20 purse strings run by a Republican majority.

21 MR. RUBIN: Is it possible for me to respond to
22 that?

23 VICE CHAIRMAN THOMAS: You sure can.

24 MR. RUBIN: Okay. Let me first assure you --

25 VICE CHAIRMAN THOMAS: You can -- you can add an

1 addendum to your opening statement, if you want to.

2 MR. RUBIN: No. Let me -- let me just very
3 briefly respond to pieces of that, if I may.

4 I certainly didn't mean it to be a partisan
5 comment. I was trying to make a point about public policy.
6 But I'll give you my view of the secrets if you say I'll
7 just take one moment since it doesn't relate to the crisis,
8 but in '93 we did have a deficit reduction program, and it
9 was powerful, and it set the stage, in my opinion, for eight
10 years of fiscal discipline.

11 The '94 election just came out exactly as you
12 said. I don't personally think it was about the '93
13 decision. I think it was about a lot of other matters, but
14 that's a political issue.

15 And you were absolutely correct in saying that
16 in 1997, the Republicans and Democrats worked together in a
17 bipartisan fashion, beginning, as you correctly say, in the
18 House of Representatives, for the reasons that you describe,
19 to arrive at a balanced budget agreement, which carried
20 forward the work that at least in my judgment, began in
21 1993. So that would be my summary of that, that period.

22 VICE CHAIRMAN THOMAS: I appreciate that.

23 Mr. Prince, so I want you to comment, if you
24 would, because I don't know you personally and I only knew
25 you from, to a certain extent, a comment that's obviously

1 gotten far more coverage than it should have if, in fact,
2 you made it, and I assume, knowing the press only reports
3 those things that occur, that you made it at some point
4 about the business of if they're playing the music you have
5 to dance. No, you don't.

6 Now, I understand there probably would have been
7 consequences. Maybe somebody would have not continued to
8 make tens of millions. But when you listen I just have to
9 commend everyone that the audio, not the video, the audio of
10 the dialogue between the questioning of the Commissioners
11 and the answer from those people in Citibank who were in a
12 position to make up all these things and have a knowledge, I
13 understand that you're at the top, but these were the people
14 who were not.

15 And the creations that you made, arguably driven
16 by the desire of markets, and your job is to make markets,
17 and your argument is we didn't know, you didn't understand,
18 had we known then.

19 At -- at some point, is it necessary, in your
20 opinion, to create a structure which stops you from doing
21 things? Because I don't think any of us want to create that
22 kind of a structure, requires you to what you're doing -- I
23 believe sunshine's a great disinfectant, that there's
24 complete transparency, that you need third parties to -- to
25 have an understanding of whether or not they would buy it?

1 More importantly, should you have to have money,
2 notwithstanding that you were adequately capitalized under
3 some regulations that were created prior to the environment
4 that we were in, what, probably, looking back, because you
5 now have hindsight, would you have preferred that was
6 comfortable to allow you to carry on your business, but
7 nevertheless, I don't believe in simply imposing structures
8 for the sake of controlling.

9 I don't want to kill the goose that mostly laid
10 golden eggs. You laid other eggs but some of them were
11 golden. And I think it's absolutely necessary. Your point
12 about national and international, we can't go back.

13 I'm very concerned that we address problems in
14 the United States and we don't get a successful and
15 negotiated agreement internationally, which doesn't advance
16 our need to control.

17 Given the nature of your company in terms of its
18 significant international involvement, what could have been
19 done that would have made it possible for you to carry on
20 aspects of business that makes sense but would have limited,
21 controlled, mitigated, but you wound up doing?

22 MR. PRINCE: There's a lot there, if I may. Let
23 me just respond to the quote that you mentioned.

24 VICE CHAIRMAN THOMAS: No, it's the alleged
25 quote that I read in the media, because I never heard it.

1 MR. PRINCE: Well, you were in Japan, so that's
2 why you didn't hear it directly. And I would appreciate the
3 courtesy of quoting the entire quote. The entire quote
4 started with the statement that when the liquidity dried up,
5 the financial environment would become very complicated, but
6 that as long as the music was playing, you had to get up and
7 dance.

8 Now, I think that reflects --

9 VICE CHAIRMAN THOMAS: Just let me say,
10 Mr. Prince --

11 MR. PRINCE: Can I finish my answer, please?

12 VICE CHAIRMAN THOMAS: -- I'm not surprised that
13 the entire quote was not printed, given my background and
14 experience.

15 MR. PRINCE: Well, it actually was printed in
16 many places. If I can just finish my answer?

17 I think I've been quoted in Secretary Paulson's
18 book, at about the same time as asking the regulators to
19 impose limitations on the companies so that they would not
20 be engaging in some of these activities.

21 I want to emphasize that this was about
22 leveraged lending; it had nothing to do with the mortgage
23 business. It had nothing to do with the CDO business, it
24 had nothing to do with the issues that we've been talking
25 about here.

1 But in terms of the quote itself. The quote
2 itself related to the leveraged lending business, and I
3 specifically asked the regulators if they would take action
4 in regard to that.

5 VICE CHAIRMAN THOMAS: You started off your
6 statement in using the term you wanted the regulators to
7 impose? So you wanted them to stop you from dancing?

8 Can't -- can't you set up structures inside, or
9 is it that you would feel then you had a -- you -- if you
10 limited yourself, others would not? And that's the
11 origination of imposed. So it was imposed on everyone
12 because none of you can regulate yourself in terms of
13 creating these triple synthetic, Triple-B, the Triple-A
14 senior tranches that are never, ever going to go down?

15 MR. PRINCE: Sir, you must have misunderstood
16 me. I apologize.

17 As I said, this had nothing to do with the
18 mortgage business. This had to do with the leveraged
19 lending business. In the summer of 2007, the leveraged
20 lending business, banks lending to private equity firms, was
21 a matter of great topic, a matter of great discussion.

22 And at that point in time, because interest
23 rates had been so low for so long, the private equity firms
24 were driving very hard bargains with the banks. And at that
25 point in time the banks individually had no credibility to

1 stop participating in this lending business.

2 It was not credible for one institution to
3 unilaterally back away from this leveraged lending business.
4 It was in that context that I suggested that all of us, we
5 were all regulated entities, that the regulators had an
6 interest in tightening up lending standards in the leveraged
7 lending area.

8 But again, I want to say, for the third or
9 fourth time, it had nothing at all to do with the mortgage
10 business.

11 VICE CHAIRMAN THOMAS: Thanks. In other words,
12 you weren't going to be the lemming that stopped and said
13 that I don't know if I want to keep walking. Thanks.

14 CHAIRMAN ANGELIDES: All right. Ms. Murren?

15 COMMISSIONER MURREN: Thank you.

16 EXAMINATION BY COMMISSIONER MURREN

17 COMMISSIONER MURREN: Thanks to you both for
18 being here today.

19 I want to follow on the thread of that
20 conversation, because you and many of the people that were
21 here to testify yesterday have alluded to the fact that they
22 were not rewarded for growth, that they weren't rewarded for
23 revenue growth or for earnings growth, that that was
24 secondary in the way they were compensated; am I wrong? Did
25 I misunderstand that?

1 MR. PRINCE: I'm not sure who you're quoting. I
2 apologize.

3 COMMISSIONER MURREN: Did you not say earlier in
4 your testimony that part of your major driving force in your
5 compensation was not revenue growth?

6 MR. PRINCE: In my statement, Commissioner, what
7 I said was that the risk function, the risk function, was
8 not compensated on -- on revenue growth or profit growth.
9 The risk function as an independent control function was not
10 compensated based on business volumes.

11 COMMISSIONER MURREN: Okay. Thank you for that
12 clarification, that's -- that is logical. The follow on to
13 that would be how do you then try to factor in risk into the
14 way that you compensate all of your executives?

15 And because what I hear in a little bit of this
16 notion of if people are dancing, you need to dance too, is
17 when you think about compensation, oftentimes people are
18 rewarded because of the way they're compared to their
19 industry.

20 So then it's very difficult for any manager in
21 any position to be able to say, no, we don't want to grow in
22 this business because inevitably, at the end of the year,
23 you will be compared to entities perhaps that are growing,
24 perhaps unwisely.

25 And I would like your comments, perhaps, on if

1 there is a way that things might have been structured
2 differently so that those decisions would have been easier
3 for people to make.

4 MR. PRINCE: That's a very thoughtful question.
5 The compensation structure on Wall Street is -- is one that
6 many people have criticized over the years. It is for --
7 for traders, for bankers and so forth, a compensation model
8 that is based on revenue growth, not even profit growth.

9 And a number of people over the years, Warren
10 Buffet among them, has tried to change that compensation
11 model on Wall Street.

12 Let me tell you, if I may, how compensation
13 worked for me. I spent nearly 30 years with Citi and its
14 predecessors, and over that period of time, certainly when I
15 was an executive of the company, we were paid in fair amount
16 in stock of the company. More than half of our pay was in
17 common stock of the company. And for a period of time we
18 were required to hold 75 percent of the stock we received;
19 in other words, we couldn't cash it out. In my case, I held
20 100 percent of the stock, not the 75 percent.

21 Our rules also provided that you had to hold the
22 stock as long as you were with the company. You could sell
23 it when you left. In my case, I held the stock the entire
24 time.

25 As I sit here today, I hold virtually every

1 share of stock I acquired over a nearly 30-year career. And
2 I watched it go from \$50 a share to \$30 a share to less than
3 a dollar a share.

4 So in my case, I think my interests were aligned a
5 hundred percent with stockholders. I watched a great
6 majority of my personal net worth built up over 30 years
7 disappear, because my company suffered from these problems.

8 Now, I can't speak for others. I can't speak
9 for whether other people cashed out. But I think a model
10 that requires you to have that kind of alignment with the
11 stockholders is a good one.

12 COMMISSIONER MURREN: It is good, in certain
13 respects, but I would guess that you would agree that
14 there's certain elements of that that would also themselves
15 encourage risk-taking.

16 For example, when you look at the expectations
17 and how Wall Street expectations play out in the prices of
18 equity, in particular, they typically are related very
19 directly to revenue and profit growth returns on equity
20 which, by definition, mean you're going to want to lever up.

21 So, then, is there -- and even -- perhaps this
22 isn't the time to discuss it, but my point simply is risk,
23 itself, and the assumption of liability was not necessarily
24 the norm in how people's compensation was determined. There
25 were people that cashed out. There were people actually

1 whose cash pay was substantial enough to accommodate any
2 declines in the stock price should they occur.

3 So I think that it would be fair to say that there
4 is, in my view perhaps, some greater emphasis on growth than
5 perhaps is healthy, at the corporate level; would you not
6 agree?

7 MR. PRINCE: Well, clearly you can't overstate
8 the need for risk assessments in running your business. But
9 I want to emphasize, if I may, that the CDO positions that
10 we're talking about were not put on the books by people who
11 were trying to take on more risk. They thought, they were
12 mistaken, but they thought they were taking on little or no
13 risk.

14 So very clearly, from the Commission's standpoint,
15 the notion of making sure that risk considerations are
16 embedded in the operation of a business is absolutely a high
17 criteria, I grant you that. But I think it is a more
18 complicated issue in this case, because the folks involved
19 did not think they were reaching in a risk standpoint, so
20 risk parameters weren't violated.

21 Now, in hindsight, it's been horrible, I accept
22 that, but at the time, on a prescriptive basis, going
23 forward, as the Commission needs to struggle with, the
24 notion of having stronger risk parameters, as such,
25 wouldn't, by itself, go to the essence, I believe, of what

1 happened here.

2 COMMISSIONER MURREN: The financial services
3 sector, though, is uniquely complex and has a regulatory
4 structure that is designed to help companies, in this
5 instance, because of risk-focused regulation manage their
6 own systems of risk.

7 And I'm interested in your comment, Mr. Rubin,
8 about the notion that you were in a position, both of you, I
9 guess, but perhaps just you, to have people surface problems
10 to you as they occurred.

11 But wouldn't it also be true to say that you and
12 the regulators that oversee your business, to ensure safety
13 and soundness, should have been asking the right questions.
14 And, from your perspective, I would be interested in your
15 description of your interaction with the various regulatory
16 agencies, and also to what extent you felt that they were
17 asking the right questions at the right time.

18 MR. RUBIN: Yeah, Commissioner, I think I may
19 have slightly misstated what I -- I may have slightly
20 misspoken or there may have been a misunderstanding.

21 No, I didn't say that I was in a particular
22 position to have issues raised. What I said was that a -- a
23 board cannot know what's in the position books of a
24 financial services firm.

25 I've been on three public boards. Two were not

1 in the financial sector, and that was true there too.
2 You're not going to know what, on a granular level, what's
3 happening in a business.

4 So what you need to do, what a board needs to do
5 and I believe Citigroup did do, is to put strong people in
6 the relevant positions. And then what you're depending on
7 is both those people and a whole set of checks and balances,
8 an internal auditor, a CFO, legal counsel and the rest, to
9 surface problems when they exist. And that was what I had
10 alluded to.

11 COMMISSIONER MURREN: And in the instance of
12 Citigroup --

13 MR. RUBIN: Right.

14 COMMISSIONER MURREN: -- observers would say
15 that that was not present, that the internal communications
16 necessary for that to work effectively weren't there, the
17 infrastructure wasn't there, properly allocated and properly
18 executed for risk management.

19 But you have said that this isn't true. Given
20 the outcome, do you think that there was a way for you to
21 have done that better and do you think that the regulators
22 should have noted that more strongly in what they did?

23 MR. RUBIN: I don't agree with the -- with
24 the -- I don't think that's right, Commissioner, in terms of
25 the -- the processes as not being there.

1 We had the board meetings, I guess, roughly
2 speaking, once every month or thereabouts, and the
3 independent risk management people reported both to the
4 audit committee and to the board, certainly in writing and
5 very often verbally, and I think we actually had very robust
6 processes around reporting risk.

7 As Mr. Prince said, in the instance that we're
8 talking about, you had a particular set of instruments,
9 these Triple-A instruments, that simply weren't viewed, and
10 I think understandably, given the way Triple-A had been
11 viewed in the entire time, in the many decades I was in the
12 industry --

13 COMMISSIONER MURREN: But we're talking about --

14 MR. RUBIN: They weren't viewed --

15 COMMISSIONER MURREN: -- processes.

16 MR. RUBIN: Yeah. No, I think the processes
17 were very strong. I think you had a -- you had a -- well,
18 can I say, Commissioner, you had a very well-regarded head
19 of risk management.

20 You had, I think, something like 2500 people or
21 thereabouts that worked in this area, and he presented to
22 both the audit committee and to the board at every meeting.

23 COMMISSIONER MURREN: So let's talk about the
24 regulators for a second.

25 MR. RUBIN: Yes, ma'am.

1 COMMISSIONER MURREN: Your interactions with
2 them, do you feel that they asked the right questions at the
3 right times? Do you feel like your interactions with them
4 were the kinds of things that would support every agency
5 feeding back to the Federal Reserve about the safety and
6 soundness of your enterprise? Do you think that that worked
7 effectively?

8 MR. RUBIN: Commissioner, I was not personally
9 involved -- given my role in the institutions, which I
10 described in my statement, I was not involved in the
11 interactions between the company and the regulators, so I
12 can't answer that.

13 COMMISSIONER MURREN: And you, Mr. Prince?

14 MR. PRINCE: Well, I was, and I -- I --
15 Commissioner, I would describe it as follows: The
16 regulators were embedded in the organization; that is to
17 say, they were representatives of the regulators, the
18 various regulators, who had offices in our building and who
19 worked there on a daily basis.

20 In addition to that are various staff functions,
21 the risk function, the audit function, the legal function
22 would meet with the regulators on a periodic basis. And
23 without knowing every meeting, my guess is it was at least
24 once a month.

25 I would personally meet with regulators on a

1 frequent basis, at least once a quarter, sometimes on a
2 private basis. I think that what happened here is that the
3 regulators also mistook the ultimate safety of the CDO
4 positions. I don't think it was a situation where the
5 regulators weren't active. It certainly felt active from
6 the company's standpoint.

7 I don't think it was a situation where the
8 regulators didn't know what was going on. As I said, they
9 lived with us day by day by day. I think that the mistake
10 that was made by everyone about the value of these
11 instruments was fundamentally also made by the regulators.
12 And I think that's basically what happened.

13 I don't think it was a failure of regulatory
14 involvement with the company.

15 COMMISSIONER MURREN: Thank you. Concede my
16 time.

17 CHAIRMAN ANGELIDES: Thank you very much,
18 Ms. Murren.

19 Mr. Wallison?

20 COMMISSIONER WALLISON: Thank you, Mr. Chairman.

21 EXAMINATION BY COMMISSIONER WALLISON

22 COMMISSIONER WALLISON: Let me start with you,
23 Mr. Prince. I want to thank both of you for coming to this
24 and answering our questions.

25 Let me start with you, though, Mr. Prince. You

1 talked about --

2 CHAIRMAN ANGELIDES: Mr. Wallison, pull the mic
3 a little closer to you, I think for everyone, so we can hear
4 your mellifluous --

5 COMMISSIONER WALLISON: Mellifluous.

6 CHAIRMAN ANGELIDES: Sorry about that.

7 COMMISSIONER WALLISON: Okay.

8 CHAIRMAN ANGELIDES: Easy for me to say.

9 COMMISSIONER WALLISON: Mr. Prince, you talked
10 about a 30 percent decline in housing prices, completely
11 unprecedented event, and you talked about it as though it
12 was kind of in the common talk today; like a black swan, it
13 just sort of happened.

14 Have you considered why it happened? Have you
15 given any thought to that, and if you have, would you
16 describe to us what your thinking is?

17 MR. PRINCE: Well, I have given that some
18 thought, as you would imagine. I know that for a period of
19 time before the financial crisis, David Bushnell would say,
20 you know, our stress testing is X or Y, and we would have to
21 have a decline of X or Y, and we haven't had that since the
22 Great Depression.

23 And I thought about why in this time period we
24 had such a huge decline. How could that be the case? I'm
25 certainly not an in-depth expert on the mortgage market.

1 But my guess is that the period of time before the crisis in
2 which home prices appreciated so much and in which so much
3 expansion of lending occurred could be seen as a bubble
4 period in housing as well as other things.

5 So that if you were to draw a trend line that
6 would go up at a certain number of degrees, that because of
7 the easy money and other factors, that trend line in housing
8 would have accelerated very quickly.

9 So instead of going up at a steady incline, it --
10 it went up at a rapid incline. And I think that coming back
11 down, on the other side of that, is the 30 percent kind of
12 number that we see.

13 COMMISSIONER WALLISON: Well, we've --

14 MR. PRINCE: So that the decline is in some way
15 a function --

16 COMMISSIONER WALLISON: Sure.

17 MR. PRINCE: -- of the increase.

18 COMMISSIONER WALLISON: Well, we've had bubbles
19 before. We've had, perhaps not quite as large as this one;
20 this was a very large bubble, but we've had them before.

21 But when they deflated, the mortgage failures,
22 as probably Mr. Bushnell told you, were not substantial.
23 They certainly were not 30 percent; it was certainly not a
24 30 percent decline in housing values.

25 Were you aware, for example, that in this

1 particular bubble, 26 million, 27 million really, of
2 mortgages were subprime or Alt-A; that is to say, they were
3 ready to fail as soon as the bubble deflated?

4 Now, when I asked Mr. Bushnell that yesterday,
5 he was not aware of it. I asked some of the other people at
6 the table yesterday whether they were aware of it, and they
7 were not aware of it.

8 This is -- when Alan Greenspan testified,
9 however, he mentioned that there were 12 million mortgages
10 that were made by Fannie Mae and Freddie Mac that were not
11 reported as Alt-A or subprime by them. So people were not
12 aware that a very substantial number -- almost half of all
13 of the bad mortgages in the economy at that time were made
14 by Fannie and Freddie and were either guaranteed by them or
15 on their books.

16 Now, would it have -- would it make it somewhat
17 clearer to you why this happened, why we had a 30 percent
18 decline in housing prices if you understood or knew, at the
19 time, that so many of the mortgages, half of all mortgages
20 in our financial system were of poor quality?

21 MR. PRINCE: Well, Commissioner, it's hard to
22 put yourself back, mentally, at that timeframe, after all
23 that's happened.

24 The events over the last couple of years color
25 one's thinking. It's hard, now, to -- to think of a

1 subprime loan as not being a, quote, bad loan. But -- but
2 I'm not sure that was the case at the time. I'm not sure
3 that from a policy standpoint, from a lending standpoint,
4 subprime loans were necessarily equated to bad loans.

5 COMMISSIONER WALLISON: I'm -- I'm really very
6 happy that you said that, because that is exactly right, and
7 that's the point I think I would like everyone to
8 understand.

9 Most people were very proud of the fact,
10 especially here in this building, and elsewhere in
11 Washington were very proud of the fact that subprime loans
12 were being made and the -- and the home ownership rate in
13 this country was going up during this period.

14 Now, when it turns out that these mortgages
15 failed and caused, I believe, at least there are indications
16 that they caused the financial crisis, everyone is running
17 away from it and trying to point fingers at who made these
18 loans.

19 But we have to remember that 64 percent, there
20 was a 64 percent home ownership rate in 19 -- in 1994, but
21 by 2005, and I'm talking about two administrations here, the
22 Clinton Administration and the Bush Administration, it had
23 gone up to 69 percent. And everyone was very proud of this.

24 So I think we have to look at this as a question of
25 government policy and not a question of casting blame on

1 people who happen to be involved at the time.

2 Let me go to one other subject: The National
3 Community Reinvestment Coalition says in their annual report
4 in 2007 that over 4 and a half trillion dollars in CRA, that
5 is, Community Reinvestment Act commitments, were made by
6 banks in connection with efforts to get approvals from
7 regulators for mergers.

8 You were much involved, I think, in this, as the
9 general counsel of Citi, for a while. And Citi's
10 commitments, if I recall the number correctly, was something
11 like 400, 500 billion dollars, somewhere between 400 and 500
12 billion dollars.

13 Are you familiar with the fact that these
14 commitments were made in connection with applications to the
15 Fed or to another regulator for approval of a merger?

16 MR. PRINCE: Well, that's a long time ago, but I
17 would say in a general sense, yes.

18 COMMISSIONER WALLISON: And while you were at
19 Citi there were announcements that these commitments were
20 being met; that is to say, that they were made and now these
21 loans that actually been made in order to provide financing
22 for people to buy homes. Were they, in fact, made?

23 MR. PRINCE: Well, Commissioner, I'm -- I'm --
24 I'm confident that the commitments that the company made in
25 the CRA -- CRA area were -- were fulfilled, yes. I don't

1 know the details, but I'm absolutely confident.

2 COMMISSIONER WALLISON: Understood. Understood.

3 MR. PRINCE: We committed we would make these
4 loans and we did.

5 COMMISSIONER WALLISON: You made them, and the
6 announcement were valid, they, the loans, were actually
7 made. Okay.

8 I just have one more question for you, and that
9 has to do with the fact that you talked about the downgrade
10 by the rating agencies as being precipitous and causing
11 tremendous turmoil in the markets.

12 But the downgrade really had one effect and that
13 is it was an accounting effect, wasn't it? I mean, that is
14 to say, once the downgrade occurred then it became necessary
15 for financial institutions that held these mortgages to
16 write them down in some way or take losses on their balance
17 sheets.

18 I'd just like your views on this whole question of
19 fair value accounting and mark-to-market accounting and the
20 way the -- the accounting rules operated to have an effect
21 on the financial crisis.

22 MR. PRINCE: Well, that's a -- that's a very
23 broad topic, and I'm sure you could have days of hearings
24 just on mark-to-market accounting.

25 COMMISSIONER WALLISON: I hope we will.

1 MR. PRINCE: I wish you well on that.

2 COMMISSIONER GEORGIU: Roll call.

3 MR. PRINCE: And I -- and I hope I'm not here
4 for it, but my basic view on that is that the debate on
5 mark-to-market accounting I think is a false debate. The
6 debate on mark-to-market accounting is either attributed to
7 all mark-to-market accounting or it should be no
8 mark-to-market accounting. And by defining the debate that
9 way, it becomes a very artificial discussion.

10 In almost every area that we live in, there are
11 moderating factors. If the stock market has a big down day,
12 it has stock limits in it. If a company's pension plan is
13 underfunded, you could fund it over a number of years, et
14 cetera, et cetera, et cetera.

15 There are very few areas where -- where the
16 absolute nature of today's mark-to-market accounting
17 obtains. There's no question that the mark-to-market
18 accounting is not associated with the cash flow of these
19 instruments. There's no -- there's no question of that.

20 COMMISSIONER WALLISON: Right.

21 MR. PRINCE: And it's entirely possible that at
22 some point in the future, people will make a lot of money
23 from these instruments because they will pay out. But,
24 again, the debate now isn't about those kind of issues. The
25 debate is about we have to have mark-to-market accounting as

1 a theoretical purity --

2 COMMISSIONER WALLISON: Right.

3 MR. PRINCE: -- or we don't. And I think that's
4 a false debate.

5 COMMISSIONER WALLISON: Thank you for that
6 answer.

7 Mr. Rubin, almost everyone who has come before
8 our Commission has testified that the high levels of
9 delinquency and defaults on subprime and Alt-A loans, after
10 the bursting of the bubble in 2007, was one of the
11 preliminary -- was one of the primary causes of the
12 financial crisis.

13 It was the deterioration, indeed, of these
14 subprime loans that caused the CDO problem that you're so
15 well aware of, so I was a bit surprised that when you
16 listed, oh, almost a dozen items in your testimony as the
17 causes of the financial crisis, the delinquency and defaults
18 on subprime loans was not among them. Why -- why was that?

19 MR. RUBIN: Well, to some extent,
20 Mr. Commissioner, there was a question of how much I was
21 going to list.

22 COMMISSIONER WALLISON: You listed a dozen
23 items.

24 MR. RUBIN: I listed a dozen and said much else
25 at the end, you're right.

1 But I guess what I was thinking -- what you said
2 was factually correct. What I did was to list the factors
3 that led to the subprime foreclosure rates rather than list
4 the subprime foreclosure rates themselves.

5 I referred to over leveraging consumers, I
6 referred to excess lending by -- by lenders, I referred, if
7 I remember correctly, to regulatory problems, and I referred
8 to excesses and abuses in mortgage extension.

9 It was that combination of factors that led or at
10 least contributed greatly to the problems in subprime. You
11 were absolutely correct. I could have said, and all of that
12 led to problems of subprime.

13 And I instead referred to the factors that led
14 to the problem rather than to that particular consequence of
15 the problem.

16 COMMISSIONER WALLISON: When you were Secretary
17 of the Treasury, do you recall the housing policies of the
18 Clinton Administration and the strong effort to increase
19 home ownership by increasing the credit available to
20 moderate- and low-income borrowers?

21 MR. RUBIN: Yes, I do.

22 COMMISSIONER WALLISON: And those, I assume, you
23 thought were successful, at the time?

24 MR. RUBIN: I did, indeed.

25 COMMISSIONER WALLISON: And so you supported

1 those policies?

2 MR. RUBIN: I did.

3 COMMISSIONER WALLISON: Between 1994 and 2005,
4 as I mentioned before, the home ownership rate in the United
5 States increased substantially.

6 Would -- at the time, everyone was very pleased
7 about this, as I mentioned. Would you have gone to
8 Congress, at that point, understanding what you know now,
9 and said to Congress, we have to stop this subprime and
10 Alt-A lending, because sometime in the future it is going to
11 cause us tremendous problems. Would you have gone there, as
12 Secretary of the Treasury, and done that?

13 MR. RUBIN: No. Let me, if I may give you my
14 view of that, because I think you're raising a very, very
15 important question.

16 I believe that CRA served very valuable purposes
17 in making credit available to those who would otherwise not
18 have had access to credit, particularly inner-cities. And
19 one reason I mentioned my chairmanship of LISC, as the
20 nation's largest inner-city development organization, is
21 because it relates -- it's that experience that I think has
22 given me some sense of this issue.

23 What I think we do need and need very badly, I
24 don't think the problem lies in CRA, and I think it's very
25 important to have subprime credit available.

1 I think where our problem lies is that it's
2 clear, now that we've had this experience, that there were
3 excesses and abuses and substantial excesses and abuses. So
4 I think what we need is to continue with CRA. I think we
5 continue to need, and I think it's very important, to make
6 credit available in inner-cities and corresponding the
7 distressed rural areas. But I do think we need very strong
8 consumer protection, because then you can get at the
9 excesses and the abuses without a problem. I think at least
10 in two respects, if I may, Commissioner.

11 COMMISSIONER WALLISON: Yes.

12 MR. RUBIN: I think that we need --

13 COMMISSIONER WALLISON: If I can get more time.
14 Go ahead.

15 MR. RUBIN: I apologize. I think we need
16 effective disclosure, but I also think there are some
17 instruments that are inherently susceptible to abuse. And I
18 think serious consideration ought to be given to barring
19 those instruments.

20 COMMISSIONER WALLISON: All right. I don't
21 think, as I'm agreeing with you in this sense, CRA is not
22 the problem, but Fannie Mae and Freddie Mac have on their
23 balance sheet, had on their balance sheet in 2008, have on
24 their balance sheet probably today, about 12 million
25 subprime and Alt-A loans that we really didn't even

1 understand were on their balance sheet before they disclosed
2 it in 2009. That is one of the reasons we have this
3 problem.

4 Did you ever attempt when you were Secretary of
5 the Treasury to rein in the kinds of things that Fannie and
6 Freddie were doing at that time?

7 MR. RUBIN: Commissioner, at the time, let me
8 give you two responses to that, if I may. If you -- if
9 you -- if we have serious consumer protection put in place,
10 then the kinds of loans that you're referring to, if in fact
11 they are the consequence of excesses and abuses, were no
12 longer -- hopefully no longer exist in the subprime loans or
13 mortgages view up on the books of Fannie and Freddie will be
14 sound, at least probabilistically, sound loans.

15 When I was at --

16 VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the
17 Commissioner an additional five minutes.

18 MR. RUBIN: Okay. When I was at Treasury, there
19 were -- we had concerns about Fannie and Freddie. And we
20 particularly had concerns about these very large
21 organizations operating with the implicit guarantee of the
22 federal government.

23 And the Deputy Treasury-Secretary at the time,
24 Larry Summers, and my successor as Secretary, actually got
25 quite involved in that issue. I was not personally that

1 involved but he was very involved in focusing on those
2 issues.

3 COMMISSIONER WALLISON: What would be your idea
4 of a loan that would enhance the ability of low and middle
5 income people to buy homes, an affordable housing loan, as
6 it was req- -- as Fannie and Freddie were required to make
7 it that would be a sound loan?

8 I mean, if you -- if you were going to require
9 organizations as Fannie and Freddie were required to make
10 certain kinds of loans, how can you then say at the same
11 time that if we regulated these loans they would be sound
12 loans rather than the kinds of loans that they seem to have
13 made?

14 MR. RUBIN: Well, I'm not an expert on mortgage
15 extension, but I -- I -- I think what I would -- this is a
16 first-flash response, and if I had more time to think about
17 it I could probably give you a more comprehensive response,
18 but I think what I would do as part of consumer protection,
19 more generally, not just with respect to Fannie and Freddie,
20 is I would have suitability requirements so that loans could
21 only be extended to people who had -- who were -- who were
22 thought to have the means there but because of their
23 employment assets, whatever else might be, to constitute
24 sound borrowers. And then, as I said a moment ago, I think
25 there are probably certain instruments that I would

1 prohibit.

2 If it were practical, and I think it may not be
3 financially practical to do this, I do think it would be
4 very important to have some kind of counseling available to
5 low-income borrowers because I think too often borrowers in
6 that position, and as I said, I've seen a lot of this world
7 through the eyes of LISC, which I think handles all this
8 very soundly, I might add.

9 I think very often, low-income borrowers really
10 are not adequately equipped to make the decisions they need
11 to make. But that may just not be practical. So I would
12 have suitability requirements, I would probably bar certain
13 instruments, and I would have disclosure that was done in
14 such a way that it was readily accessible to people who were
15 not sophisticated.

16 COMMISSIONER WALLISON: And I assume down
17 payments?

18 MR. RUBIN: And what?

19 COMMISSIONER WALLISON: Down payments? Down
20 payments?

21 MR. RUBIN: Oh, absolutely. I absolutely would
22 have adequate, adequate down payments.

23 COMMISSIONER WALLISON: Thank you very much.

24 CHAIRMAN ANGELIDES: That's it?

25 VICE CHAIRMAN THOMAS: Mr. Chairman?

1 CHAIRMAN ANGELIDES: Yes?

2 VICE CHAIRMAN THOMAS: Might I briefly correct
3 the record? Staff has indicated to me in my opening remarks
4 that I said that Republicans gained the majority in the
5 House of Representatives in 1944. No matter how much that
6 might be wished, it isn't true; it was 1994. I want the
7 record to reflect that.

8 CHAIRMAN ANGELIDES: Mr. Georgiou?

9 COMMISSIONER GEORGIU: Thank you, Mr. Chairman.

10 EXAMINATION BY COMMISSIONER GEORGIU

11 COMMISSIONER GEORGIU: As they say, imitation's
12 the sincerest form of flattery, and recognizing that the
13 Chair and the Vice Chair have stolen some of my thunder
14 regarding the collateralized debt obligation problem, I
15 still feel compelled to return to it briefly, with both of
16 you, if I can, for two -- for at least two reasons.

17 One is that Citi wrote off more than 30 billion
18 of the 43 billion that you had on the books, which was
19 roughly a third of the capital that the whole bank had at
20 the time.

21 And second, because I think it's emblematic of
22 something that went seriously wrong in our system that
23 everybody believed was impossible.

24 I mean, yesterday, we had a panel of your
25 underlings, if you will, who were very serious, high-ranking

1 people within the bank, who sat there, four of them,
2 Messieurs Maheras, Dominguez, Bushnell, and Barnes, and they
3 all made a lot of money, in one instance almost 100 million
4 dollars in the course of the three years before all the
5 troubles hit at Citi.

6 And notwithstanding that and notwithstanding
7 their respective responsibilities for originating these
8 CDOs, supervising the risk associated with them and all the
9 other aspects of their responsibilities, all of them
10 essentially said that this was inconceivable, unknowable,
11 couldn't have happened, everybody thought it didn't happen,
12 every other institution who was dealing with them had the
13 same view, and so we were hit with this calamity which
14 nobody could have anticipated.

15 And it seems to me that yesterday I likened it
16 to the medieval alchemy. And today, as I study it more, I'm
17 beginning to believe that maybe it was hallucinatory. I
18 mean, and this is something that I think really deserves
19 exploration, because if you look at the fundamentals, it
20 belies logic. That's not to say that there weren't a lot of
21 people who believed it, but I just want to -- I want to
22 focus -- focus your attention on it yet one more time, if I
23 can.

24 These RMBS securitizations that occurred
25 resulted -- and this is out of a Goldman Sachs analysis, you

1 know, a post hoc analysis, basically, that 75 percent of the
2 tranches were Triple-A; 10 percent, Double-A; 8 percent, A;
3 5 percent, Triple-B; and 2 percent equity and the underlying
4 RMBS. So the Triple-B tranches were at the bottom 7 percent
5 of the tranches in the underlying securities.

6 Now, they take all the Triple-B tranches out of
7 all these underlying RMBS and slice and dice them, and what
8 you get in the collateralized debt obligation is 60 percent
9 of something that's characterized to be Triple-A super
10 senior tranches; 20 percent Triple-A, 6 percent Double-A,
11 5 percent A, and only 2 percent Triple-B, 2 percent
12 Double-B, and 5 percent equity.

13 So suddenly you've taken what was the bottom
14 7 percent of the underlying security and made it, you know,
15 90 percent of it, more than 90 percent of it above A rated,
16 and it strikes me that the fact that everybody believed
17 this, regulators, Mr. Prince, you mentioned in your
18 testimony, nobody questioned this, is highly troubling,
19 because at the end of the day, this was the most significant
20 single matter that impacted your books and it certainly
21 impacted whole -- the books of a lot of other financial
22 institutions.

23 So -- so -- and I guess there's a comment that
24 was given to us by a former senior staff member from the
25 Federal Reserve who warned us that the, quote, specious

1 accuracy of complicated financial models should not be
2 trusted.

3 And basically these models, presumably somebody
4 was modelling this and somebody believed in a modelling that
5 resulted in these analyses, that is, the underwriting people
6 at your shops, the credit rating agencies, the regulators to
7 the extent that they evaluated this, but we now know that
8 everybody was horribly wrong to the tune of over a third of
9 your capital.

10 So how do we address these kinds of dilemmas I
11 guess is -- is what I put to you? And maybe, Mr. Prince,
12 you could respond to that briefly?

13 MR. PRINCE: Well, I think you've -- you've
14 stated it quite well. In hindsight it's very hard to see
15 how these structured products could have been accepted in
16 the way they were accepted.

17 I think that on a going-forward basis, if I can
18 say so, the Commission needs to think about the next issue.
19 In other words, it's very unlikely that structured products
20 are going to be a problem for anyone in our lifetimes.
21 Those are not likely to be accepted in the same way.

22 COMMISSIONER GEORGIU: Thankfully.

23 MR. PRINCE: And the question really is, how
24 could an industry, how could the control processes for an
25 industry have missed something so universally, and how do

1 MR. PRINCE: Yes.

2 COMMISSIONER GEORGIU: Thank you. Mr. Rubin?

3 MR. RUBIN: Commissioner, I -- I would respond
4 to that very thoughtful question the following way: I've
5 been involved with financial markets for about 40-some
6 years, and I can remember when the Black and Scholes models
7 first came into prominence as a way of measuring option
8 volatility.

9 And we actually hired Fisher Black, who, had he
10 lived, would have won a Nobel prize because his
11 co-developers of that did, and had long conversations with
12 Fisher about how do you think about models.

13 And the problem with all models, and it's one
14 reason I make the suggestion I do with respect to leverage
15 constraints, is that they're no better than the information
16 that you feed into them.

17 And in this case, the information that was fed
18 into them and is one reason why Commissioner Born is right
19 about derivative regulation, though I would add, margin
20 capital requirements to be substantially increased as part,
21 the information that's fed into them is usually 10 or 20
22 years of history, whatever it may be and in this instance,
23 and I think it was the great lesson of this crisis is that
24 the downside of the financial markets turned out not to be
25 reflected in the experience of the last 10, 20, 30, or even

1 40 years, but rather to be far greater than that and far
2 greater than anybody had thought.

3 And I think the one thing that could have made
4 an enormous difference here is if there had been a
5 recognition, although there was virtually no recognition of
6 this, very much including by myself, that the real potential
7 downside of our system under stress conditions was not
8 reflected in the experience of the last some decades, but
9 rather it was far worse.

10 And I think as you all go forward it seems to me
11 that what we need to do, in both the private sector and the
12 public sector, is to have changes and reforms that reflect
13 what is now a new understanding of the downside risk of our
14 system.

15 COMMISSIONER GEORGIU: Okay. But -- and let me
16 try to keep the focus on you folks, for just a minute here,
17 because, you know, some people saw this, and I'm not saying
18 that you needed to be as prescient as they were but, you
19 know, there's a famous December of '06 meeting that David
20 Viniar, the CFO of Goldman Sachs, called when they had lost
21 money for 10 days in a row.

22 They had apparently a trigger, which you may
23 know about, when you lose money in a particular trade for 10
24 days in a row, you at least call a meeting. And they did,
25 and they analyzed this, and they basically shifted their

1 position to sort of offload some of their exposure to the
2 mortgage markets.

3 And of course, people like Paulson, you know,
4 made 15 billion dollars betting against the subprime market
5 on the hedge fund side. But you folks -- but Mr. Rubin, I'm
6 trying to focus on you, you had a whole history at Goldman
7 Sachs and yet careening into `07, if you will, Citi made a
8 number of other bets that seems to me to have been, in
9 retrospect, further putting you in jeopardy in this regard.

10 I mean, you bought the Argent, the Ameriquest
11 platform from Roland Arnall in February of `07, and --
12 and -- and we're continuing essentially to advance your
13 exposure in this regard.

14 And let me just point out one other: In July of
15 `07, you actually started to buy back in exercise, having to
16 exercise these liquidity puts to bring the CDOs back onto
17 your balance sheet where they had been off-balance-sheet,
18 and both of you testified that it wasn't until something
19 like October of `07 that it came to your attention.

20 Well, that seems awfully late. And maybe had you
21 been in a position to know earlier, you might have taken
22 some ameliorative action to protect the balance sheet of
23 Citi in the meantime.

24 So, Mr. Rubin, could you respond to that?

25 MR. RUBIN: Yeah, let me respond to that, if I

1 may.

2 You are correct, Commissioner. There were some
3 people. There were some hedge fund managers. Paulson was
4 one. I think there actually are some others who really did
5 see this complete picture. I can't speak to what David
6 Viniar saw or didn't see, but I don't think that any major
7 firm really saw -- and if you look at the various activities
8 that are engaged in the LBL area as well as in these areas,
9 I think it bears this out, really saw the potential for the
10 kind of crisis that we had.

11 In terms of the purchase back at the puts, I
12 mean, at that point I wasn't aware of it and I think I
13 testified, I know I said this in my statement, I wasn't
14 aware of this 43-billion-dollar exposure until I think it
15 was September or thereabouts. So that was activity that was
16 taking place within the business at a level that you just
17 wouldn't see if you were on a board.

18 And those put -- those positions were taken back
19 pursuant to the puts because the market had basically, at
20 least is my understanding, had basically frozen.

21 COMMISSIONER GEORGIU: Well, you couldn't sell
22 them. I mean that --

23 MR. RUBIN: Yeah, they had no choice.

24 COMMISSIONER GEORGIU: They couldn't sell them
25 so you took the puts back.

1 But -- but wouldn't that -- wasn't that a signal
2 to somebody? Shouldn't that have been a signal to somebody
3 that your exposure was dramatically increasing by having to
4 take these back?

5 MR. RUBIN: Well, let me just, if I may.

6 COMMISSIONER GEORGIU: Right.

7 MR. RUBIN: You're correct. They -- they
8 were -- they, at least as I understand it, though I wasn't
9 aware of it at the time, they had to buy back those tranches
10 because the markets had fundamentally become frozen.

11 COMMISSIONER GEORGIU: Right.

12 MR. RUBIN: But still --

13 COMMISSIONER GEORGIU: But that's -- this is
14 way earlier, you know, this is almost a year; it's more than
15 a year before Lehman fails; it's nine months before Bear
16 Stearns fails.

17 MR. RUBIN: It was -- it was, as I remember
18 correctly, what you said, July of '07.

19 COMMISSIONER GEORGIU: July of `07.

20 MR. RUBIN: July, `07, about three months before
21 we became aware of these Triple-A positions.

22 COMMISSIONER GEORGIU: Right.

23 MR. RUBIN: But they still believed, as I
24 understand it, and I think in good faith, as did the
25 universe in general, almost, with some very few exceptions,

1 as you correctly say, that these were Triple-A securities,
2 that the risks were de minimus, and that this market would
3 clarify in time, and they would begin to function again.

4 COMMISSIONER GEORGIU: Right. Okay. Well,
5 yesterday we heard from -- from -- well, let me -- let me --
6 let me actually ask you about one other question.

7 I recall, if my memory serves, that you had to
8 either miss your Thanksgiving dinner or get up from your
9 Thanksgiving dinner in November of '07, to fly to Abu Dhabi
10 to raise seven and a half billion dollars in capital from
11 the Abu Dhabi investment authority. And I guess I -- I
12 mean, obviously you needed that capital at that time.

13 Would it have been possible for you to have raised
14 more capital for Citi, either then or prior to then, that
15 might have avoided the taxpayers having to bail out Citi at
16 the time?

17 Now, I recognize it was expensive capital. It
18 was, I get points plus 11 percent. It was really a hard
19 money loan in certain characterizations, but could you speak
20 to the capital requirements?

21 Because Dr. Greenspan yesterday said that one of
22 the things that he would now recommend, even though he
23 basically didn't take much responsibility for this, but he
24 did suggest that on a go-forward basis, there ought to be a
25 whole lot more capital and a whole lot more liquidity

1 required of these large financial institutions in order to
2 avoid the risk that the taxpayers will have to bail them out
3 in the future.

4 MR. RUBIN: And as you know from my statement, I
5 agree with Dr. Greenspan's positions.

6 COMMISSIONER GEORGIU: Right.

7 MR. RUBIN: I think the average constraint
8 should be very substantially increased, which means you
9 would have more capital in these organizations.

10 My recollection, Commissioner, is that at that
11 time, which was shortly after our new CDO -- no, that was,
12 I'm sorry, that was when I was chairman, which is we were in
13 the search process, one thing or another, that was we tried
14 to raise -- I think I'm right in this, but you better ask
15 others to confirm this -- but my recollection is that we
16 raised as much capital as we could in that period of time.

17 COMMISSIONER GEORGIU: Right.

18 MR. RUBIN: I don't think that there was the
19 opportunity to raise more capital. Although, as I say,
20 there are others who will remember that better than I.

21 COMMISSIONER GEORGIU: Right. The --

22 MR. RUBIN: We have, because your point is
23 extremely well taken. From that point forward, we had a
24 highly proactive focus on raising private capital and
25 ultimately raised some numbers of tens of billions, I don't

1 remember the exact amount, through this period of difficulty
2 for Citi.

3 COMMISSIONER GEORGIU: Right. But of course,
4 by that time the capital was harder to raise and more
5 expensive to raise, right?

6 MR. RUBIN: Yeah. But I don't think we ever,
7 and again, there are others, Commissioner, who have a better
8 recollection of this than I do, but I don't think we ever
9 held back from raising capital at that point because of
10 price, at least not as far as I can recollect.

11 COMMISSIONER GEORGIU: Mr. Prince, yes, if I
12 could, please. Yeah, thank you.

13 Mr. Prince, from '06 to '07, this is referring
14 back to the dance metaphor there. Citi increased its
15 leveraged loan exposure limit from 35 billion to 100
16 billion.

17 If you were at all concerned about this
18 business, how come you allowed the limits to be tripled
19 during that period?

20 MR. PRINCE: Leveraged lending, Commissioner, is
21 a business of lending money to private equity firms and so
22 forth for them to conduct their activities.

23 It was widely reported in the press at the time
24 that the private equity firms were driving very hard
25 bargains with the banks. They were insisting on no mat

1 clauses and payment in kind interest and so forth and so on.

2 My belief then and my belief now is that one
3 firm in this business cannot unilaterally withdraw from the
4 business and maintain its ability to conduct business in the
5 future.

6 Running a securities business is a lot like
7 running a baseball team where none of the players have
8 contracts, and people can leave any day and go to another
9 team.

10 And if you are not engaged in business, people
11 leave the institution. And so it's impossible, in my view,
12 in the leveraged lending business, for you to say to your
13 bankers, we're just not going to participate in the business
14 for the next year or so until things become a little more
15 rational. You can't do that and expect that you'll have
16 any people left to conduct business in the future.

17 COMMISSIONER GEORGIU: Okay. I think if I --
18 if I could, just one more minute.

19 The -- there are several issues. It seems to me
20 that if we -- I'm going to ask, and if we don't get a chance
21 to answer them, I would ask you to try to respond in writing
22 too, because there's been a lot of discussion about a whole
23 variety of forms of arbitrage, which were engaged in by the
24 principal financial institutions that are coming before us.

25 Regulatory arbitrage, to the extent that smart

1 lawyers try to structure things in a way to -- to yield the
2 least restrictive regulatory process.

3 Capital arbitrage, very important in that people
4 move things off-balance-sheet so that you don't have to hold
5 capital against them or you hold them in your trading desk
6 where one of the Fed employees that we interviewed said that
7 if you hold the trading assets, the capital requirements are
8 so low on those that you're basically holding 750 or 800 to
9 1 leverage on them.

10 So there's a lot of different ways that very smart
11 people who work for these institutions are able to avoid
12 what, it seems to me, was one of the glaring failures of our
13 system in that insufficient capital, insufficient money, was
14 being put where their mouth was by these institutions and
15 being held to cushion yourselves against the risk.

16 Could you speak briefly to that? I know we
17 don't have a lot of time, but, Mr. Prince?

18 MR. PRINCE: I think, Commissioner, with respect
19 that question is important enough and detailed enough that I
20 would prefer to respond --

21 COMMISSIONER GEORGIU: That would be -- that
22 would be fine.

23 MR. PRINCE: -- supplementally.

24 COMMISSIONER GEORGIU: Mr. Rubin?

25 MR. RUBIN: Yeah, I'd -- I agree with Chuck that

1 a written response would be appropriate. I would make one
2 general comment, if I may.

3 COMMISSIONER GEORGIU: Sure.

4 MR. RUBIN: I think one of the challenges of
5 those, who are engaged in this financial reform effort are
6 faced, is the very technical -- the technicality of the
7 problem.

8 And I think that the kinds of loopholes,
9 loopholes may be the wrong word, the kinds of issues that
10 you've identified do need to be addressed in terms of
11 increasing constraints on leverage. And I think that should
12 hopefully will be part of this process.

13 COMMISSIONER GEORGIU: Right.

14 MR. RUBIN: But however you do it, I've been
15 around this for a long time, but however you do it, there
16 will always be people seeking to find ways around that.

17 COMMISSIONER GEORGIU: Well, there's no
18 question about that.

19 MR. RUBIN: I think this will always be a work
20 in process.

21 COMMISSIONER GEORGIU: Right. But there could
22 be some things done.

23 MR. RUBIN: I agree.

24 COMMISSIONER GEORGIU: And, you know, one
25 thought is maybe there should be a principle of the total

1 amount of capital required for a pool of assets should be
2 the same after a securitization as before, you know, that
3 you ought not to be able to transfer assets
4 off-balance-sheet and end up with a circumstance where you
5 don't have to hold any capital against them, particularly in
6 circumstances where they may have to come back.

7 And, you know, it's been pointed out to me that
8 50 percent of the mortgages that you held were
9 off-balance-sheet in 2007 and 58 percent in 2008.

10 Now, I know there's some new cap -- new balance
11 sheet requirements that have come in as of 1/1 of '10 that
12 may require you to bring some of them back on, but there's a
13 reason why you had over a trillion dollars of assets off
14 balance sheets. Somebody believed that it was in the
15 interest for the organization in some capacity, I don't know
16 what capacity, less capital, less visibility, who knows, but
17 you moved a lot of assets off-balance-sheet, and so did a
18 lot of other people; you're not alone in this regard. And
19 it seems to me that for transparency and clarity, that needs
20 to be addressed.

21 MR. RUBIN: Can I make a one-second response?

22 CHAIRMAN ANGELIDES: Sure, very quickly, because
23 we have to move on.

24 MR. RUBIN: I'll just take one second. You've
25 identified a very important problem. On the other hand,

1 it's -- it's that securitization, as long as it's done under
2 sound basis, that is very central to the functioning of our
3 economic systems.

4 It seems to me that you're exactly right except
5 that you've got to find some way to enable institutions to
6 engage in securitization that doesn't at the same time lead
7 to problems.

8 COMMISSIONER GEORGIU: Right. And one thing, I
9 know I'm passed my time, but let me just --

10 CHAIRMAN ANGELIDES: Way past.

11 COMMISSIONER GEORGIU: -- say one thing. One
12 idea that has been floated about is to have you take some
13 risk in connection with these securities. Maybe you need to
14 hold them.

15 Greenspan said it yesterday, I mean, said it in
16 his prior testimony, maybe you need to hold them and be long
17 and align with the investors some portion of it so that
18 your -- your diligence is appropriately incented to be sound
19 because you know you're going to have -- thank you very
20 much.

21 CHAIRMAN ANGELIDES: All right. I yield you a
22 couple of minutes out of my time.

23 Just one note for the Commission members,
24 according to our staff, this is an estimate, just an
25 estimate, but of the 51 billion dollars in losses related to

1 subprime exposure, 10 -- close to 11 billion dollars appear
2 to have been in the bank and some 40-plus were in the
3 non-bank, just for the numbers.

4 COMMISSIONER HOLTZ-EAKIN: All right.

5 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin?

6 COMMISSIONER HOLTZ-EAKIN: Thank you,
7 Mr. Chairman.

8 EXAMINATION BY COMMISSIONER HOLTZ-EAKIN

9 COMMISSIONER HOLTZ-EAKIN: Let me begin with
10 apologies, first of all, that due to the vagaries of travel,
11 I was late and missed your testimony and came in the middle
12 of yours. And I do apologize, it was not my intention.

13 And that, also, because of a prior commitment, I
14 was unable to hear the testimony yesterday of the other
15 representatives of Citi. And so to the extent that I'm less
16 than perfectly informed, I apologize in advance.

17 Mr. Rubin, I did want to pick up on something you
18 just said, because it really did catch my attention. You
19 said no one could have foreseen this kind of crisis. And
20 that was a universally sort of held belief.

21 I think the important thing to recognize is that
22 the question is not whether you could have foreseen the
23 whole crisis. The question is, could you have foreseen the
24 spark that lit the crisis, which is the poor standards in
25 underwriting, the poor assessments of risks associated with

1 mortgages, the inadequate hedging and capital provisioning
2 against that. If that's done, there is no crisis.

3 And in light of the fact that we've had housing
4 crisis, the savings and loan crisis, that you are familiar
5 and many are with the activities of Fannie Mae and Freddie
6 Mac and identified them as a risk, and that, in your
7 experience, you've seen crises in Mexico and in Thailand and
8 in the Far East, wouldn't there be grounds to be at least a
9 little suspicious at some point?

10 MR. RUBIN: It's a good question. I didn't say
11 that no one could have foreseen. Actually, I think some
12 people did foresee. What I said was that very few people
13 foresaw the full combination and clearly --

14 COMMISSIONER HOLTZ-EAKIN: They didn't need to;
15 the point is they didn't need to. They just needed to see
16 the mortgage piece.

17 MR. RUBIN: Well, you know, I'm not so sure
18 about that. It seems to me that what you had, and I said it
19 in my opening statement, was you had a large combination of
20 forces that had come together.

21 I at least think, and it's interesting
22 discussions that one could have, I think that a few of those
23 that occurred you would have had a very different experience
24 than we had.

25 I think it was an extraordinary combination of

1 many factors that came together. And you could say, well,
2 you could see some of these, why didn't that suggest to you
3 that this could be a problem.

4 As I said in my opening statement, I actually did
5 worry about excesses back in 2005 and 2006, and talked
6 about it in speeches, one thing and another.

7 But what I didn't see and virtually nobody saw
8 was that it wasn't really those excesses, but it was so many
9 other factors coming together at the same time and I think
10 it was that extraordinary combination that lead to this
11 crisis.

12 And, you know, it's interesting, and I know
13 you've been around for a long time too. As long as we've
14 had capital markets we've had crises. And then when you
15 look back, you always look back and you look back and you
16 say, well, these were -- these were obvious warning signs.

17 But they're not obvious at the time. They're
18 only obvious in hindsight. And I think we all -- I
19 personally think unfortunately that market-based systems,
20 which I believe in strongly, will have periodic down cycles,
21 hopefully not like we've just experienced, and that's why I
22 think this financial reform effort is so extremely
23 important.

24 COMMISSIONER HOLTZ-EAKIN: In your testimony,
25 you did talk about low rates causing markets to reach for

1 yield. And one way to interpret that is that, you know,
2 many people, Citi included, were increasingly borrowing at
3 very short term and lending longer to take advantage of a
4 very steep yield curve.

5 And I guess my question is, did Citi create a
6 structure which was, in light of the way the yield curve
7 ultimately shifted, too dependent on a steep yield curve to
8 survive the change in rates?

9 MR. RUBIN: Well, I actually was referring to
10 something slightly different, but it certainly, and I'm not
11 sure I totally understand the question, but it's certainly
12 true that across the financial world, not just in this
13 country, but around the globe, there was a so-called carry
14 trade, which is what you're referring to, I think.

15 COMMISSIONER HOLTZ-EAKIN: Well, in particular,
16 just your off-balance-sheet activities, funding things at
17 very short maturities and at the very low rates there to
18 make money at the -- at the longer maturities and reach
19 yield. Is that something that across Citi became too much
20 of the business model?

21 MR. RUBIN: Well, that's a good question that I
22 don't know that -- I would say, in retrospect, not just at
23 Citi, but I guess I'm just repeating myself, and I
24 apologize, but across -- across the entire financial system,
25 there was a dependence -- or I shouldn't say a dependence,

1 but there was a great deal of this kind of a carry trade
2 going on. I actually meant in my statements something
3 slightly different though.

4 I was referring to this massive influx of
5 capital from abroad that caused the bond market yields to be
6 lower than they otherwise would have, and I think that was
7 very centrally involved, because as you know very well
8 because I know your background, mortgage -- mortgage yields
9 tend to be a function of the tenure, and that's really what
10 my reference was to.

11 COMMISSIONER HOLTZ-EAKIN: One of the risks that
12 you're exposed to, then, is interest rate risks. And so I
13 think the question becomes risk management.

14 And, Mr. Prince, you said, very clearly, you
15 cannot overstate the need for a risk assessment in running
16 your business. And, as I understand it, one of your
17 capacities was managerial advice and this strikes me as
18 central to both of your portfolios.

19 And I just want to review some of the things
20 that at least the preparation of this hearing reveals, which
21 is that on March 29, 2004, OCC examiners concluded an
22 examination of fixed-income derivatives business at
23 Citibank, which included the business group working on CDOs,
24 and included that, quote, the quality of risk management is
25 less than satisfactory. And that report was transmitted to

1 Citibanks -- some six banks -- six months later.

2 The OCC also concluded that certain CDO tranches
3 super senior positions continue to pose risk management
4 challenges.

5 Obviously, Citi had the chance to respond to
6 that, but as we've heard, you seem to place a lot of
7 reliance on credit rating agencies in assessing the risk
8 associated with those senior CDO positions.

9 How much reliance was placed on the rating
10 agencies from each of you?

11 MR. PRINCE: Well, Commissioner, with respect,
12 the -- the positions that are involved weren't known to me,
13 and I think to Bob, until September, October -- so -- of
14 '07, so --

15 COMMISSIONER HOLTZ-EAKIN: So you don't know how
16 much the rating agencies placed as the risk?

17 MR. PRINCE: So you asked how much did we place
18 from the rating agencies?

19 COMMISSIONER HOLTZ-EAKIN: How much did Citi?

20 MR. PRINCE: Okay. I apologize. I
21 misunderstood the question. I don't know the answer to
22 that. David was here yesterday, David Bushnell, and I think
23 he would have been the proper one to answer that question.

24 COMMISSIONER HOLTZ-EAKIN: Mr. Rubin?

25 MR. RUBIN: Yeah, I'll -- I'll identify with

1 something that Chuck said and then I'll just add one
2 comment, if I may.

3 Both of us learned about -- well, I'll speak for
4 myself, but I think it was also true of Chuck -- learned
5 about this in the fall of '07, and clearly -- and I remember
6 that initial -- when I initially heard about it, and I had a
7 reaction, which is in my statement, you'll see it there, to
8 the effect that if you're engaged in an arbitrage kind of a
9 business, and admittedly I had an arbitrage background and
10 it probably caused me to think this way, then the other side
11 of that transaction is to completely dispose of the risk.

12 But the people who were running the businesses
13 replied, and I think their reply was totally understandable,
14 that these were Triple-A securities and had de minimus risk
15 and that certainly was how Triple-A securities had always
16 been seen in all the time that I've been in the business.

17 So I would say from their response that they
18 were very much relying on those Triple-A ratings. Though I
19 also understand, and I don't recollect where I know this
20 from, but that David Bushnell's people did an enormous
21 amount of independent analysis, as well. And I believe
22 that's where I saw the number, now that I think about it,
23 that they had calculated that it was something like a 1 in
24 10,000 probability of a default on these instruments.

25 COMMISSIONER HOLTZ-EAKIN: So you're both

1 comfortable, it's fair to say, that Citi had adequate
2 supplemental internal risk assessment to --

3 MR. PRINCE: Had what? I'm sorry.

4 COMMISSIONER HOLTZ-EAKIN: Adequate supplemental
5 risk assessment internally on top of the credit rating
6 agencies?

7 MR. RUBIN: Well, I think you need to go back to
8 David Bushnell was here yesterday but -- and I was -- I
9 didn't hear --

10 COMMISSIONER HOLTZ-EAKIN: You were his
11 superiors. Were you satisfied with the risk assessment in
12 your organization?

13 MR. RUBIN: I think David, who I knew reasonably
14 well, was very knowledgeable and very capable. And my
15 impression was that they did a --

16 COMMISSIONER HOLTZ-EAKIN: Is that a yes?

17 MR. RUBIN: -- a very good -- that is -- that is
18 a yes.

19 COMMISSIONER HOLTZ-EAKIN: Mr. Prince?

20 MR. PRINCE: I had great confidence in David
21 Bushnell before this and I have great confidence in him now.
22 I would trust his judgment on how this should best have been
23 run.

24 COMMISSIONER HOLTZ-EAKIN: So you felt that both
25 that the internal processes, while you weren't aware of the

1 details of the assessment of the risk, the internal
2 processes surfaced things appropriately?

3 MR. PRINCE: Correct.

4 COMMISSIONER HOLTZ-EAKIN: In the OCC's
5 examination report for Citibank that ended the year
6 September 31st, 2007, has stated that traditionally the
7 board has been provided limited information on the material
8 risks impacting this legal entity. And consequently they
9 have been unable to become quite familiar with the risk
10 assumed within the bank.

11 In light of that assessment by a key regulator,
12 are you still happy with the fact that the company is proud
13 of its -- this is your response, the company is proud of its
14 board processes, both at the parent level and the bank
15 level. Do you still feel that there is a reasonable basis
16 for Citibank to be proud of those processes prior to 2008?

17 MR. PRINCE: I'm sorry, Commissioner, what's the
18 date of that report?

19 VICE CHAIRMAN THOMAS: Prior to the answer, I
20 yield the gentlemen an additional five minutes.

21 COMMISSIONER HOLTZ-EAKIN: Thank you.

22 MR. PRINCE: I'm sorry, Commissioner, what's the
23 date of that report?

24 COMMISSIONER HOLTZ-EAKIN: That report is
25 December 31st, 2007, for the year ending in 2007.

1 MR. PRINCE: Well, that was after I left, so I
2 haven't seen that, and I haven't seen the company's response
3 to it, but I think it's -- I think it's worth noting that
4 the regulators, including the Fed, who are involved in the
5 company throughout this entire period, the Fed saw
6 everything that went to the board of directors at every
7 meeting, and if they felt that the processes relating to the
8 board were inadequate, it probably would have been useful
9 for them to raise it at an earlier point in time.

10 COMMISSIONER HOLTZ-EAKIN: Mr. Rubin?

11 MR. RUBIN: I think that, and I'm repeating what
12 I said earlier, that David Bushnell was extremely well
13 qualified for his job. And I -- I don't have any doubt that
14 they acted in good faith in deciding what needed to be
15 brought to the board. And I think that they had good
16 processes.

17 I think that after the fact -- well, let me add
18 one more thing, if I may, Commissioner, because I think it's
19 important. I think in terms of the facts at the time that
20 those positions were taken, that they were evaluating them
21 and making the decision to retain them rather than dispose
22 of them, they sought Triple-A securities and sought
23 de minimus risks.

24 Obviously, in retrospect, after the enormous
25 developments that took place and the tremendous costs that

1 they -- that those developments led to, these securities had
2 a very different look. But I think that in evaluating
3 whether they did what they needed to do, in terms of
4 bringing issues to the board's attention, you have to
5 evaluate them in terms of the facts at the time and what was
6 reasonable for them to do at the time. And my judgment
7 would be that they acted in good faith and did what they
8 felt was appropriate.

9 COMMISSIONER HOLTZ-EAKIN: The Fed, at the same
10 time, this is the report of the senior supervisors' meeting,
11 which had participants from the Federal Reserve Bank, the
12 Federal Reserve Board, the Office of the Comptroller of the
13 Currency, the SEC, the UKs FSA, and the Japan's FSA felt
14 that poor communication across all business lines
15 decentralized nature of the firm created silos, that senior
16 management did not fully appreciate the market risk of the
17 leveraged loan pipeline or of the retained super senior CDO
18 positions, and that management found that the balance sheet
19 in risk loans were not adequately enforced. And traditional
20 risk metrics for leveraged loans to CDOs did not fully
21 represent risks.

22 So in both the measurement of risk and the
23 conveyance of risks, the same regulators who you place such
24 strength in, found that the activities appeared to be
25 inadequate. Are you still satisfied with both the metrics

1 used to assess risk and the conveyance of the --

2 MR. RUBIN: That report you just read,
3 Commissioner, is dated when?

4 COMMISSIONER HOLTZ-EAKIN: This is dated
5 November 19th, 2007.

6 Speaking simultaneously

7 CHAIRMAN ANGELIDES: And can I just add, because
8 Mr. Holtz-Eakin was flying in, I did reference it earlier,
9 just so you know, this is the November 19th meeting, which
10 Mr. Rubin attended; part of the meeting Mr. Bushnell was
11 there. This is the one I referred to earlier.

12 COMMISSIONER HOLTZ-EAKIN: Thank you.

13 MR. RUBIN: I think the -- I think the problem
14 with a report like that, Mr. Commissioner, is that you have
15 to distinguish -- it's actually a very important point, so I
16 would like to spend a moment on it, if I may.

17 COMMISSIONER HOLTZ-EAKIN: Please.

18 MR. RUBIN: I spent a career evaluating trading
19 operations at Goldman Sachs when I was running it or
20 co-running it and so forth. And the challenge always was to
21 try to figure out whether people had acted reasonably and
22 sensibly in light of the facts that they knew at the time as
23 opposed to when you look back at them after you knew what
24 had happened.

25 And I think the report you need to read is not

1 the one you just read, because at that point they knew what
2 had happened. I think what you've got to do is find the
3 reports that they issued before that, before they knew what
4 was happening, so that you would know what they felt --

5 COMMISSIONER HOLTZ-EAKIN: Please, continue.

6 My apologies.

7 MR. RUBIN: Excuse me?

8 COMMISSIONER HOLTZ-EAKIN: Please continue. Our
9 apologies.

10 VICE CHAIRMAN THOMAS: I apologize.

11 MR. RUBIN: I'm -- I'm a little -- all right.

12 COMMISSIONER HOLTZ-EAKIN: Go ahead. You did
13 nothing wrong; we did.

14 MR. RUBIN: So I think what one needs to do is
15 look back at the reports that were issued before the crisis
16 developed. And then if there were problems, and I don't
17 know if those reports stated these sorts of problems or not,
18 but if there were problems, I presume the regulators would
19 have brought them to the attention of the company, and the
20 company would have addressed them.

21 It is very -- and I can tell you from my own
22 experience, because I lived this for years, it is very, very
23 difficult after the fact to try to make a judgment as to
24 what was reasonable at the time because you get so
25 influenced by knowing what had happened.

1 COMMISSIONER HOLTZ-EAKIN: It's a fair point.
2 Are you aware of any reports from supervisors prior to the
3 crisis, 2004, 2005, 2006, which suggests this same
4 characterization of Citibank's internal risk assessment and
5 communication of risk?

6 MR. RUBIN: If there -- if there were such
7 reports, Commissioner, I'm not aware of them. And if there
8 were such reports, I assume that the company would have
9 addressed to them -- addressed them in response to those
10 reports and that the regulators would have insisted they be
11 addressed.

12 COMMISSIONER HOLTZ-EAKIN: Well, if there were
13 such reports, they're still writing the same thing later.
14 So we can pursue the existence of the reports, and I'd ask
15 the liberty to come back to you with additional questions on
16 that front.

17 MR. RUBIN: Thank you.

18 COMMISSIONER HOLTZ-EAKIN: Thank you. I yield
19 back my time.

20 CHAIRMAN ANGELIDES: Yes. And I just might add,
21 Mr. Holtz-Eakin, and I think you did point out, I just want
22 to point out that Mr. Holtz-Eakin did reference reports that
23 were pre-crisis, very specifically. And I think you
24 referenced the `04 and the `05 reports that are very clear
25 on this subject. So I -- we will -- we will direct the

1 Commission staff to provide that information to you.

2 I also just want to correct something, for the
3 record. When I asked the question to the staff of on
4 balance sheet, off-balance-sheet losses, it was -- there was
5 a miscommunication. So the 10 billion and 40 billion dollar
6 number do not use, folks. We will get you the right number.
7 Except I will say that the losses in the non-bank were very
8 substantial.

9 All right, let's go now to Ms. Born and then
10 we'll go to Mr. Thompson.

11 COMMISSIONER BORN: Thank you very much,
12 Mr. Chair.

13 EXAMINATION BY COMMISSIONER BORN

14 COMMISSIONER BORN: And I also want to sincerely
15 thank both Mr. Prince and Mr. Rubin for being willing to
16 appear before us today and help us with this important
17 inquiry.

18 Mr. Rubin, you said in your book, several years
19 before the financial crisis erupted that unregulated OTC
20 derivatives can cause problems, in your view, when the
21 markets become stressed.

22 Do you believe that they did, in fact,
23 contribute to the financial crisis?

24 MR. RUBIN: I believe that the -- at the very
25 least, the credit default swaps seemed to have played a role

1 in the financial -- and maybe even a meaningful role in the
2 financial crisis. Whether any derivatives beyond that did
3 or not, I do not know, Commissioner.

4 My reference, by the way, in the book, which I
5 appreciate that you obviously read, is -- was derivatives
6 more broadly, not just over-the-counter derivatives.

7 COMMISSIONER BORN: Do you now think that
8 there's a need for any regulation of the OTC derivatives
9 market?

10 MR. RUBIN: I think that there should be, and I
11 thought this when I was at Goldman Sachs. I think that
12 there should be regulations of over-the-counter derivatives,
13 but I also think that the regulation of listed derivatives
14 should be enhanced, particularly through increased capital and
15 margin requirements.

16 COMMISSIONER BORN: You say in your testimony
17 that you feel that standardized derivatives should be
18 exchange-traded and that customized contracts should be at
19 least cleared, if possible, and if not, there should be
20 disclosure of information about them. Could you elaborate
21 on what benefits you think that would provide?

22 MR. RUBIN: At the very least -- well, if you
23 standardize them, to the extent that you can get, and I know
24 you're an expert in this field, Commissioner, but to the
25 extent that you can standardize these instruments, not only

1 do you have disclosure and transparency to the regulators
2 and to the markets, but you also have potentials for netting
3 within organizations that I think could considerably reduce
4 the risk in times of stress.

5 The over-the-counter derivatives obviously
6 present a more difficult problem, but it does seem to me,
7 and I understand that technically this is very difficult,
8 but it does seem to me that if it is possible to put these
9 over-the-counter derivatives through a clearing system, you
10 then go with reduced counterparty risks and you increase
11 transparency.

12 If that is technically not possible, and I
13 understand there are a lot of technical problems, then it
14 seems to me at the very least, there ought to be some means
15 found for creating transparencies so that the regulators at
16 the very least, I'm not sure what I think about the markets,
17 but the regulators at the very least know what the exposures
18 are.

19 COMMISSIONER BORN: You said in the past that
20 there was no political will to regulate over-the-counter
21 derivatives.

22 Do you -- in your view was the lack of political
23 will related to pressure by the financial services industry?

24 MR. RUBIN: In the -- I think they were very
25 strongly held views in the financial services industry in

1 opposition to regulation. And I think that they were not
2 overcomeable, it's probably not a word, overcomeable, but not
3 surmountable at that point.

4 Can I just do one brief anecdote? When I was at
5 Goldman Sachs, in my last year or two, my co-partner, senior
6 partner and I, felt a very serious concern about this, and I
7 went to see Dick Fisher, who at that time was the senior
8 partner at Morgan Stanley and really a distinguished leader
9 of our industry, and he agreed.

10 And so I started an effort to see if we could do
11 something. And our focus then was on margin requirements,
12 Commissioner. It didn't have the breadth of the later
13 proposals.

14 And it very quickly became apparent that there
15 was simply no possibility of moving forward. And that was
16 for the very reason you said, and that is, the industry had
17 very strong views on this and it wasn't going to be
18 something that we could do.

19 COMMISSIONER BORN: Do you think that the lack
20 of political will may also have been affected by a pervasive
21 view that the market was appropriately self-regulatory and
22 that there wasn't a need for regulation?

23 MR. RUBIN: I don't -- that's a level of
24 sophistication, it's a terrifically interesting and
25 important question, but I don't think when you got into the

1 political arena that that really was what this was about. I
2 think this was more about the interests of those who were
3 involved and their ability to effect those interests,
4 effect, e-f-f, yeah, effect those interests, rather than the
5 much more sophisticated question that you're raising.

6 COMMISSIONER BORN: You said that you think that
7 at the least credit default swaps played a role in the
8 financial crisis.

9 Looking at the bigger over-the-counter
10 derivatives market, there is a lot of inner-connectivity
11 that's created through the contracts. There's also a lack
12 of transparency. And I wonder whether or not those problems
13 plus the lack of effective price discovery played a role in
14 some of the financial panic that struck in 2007 and 2008.

15 MR. RUBIN: Oh, listen, that point is extremely
16 well taken, and it's too big to fail idea, but the other
17 area is too interconnected to fail. And that's precisely
18 the point that you're raising. So I think the answer to
19 your question is yes.

20 COMMISSIONER BORN: Do you think that your
21 proposals for exchange-trading, if possible, clearing, if
22 possible, disclosure of information, at least to the
23 regulators, would address some of that problem?

24 MR. RUBIN: In part, Commissioner, but I felt
25 back when I was at Goldman Sachs and I felt ever since and I

1 still feel now that you do need one more piece. And I do
2 think that you need substantially increased capital to
3 margin requirements because that will give you greater
4 cushion in the event that problems occur.

5 And I think I said in my book, as long as you
6 have normal conditions, I don't think any of this is
7 particularly a problem. But the trouble is under stress
8 conditions, you can get very serious issues very quickly.
9 And so I think you need a bigger cushion.

10 COMMISSIONER BORN: In that connection, you
11 know, there are margin requirements on exchanges. They can
12 be raised and probably should be raised. The -- in the
13 over-the-counter derivatives market, the instruments
14 themselves have lent themselves to high levels of leverage.

15 There are a number of instruments which have
16 seemingly been designed just to build in a great deal of
17 leverage. And there aren't currently any mechanisms to
18 require margin or collateral on that; is that correct?

19 MR. RUBIN: Yes, that is correct.

20 COMMISSIONER BORN: Do you think -- I'm
21 concerned that some of the complexity that's entered into
22 the market, some of the highly complex instruments may not
23 really be fully understood by the parties, either by the
24 over-the-counter derivatives dealers themselves, their
25 management and board, boards, or by the entities that are

1 purchasing them.

2 And I think particularly of the problems we've
3 heard in municipalities, like Jefferson County, Alabama, the
4 grease problems that were evidently somewhat designed to
5 disguise the amount of greases, exposures, and debt, I would
6 like your views on the need for this degree of complexity.
7 I'm not sure regulators have the capability of understanding
8 these instruments. I don't know if anybody else does fully.

9 MR. RUBIN: Oh, it's a very good question,
10 Commissioner. And I think I -- my recollection is I did
11 discuss this in my book. I may be wrong about that
12 recollection, but I think I did.

13 I think the complexity -- I think the complexity
14 is understandable and actually useful -- well, not
15 complexity, per se, is never useful, I suppose -- but
16 is a product of the purposes that are trying to be
17 accomplished.

18 On the other hand, I think your point is
19 correct, and I lived this for a long time, so I actually
20 knew a fair amount about it. I think your point is correct
21 that I think users of these instruments very often don't
22 understand that the complexities and the risks embedded in
23 them, not under normal circumstances, but under stress
24 conditions.

25 And that's exactly why I think, or it's one

1 reason why I think, capital margin requirements could be
2 greatly increased. Number one, at least you would have
3 greater cushion. And I also think that if you have greater
4 capital margin requirements, it would cause people to focus
5 more on trying to understand the risks they were taking and
6 probably result in less use of these instruments. And I
7 think on balance, that would be a desirable outcome.

8 COMMISSIONER BORN: Thank you.

9 CHAIRMAN ANGELIDES: Okay, fine. Mr. Thompson?

10 COMMISSIONER THOMPSON: Yes?

11 CHAIRMAN ANGELIDES: Ms. Murren, do you have a
12 question, before I go to Mr. Thompson, on this point?

13 COMMISSIONER MURREN: Just a follow-up on your
14 comment about your perspective that you think capital --

15 VICE CHAIRMAN THOMAS: I yield the Commissioner
16 two minutes.

17 CHAIRMAN ANGELIDES: Fine.

18 COMMISSIONER MURREN: It will be short.

19 EXAMINATION BY COMMISSIONER MURREN

20 COMMISSIONER MURREN: You mentioned capital
21 requirements are very important. Did Citigroup ever create
22 products that were specifically designed to avoid capital
23 requirements?

24 MR. RUBIN: I don't know the answer to that.

25 COMMISSIONER MURREN: And you, Mr. Prince, would

1 you create a product simply to -- or at least one of the
2 principal reasons for designing the product was to avoid
3 capital requirements?

4 MR. PRINCE: I -- I think the answer is no
5 because the product would have to be designed as something
6 that a client would want. In other words, you wouldn't --
7 you wouldn't create a product that was internally focused.

8 If your question is, would the -- would the team
9 create products -- and in the course of creating the
10 products, try to minimize capital burdens, my guess is the
11 answer is yes, but I don't know for sure.

12 COMMISSIONER MURREN: So then it wouldn't
13 surprise you to know that in the minutes of one of your
14 meetings that specifically relate to the creation of new
15 products, in this instance, it would be liquidity puts, that
16 there was a notation that specifically referenced the fact
17 that this type of structure would avoid capital
18 requirements?

19 MR. PRINCE: I have no way of responding without
20 seeing the document and understanding the context of it.

21 CHAIRMAN ANGELIDES: We will -- we will provide
22 the document. What is the document, so we can reference it,
23 Ms. Murren?

24 COMMISSIONER MURREN: It's the minutes of a
25 meeting that took place in 2002 of a CMAC.

1 CHAIRMAN ANGELIDES: CMAP, which is the
2 committee that approved new products for your institution,
3 correct?

4 COMMISSIONER MURREN: Yes.

5 CHAIRMAN ANGELIDES: All right. We'll provide
6 that document so you can review it, and if the staff would
7 make sure we follow up.

8 COMMISSIONER MURREN: Thank you.

9 CHAIRMAN ANGELIDES: Can we go -- let's go do
10 this. Mr. Thompson -- is it --

11 COMMISSIONER WALLISON: Can you --

12 CHAIRMAN ANGELIDES: Absolutely, Mr. Wallison.

13 COMMISSIONER THOMPSON: Thank you, Mr. Chairman.

14 EXAMINATION BY COMMISSIONER THOMPSON

15 COMMISSIONER THOMPSON: The topic you're on is
16 actually something that is important to me and it's all
17 around financial innovation.

18 And, Mr. Rubin, you've had a long, long career
19 in both the private sector and the public sector. You've
20 seen innovation in this industry for a long time, and you
21 understand the public policy role for making sure that we
22 protect the public's interest when there are innovations
23 that hit a marketplace regardless of industry.

24 So I guess my question of you is, what steps should
25 be taken to ensure that products that have a societal
26
27

1 effect, like some of the structured products that were
2 brought to market by this industry, are well tested before
3 they get there, before we create in the process another
4 calamity like the one we're experiencing?

5 MR. RUBIN: That's an interesting question. I
6 think that probably as desirable as it would be to
7 accomplish the purpose that you just outlined, that may not
8 be doable because the problem is -- well, let me put it
9 differently -- when problems develop with these kinds of
10 instruments, it's usually because of some set of
11 circumstances that hadn't been anticipated.

12 So what you can do internally and what all of
13 the institutions do is they test their instruments
14 against, I think I said this before actually, some past
15 history of 10 years or 20 years or whatever it may be, and
16 they look at what was the worst reasonable case, and then
17 they make a judgment, okay, what are the risks of loss, and
18 it's one thing or another.

19 And then what happens when you have very great
20 difficulty is something else happens, something you didn't
21 anticipate. And because of that problem -- that's actually
22 a very good question. Because of that problem, it seems to
23 me that the answer comes back to where I was before.

24 I think you've got to create a system that can
25 deal with the unanticipatable or at least unanticipated.

1 And that's why I think leverage constraints have to be
2 substantially increased and why I would increase margin
3 capital requirements on all these innovative products.

4 I might add, and I think this is important,
5 well, I'd like might add one more thing if I may. I think
6 financial innovation actually does play an important role in
7 our economy and a constructive role. I just think you need
8 an appropriate, if you will, regulatory framework for it.

9 COMMISSIONER THOMPSON: Well, some would argue
10 that financial innovation is nothing more than regulatory
11 arbitrage of one sort or another. Would you agree or not
12 with that?

13 MR. RUBIN: No. I actually don't think so. I
14 think an awful lot of innovation has nothing to do with
15 regulatory arbitrage.

16 I remember a case of a country, for example,
17 that had a very large exposure in the oil business, and they
18 basically needed -- well, they didn't need, but they decided
19 they wanted some way to hedge themselves against future oil
20 price movement so they continued to fund their social
21 programs. Nothing to do with regulatory arbitrage, but they did
22 need to create an innovative structure to do that, and I
23 think we should have a system that allows us to do that, but
24 on the other hand, I think we have to recognize that there
25 is systemic risk that can be created in doing that, and

1 that's why we need the kind of framework that Commissioner
2 Born and I were discussing a bit ago.

3 COMMISSIONER THOMPSON: Mr. Prince, can the risk
4 management systems of an organization like Citi keep up with
5 the rate and pace of innovation that goes on within the
6 organization of Citi?

7 MR. PRINCE: Well, that's a -- that's a very
8 important question. I think that the risk function we had
9 at Citi was extremely robust. As I said, David was thought
10 of as the best risk manager on Wall Street.

11 We had a couple thousand people in the risk
12 organization independent of the businesses able to say no
13 any time they wanted to. The businesses operated under the
14 constraints, risk limits and so forth.

15 A different question, and perhaps the one you're
16 getting to, is whether or not the intellectual capacity,
17 the -- the -- the smartness of the people can keep up with
18 the innovation of the traders and so forth. I think that
19 the key there, and what I took very seriously as my job, was
20 to make sure we had the best people involved.

21 When I became CEO, the first thing I did was to
22 put David in charge, because he understood the securities
23 business. He had been a trader in his past life. I made
24 the risk function independent of the businesses. I took
25 great comfort over the years from the frequent comments from

1 the regulatory authorities commenting on David's strength as
2 an individual and on the strength of the function,
3 notwithstanding the after-the-fact document, apparently.
4 And I think that's, in some level, the best you can do.

5 We never had a situation where a product went
6 out the door that hadn't been looked at by risk. And
7 whether, at times, they didn't do as good a job as they
8 could have, I'm sure, human nature being what it is. But to
9 set up a structure and to put the right people in that
10 structure is I think the best you can do.

11 If I can, just one point. I think the
12 regulatory situation ought to be changed.

13 COMMISSIONER THOMPSON: That's where I'm going
14 next.

15 MR. PRINCE: I think all of the different
16 regulators and the different schematics I think is crazy.
17 And I think, to the extent your earlier question went to
18 that, I just wanted to make sure I commented on that.

19 COMMISSIONER THOMPSON: Yeah, I -- I --
20 innovators and by their sheer nature are passionate about
21 what they do, and so it's -- my personal opinion is it's not
22 clear to me that a risk management function can keep up with
23 the passion and the creativity that a very aggressive,
24 innovative team brings to bear.

25 And I think that poses a systemic risk, quite

1 frankly, to the industry, because of the pace of innovation
2 that has occurred. But that's just my opinion, if I might
3 add.

4 On the regulatory front, yesterday Mr. Bushnell
5 said that he thought that some consolidation of the
6 regulatory oversight was, in fact, warranted because there
7 were way too many regulators, if you will, that they would
8 have to deal with.

9 If I look at what happened in Canada or if I
10 look at what happened in the UK, would you comment, given
11 that you are a global bank, on the differences that you
12 observed in the regulatory scheme of their -- and the
13 recovery process perhaps, because all those economies were
14 hit just like we were, but the recovery process and the
15 rigor of their oversight versus what we have here.

16 MR. PRINCE: I think that's, with respect, too
17 broad a question for me to cover in any depth. If I can,
18 let me give you the best answer I can under the
19 circumstances.

20 I think that the regulatory structures in the
21 various jurisdictions you talked about compare with the
22 United States in some ways more favorably.

23 The regulatory structure in the U.S., being
24 historically based from the time after the Depression, has
25 great inefficiencies in it, great overlaps, great

1 redundancies. And I think that a more streamlined and a
2 more efficient regulatory structure would lend itself to
3 greater probity for the -- for the industry.

4 I think the way that the various economies have
5 reacted to the crisis may be due in part to that, but I
6 think it's also due in part to the nature of the closed or
7 open nature of the financial services industry.

8 In Canada, for example, it is a more closed
9 industry. In the U.S. and the UK, it is more open to the
10 market of this institute in respects. So it's not just the
11 regulatory environment.

12 COMMISSIONER THOMPSON: All right. Thank you
13 very much. I yield the rest of my time, Mr. Chairman.
14 Thank you.

15 CHAIRMAN ANGELIDES: Thank you, Mr. Thompson.

16 Now, Mr. Wallison, you had an item and then
17 Mr. Georgiou and then we'll go to the Vice Chair, and I have
18 just a few remaining questions. Yes, Mister --

19 COMMISSIONER WALLISON: Thank you very much.

20 EXAMINATION BY COMMISSIONER WALLISON

21 COMMISSIONER WALLISON: This is for Mr. Rubin.

22 I was -- and I could have misunderstood this,
23 but I thought you said that when you were at Goldman Sachs,
24 you were concerned about something in the derivatives
25 market, and I thought it might have been credit default

1 swaps. What was that?

2 MR. RUBIN: Oh, no, it wasn't, in fact, I don't
3 think credit default swaps. To the best of my knowledge
4 credit default swaps --

5 COMMISSIONER WALLISON: They were not important,
6 then?

7 MR. RUBIN: Oh, no, no, they didn't exist until
8 much, much later.

9 COMMISSIONER WALLISON: What was it that you
10 went to see Mr. Fisher about?

11 MR. RUBIN: Oh, I was -- I'll tell you what I
12 was concerned about. October 19th, 1987, as you remember,
13 we had a 22 percent drop in the stock market.

14 COMMISSIONER WALLISON: Right.

15 MR. RUBIN: Some of the traders who were
16 involved at that time said to me they thought that portfolio
17 insurance had a real effect on that it's an issue we haven't
18 discussed here actually it's not a credit issue; it's an
19 ability of the lower trust or rather a potential for the
20 derivatives to feed back into and exacerbate cash market
21 movements.

22 And so what I thought was that we should have
23 higher margin requirements on derivatives because of that
24 potential for -- under stress conditions, for derivative to
25 feed back into cash markets. And that was the framework for

1 that discussion.

2 COMMISSIONER WALLISON: I see. Now, when you
3 were Secretary of the Treasury, however, you -- you opposed
4 any regulation of derivatives, so why --

5 MR. RUBIN: No.

6 COMMISSIONER WALLISON: -- did you oppose it?

7 MR. RUBIN: No, I -- I -- let me --

8 COMMISSIONER WALLISON: At least that's the
9 story we have in the newspapers.

10 MR. RUBIN: I don't know.

11 COMMISSIONER WALLISON: So maybe you want to
12 clear that up.

13 MR. RUBIN: I'm aware of that. Let me, if I
14 could, respond.

15 COMMISSIONER WALLISON: Sure.

16 MR. RUBIN: It will take a moment or two to
17 respond to it.

18 I think there really were two issues. I was not
19 opposed to regulation of derivatives, let me say. My dues
20 and derivatives were the dues I set out, you know, a bit
21 ago.

22 But there were two issues, and Commissioner Born
23 very rightly raised the question of risks and
24 over-the-counter derivatives. I agreed with her view,
25 because and as I already expressed about these risks. There

1 was a second issue, and the second issue, which I had been
2 advised about upon by counsel for Treasury, was that
3 approaches within the existing regulatory framework that
4 were being considered could create legal uncertainty in the
5 over-the-counter market, that it could take years to resolve
6 that in court, and that that could lead to chaotic
7 conditions.

8 COMMISSIONER WALLISON: That's right.

9 MR. RUBIN: My concern was avoiding that legal
10 uncertainty. I was not opposed to regulation derivatives.
11 Quite the contrary, I was actually tried to accomplish
12 something to that, in that regard, when I was with Goldman
13 Sachs. And my views have not changed since then.

14 COMMISSIONER WALLISON: Okay.

15 CHAIRMAN ANGELIDES: Now, Peter, we -- go ahead.

16 COMMISSIONER WALLISON: Well, there's one more.

17 CHAIRMAN ANGELIDES: Well, we're out of time.

18 COMMISSIONER WALLISON: Real quick.

19 CHAIRMAN ANGELIDES: Can you submit it for the
20 record? Can you say what the question is and we'll get a
21 written response?

22 COMMISSIONER WALLISON: Sure, I'll submit it for
23 the record. Thank you.

24 CHAIRMAN ANGELIDES: Do you want to state what
25 it is so we can get it on the record? State it -- state it

1 very quickly.

2 COMMISSIONER WALLISON: Let me just state it,
3 you were talking about stress in the CDS market, that it
4 becomes very dangerous when there is a lot of stress.

5 But my understanding is that throughout the
6 financial crisis, even after Lehman, the CDS market has
7 continued to function. And so I -- I just want to
8 understand, and don't answer it now please, because we don't
9 have the time, but I would like -- I would like you to
10 respond in writing to the question of why it is that the CDS
11 market was not disrupted and continued to function during
12 this entire --

13 MR. RUBIN: I think it actually functioned with
14 enormous volatility, but I'd be delighted to respond.

15 COMMISSIONER WALLISON: It was risk, of course.

16 CHAIRMAN ANGELIDES: Mr. Georgiou?

17 COMMISSIONER GEORGIU: I just wanted to state
18 something for the record. As you respond to the issue that
19 was raised by Commissioner Murren on the capital arbitrage
20 question with regard to the liquidity puts, you know,
21 that -- those were to be distinguished from an unconditional
22 line of credit that might otherwise be necessary to backstop
23 the commercial paper that you were selling. And that, of
24 course, you would have to show on your books and capitalize.

25 Whereas, the liquidity put was, you know, was

1 off-balance-sheet and not -- not appropriately capitalized
2 or not required to be capitalized under the rules or at a
3 very, very significantly less margin.

4 I just leave you with that as you -- as you
5 respond to that in writing. Thank you.

6 CHAIRMAN ANGELIDES: Mr. Thomas?

7 VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

8 EXAMINATION BY VICE CHAIRMAN THOMAS

9 VICE CHAIRMAN THOMAS: I want to thank both of
10 you. Just one specific question, again, if you want to do
11 it in writing, what I'm a little confused in terms of
12 talking about managing the company and stress test the rest,
13 it's my understanding based upon the documents that we
14 looked at that -- that Citi really didn't have the technical
15 capacity to assess the RMBS models until `07.

16 So I'm wondering what was going on, prior to `07
17 in terms of management tests, questions being offered. So
18 I'll give you documents and we can fit it together and you
19 can give me a timeline.

20 I started out talking about the garden of good
21 and evil, and I meant that. Because unfortunately and
22 frustratingly, we can agree that all models, all ratings,
23 all stress tests are useful. And then you can say all
24 models, all ratings, all stress tests may not be useful in
25 terms of a model you look at or a model that you don't look

1 at.

2 It -- it -- it means, then, that you've got to
3 go to some timeless kind of approaches to a certain degree.
4 I will tell you, I wouldn't be here if the function of this
5 Commission was to examine policy that would be offered by
6 the Commission for Congress to create legislation to deal
7 with this problem, because I've been down that road too many
8 times before.

9 I like things that are twofers and threefers.
10 So one of the reasons I like capital is that it does give
11 you the cushion. But it also slows everything down because
12 you just create -- we've seen folk, partly in the .com
13 bubble, create synthetic capital. It's hard to create
14 synthetic. That's why I like dividends in terms of
15 operations of companies; you get cash on the barrel; that's
16 good.

17 There's just something about -- now, if you
18 create devices that produce that, then you're getting away
19 from reality.

20 The other problem is if we talk about
21 derivatives, sure, let's classify them as standardized and
22 customized, and it's going to be, what, three weeks that the
23 market comes up with a rack of B. Spoke suits that are going
24 to fit, and they're all customized, they're not standard,
25 and you simply shift if those are the standards.

1 So I said I'm glad we're not doing this but I do
2 think the capital, a lot of transparency, and especially
3 responsibility tied to behavior.

4 I will tell you, it is impossible for me to go back
5 home, which I'm going to do shortly, and tell people that we
6 had a panel of four people who over three to five years
7 earned, based upon the creativity that they supervised,
8 which apparently they didn't understand and couldn't
9 measure, almost 150 million dollars on the way up. But that
10 same team, on the way down, didn't have a nickel clawed
11 back.

12 And I don't like government telling people what
13 they can make, but if there isn't some attempt by this
14 industry to equate value in some way with effect, across the
15 corporate model, with what ordinary people perceive as
16 value.

17 I can't comprehend a baseball player making a
18 quarter of a trillion dollars over ten years. But I can
19 tell you I can measure him. I can look at his batting
20 average, I can look at his errors, I can look at his RBIs;
21 there's all kinds of ways to measure.

22 We sat through a panel, and again, I want to
23 thank you, because Citibank's an example. It's not pulled
24 out for a certain extraordinary aspect except for maybe the
25 management in your organization, because I'm interested in

1 the national/international.

2 But basically, we've been given no opportunity
3 or understanding and plenty of declaration about how we used
4 all the tests available, and nobody knew. Yes, but
5 something happened. Something was created, assumptions were
6 made, and behavior has to have consequences. To say you're
7 sorry -- and you can make your -- your stock argument,
8 Mr. Prince, most of these guys that were in front of us
9 yesterday got something other than that as well.

10 And to make the argument that somehow a simple
11 apology still allows you to maintain a profile of income
12 based upon what devastated everyone else doesn't fit the
13 scale test, no matter how often you feel really, really sad
14 about what happened. Thank you, Mr. Chairman.

15 EXAMINATION BY CHAIRMAN ANGELIDES

16 CHAIRMAN ANGELIDES: All right. Mr. Prince and
17 Mr. Rubin, let me just make a couple of conclusive
18 comments here having now heard a day and a half of testimony
19 from folks within your organization. The two of you today
20 now having read along with many commissioners very extensive
21 documentation and interviews.

22 Let me preface this by saying that if I die 51
23 percent right and 49 percent wrong I'll be a happy man. I
24 don't aspire to reach what Mr. Greenspan thinks he's
25 reached, which is 70/30.

1 And let me also preface this by saying that I
2 believe you're men of good faith.

3 But I want to bring us back to why we're here
4 today, which is, we have been trying to examine how this
5 substantial far-flung financial empire failed to the point
6 where the United States government had to provide 45 billion
7 dollars in assistance as well as 301 billion dollars in
8 guarantees of assets.

9 I also want to kind of key off something
10 Mr. Holtz-Eakin said, which is that in one particular area,
11 subprime lending, there was a massive failure, approximately
12 50 billion dollars in losses.

13 And what I've been struck by in the
14 documentation and in the testimony is I've been struck by,
15 frankly, how much folks in the organization did not know
16 about how -- what was going on, and I'm particularly struck
17 by how much the two of you did not know about how much
18 was -- what was going on within your organization.

19 And at the end of the day you were the head
20 guys. You were the chairman and the CEO. You were the
21 chairman of the executive committee. And not, I might add,
22 Mr. Rubin, a garden-variety board member. You were in the
23 suite of executive offices.

24 And if you look at the record, Mr. Holtz-Eakin
25 did point out there were a number of regulatory reports on

1 the table. Mr. Bowen, who was here yesterday, had sent
2 information up, not, by the way, about a piddling business,
3 but a 50-billion-dollar-a-year business in which mortgages
4 were being bought and then sold, in which there appeared to
5 be very substantial compliance issues.

6 We've discussed the fact that Citigroup had
7 11 billion dollars of warehouse lines out to subprime
8 originators, which you, as management, were not aware of.
9 Mr. Holtz-Eakin referenced the senior supervisors' report,
10 which did catalogue a number of significant issues, and even
11 today, I think it's clear from the record that even after
12 HSBC had its problems, and Bear Stearns, there were -- there
13 were not the highest level of decisions about -- about how
14 to handle subprime. That didn't come until September and
15 October.

16 And it just seems to me that at the end of the
17 day, the two of you in charge of this organization did not
18 seem to have a grip on what was happening.

19 Now, Mr. Prince, I will say that on November 4th,
20 you took responsibility and you resigned. Mr. Rubin, I want
21 to ask you very clearly, because you've gone out of your
22 way, in my opinion, in the interviews I've read and in
23 public statements, to make a very fine point or a very large
24 point about how you are not involved in operations. You've
25 said how you made speeches warning about potential risks.

1 But of course you have very direct duties. You were
2 chairman of the executive committee of the board of
3 directors; you attended weekly business meetings, your
4 compensation, according at least to your own testimony, was
5 a one-million-dollar salary plus a 14-million-dollar
6 guaranteed bonus.

7 Mr. Prince, in your interview you indicated that
8 the level of interaction between you and Mr. Rubin was
9 frequent, that you would talk three or four times a day. If
10 one of you was out of town, you would talk by phone every
11 other day. Mr. Rubin, you were very involved in the
12 investment banking business. And I guess I would ask you,
13 Mr. Rubin, just very clearly, do you bear central
14 responsibility for the near collapse but for the U.S.
15 government of Citigroup?

16 MR. RUBIN: I think, Mr. Chairman, let me
17 respond to that in a number of parts, if I may, okay?

18 CHAIRMAN ANGELIDES: Sure.

19 MR. RUBIN: Because I think you posed,
20 obviously, an important question.

21 Number one, the executive committee of the
22 board, which you just referred to my being chairman of, was
23 an administrative body; it didn't have a decision. What it
24 did was it met between board meetings. Those meetings were
25 very infrequent. And it wasn't a substantive part of the

1 decision making process of the institution. It was designed
2 to deal with -- it was designed to be conveyed by the
3 chairman, which was me, so that the COO or whoever else could
4 get formal approval, if necessary, between board meetings.
5 It was not a, as I say, a substantive part of the -- of the
6 decision making process of the institution.

7 I think that all of us bear, but not just all of
8 us at Citi, I think all of us, and I said this in my
9 comment, I think all of us in the industry who failed to see
10 the potential for this serious crisis and failed to see the
11 function of the multiple factors at work bear
12 responsibility. And I think we all have a great deal to the
13 regret in that respect.

14 I was not involved, as you correctly say, in the
15 management of the people or the personnel. I was a member
16 of the board. I worked extensively with clients. My
17 interaction on other issues was on a strategic and
18 managerial level. And I think, as I said in my statement,
19 that the Triple-A securities that were at the heart of this
20 problem were understandably viewed by those who had
21 conducted the business, were involved in the business, as
22 being essentially of de minimus risk. And this really did
23 not -- this did not come to us until September of '07.

24 CHAIRMAN ANGELIDES: But it went terribly wrong,
25 Mr. Rubin, and even at the end, investors are being informed

1 that you have a 13-billion-dollar exposure when, in fact,
2 the audit risk community and the board, of which you're a
3 member, is being told 55 billion on the same day.

4 And I guess -- I don't know that you can have it
5 two ways. You either were pulling the levers or asleep at
6 the switch. And I -- and I think this is about, as we try
7 to recover from this calamity, I'm not so sure apologies are
8 important as assessment of responsibility, because that's
9 the way in which you begin to move forward.

10 And perhaps, instead of asking you what -- what
11 did you know and when did you know it, maybe I should be
12 asking you what didn't you know and why didn't you know it.

13 MR. RUBIN: I think that the board, of which I
14 was a part, and me and the other activities that I was
15 involved in had a very serious commitment to oversight and
16 to assuring, as best we could, that the institution
17 conducted its business appropriately.

18 But, Mr. Chairman, a board cannot know what is
19 going on in the positions of an institution, of a training
20 institution. There probably was some number, I don't know
21 the number, but I would guess it was a trillion dollars-plus
22 of transactions that went through Citi every day.

23 And what you can do and what Citi, in my
24 judgment, absolutely did and that I was part of doing as
25 both a member of the board and also some other activities

1 was making sure that you have the proper people in place,
2 running trading, running independent risk management, and
3 the large -- and the checks and balances functions that we
4 had, which included, obviously, our internal auditor, our
5 legal counsel, CFO, and the rest, and you can also be sure
6 that you have robust processes at the board level, which I
7 don't think there's any questions that we had. We had, as I
8 think I mentioned earlier, reports of the board at every
9 meeting about the risks in the institution.

10 And you're depending on those processes,
11 depending on having the right people in those jobs, which I
12 think we did, and depending on those processes being robust
13 and highly proactive, which we did.

14 CHAIRMAN ANGELIDES: All right, I'm going to
15 make -- I'm going to make one last comment on this, and that
16 is the following: You were not a garden-variety board
17 member. You were chairman the executive committee, and you
18 can characterize it, but to someone, I think to most people,
19 chairman of the executive committee of the board of
20 directors implies leadership, certainly 15 million dollars a
21 year guaranteed implies leadership and responsibility.
22 Mr. Rubin assumed responsibility, said it was the honorable
23 thing, and I just think, Mr. Prince -- excuse me,
24 Mr. Prince, when he resigned, said it was the honorable
25 thing to do, and I just, my point is I think that leadership

1 and responsibility matters.

2 MR. RUBIN: I agree with that, but if I may say
3 so, Mr. Chairman, the executive committee is really
4 misconstrued in that comment. The executive committee was a
5 formal administrative apparatus; the institution had nothing
6 to do with one's role in the function of the institution.

7 I did feel, in `07, because of all the problems,
8 well, actually, it wasn't because of all the problems that
9 had developed. I did feel in `07 that I should not get a
10 bonus. But the reasons was not the reason that you're
11 alluding to. The reason was I felt that in my stage of my
12 career, one thing and another, that money could be better
13 used by the rest of the institution, by the institution for
14 other purpose.

15 So I went to the compensation committee, went to
16 the management and suggested that I not get a bonus in `07,
17 which I did not get, and I did exactly the same thing in
18 `08.

19 CHAIRMAN ANGELIDES: Well, this is you'll be the
20 only one in the end who can make an assessment of your
21 responsibility. A risk business always implies that there's
22 upside and downside. It's not about the fact that there
23 were failures, but acknowledging and understanding are
24 important. But that's up to you and for people to judge.

25 MR. RUBIN: Mr. Chairman, I totally agree with

1 that, but I think it's also very important to understand how
2 one of these institutions works, what roles people can play,
3 and what they cannot possibly play. And that's why --

4 CHAIRMAN ANGELIDES: Well, you make your case.
5 Mr. Vice Chair?

6 MR. PRINCE: Mr. Chairman, before you leave the
7 point, before you leave the point, you didn't ask me my
8 opinion.

9 VICE CHAIRMAN THOMAS: We're not leaving the
10 point.

11 CHAIRMAN ANGELIDES: Oh, excuse me?

12 MR. PRINCE: You didn't ask me my opinion on
13 this, but I would like to state, if I may.

14 CHAIRMAN ANGELIDES: On Mr. Rubin?

15 MR. PRINCE: That I think it is absolutely
16 incorrect to suggest that Mr. Rubin had central
17 responsibility or any central responsibility for what
18 happened to Citigroup.

19 CHAIRMAN ANGELIDES: I appreciate you -- your
20 acceptance of your role.

21 VICE CHAIRMAN THOMAS: Okay, and I appreciate
22 that.

23 EXAMINATION BY VICE CHAIRMAN THOMAS

24 VICE CHAIRMAN THOMAS: Mr. Prince, you were CEO?

25 MR. PRINCE: Yes.

1 VICE CHAIRMAN THOMAS: And you resigned?

2 MR. PRINCE: Yes, sir.

3 VICE CHAIRMAN THOMAS: What happened at Citi,
4 then, at Citicorp?

5 MR. PRINCE: I don't understand.

6 VICE CHAIRMAN THOMAS: After you left.

7 MR. PRINCE: I -- is this a rhetorical question,
8 Mr. Vice Chairman?

9 VICE CHAIRMAN THOMAS: No.

10 MR. PRINCE: I don't understand the question.

11 VICE CHAIRMAN THOMAS: Who assumed the position
12 of CEO?

13 MR. PRINCE: Sir Win Bischoff became the CEO --

14 VICE CHAIRMAN THOMAS: When?

15 MR. PRINCE: -- of Citigroup the day I resigned.

16 VICE CHAIRMAN THOMAS: Okay. And then what
17 happened in terms of the office of CEO?

18 MR. PRINCE: At that point a search was
19 conducted, and sometime thereafter Vikram Pandit became CEO.

20 VICE CHAIRMAN THOMAS: And there was obviously a
21 search?

22 MR. PRINCE: Yes, sir.

23 VICE CHAIRMAN THOMAS: Mr. Rubin, as chairman of
24 the board, notwithstanding all of the discounting, it's
25 really hard to believe that in a time of stress, based upon

1 your background, your experience, your involvement, not only
2 at Goldman Sachs, but as Secretary of the Treasury, and the
3 role that you played getting up from your Thanksgiving
4 dinner to -- to do the kinds of things that you obviously
5 had to have fairly significant knowledge of in the
6 corporation, to then back away from any kind of critical
7 decision, I'll accept it because you've said that's the
8 case, but it just brings into question any number of items
9 we've been asking, which have been dismissed because you've
10 had such an overall structure, you were so coordinated, you
11 trusted all those people under you.

12 And yet, when we go back, and I understand I'm
13 getting older, my memory isn't as good, I just made a
14 mistake on a date, but we have the record open. In terms of
15 written questions, you said would you respond to them, and I
16 just want to give you a heads-up as we finish this that in
17 our attempt to understand at least in some depth one
18 corporate model, there are going to be additional questions
19 trying to understand how with middle management and upper
20 management panels and CEO and chairman of the board panels,
21 that we're comfortable with the assurance that you know what
22 was going on but that everybody denied any responsibility
23 involved in it.

24 MR. RUBIN: Could I just make one factual
25 correction, Mr. Vice Chairman?

1 VICE CHAIRMAN THOMAS: I need
2 factual corrections, obviously.

3 MR. RUBIN: No, no, I wasn't -- okay -- I wasn't
4 chairman of the board.

5 VICE CHAIRMAN THOMAS: You were not chairman of
6 the board?

7 MR. RUBIN: I only became chairman of the board
8 after Mr. Prince stepped down. I remained chairman of the
9 board for the four or five weeks of the search process. And
10 the search process then resulted in Vikram Pandit being
11 selected.

12 VICE CHAIRMAN THOMAS: Why would they make you
13 chairman of the board if you had no knowledge of the
14 structure, the information, the operation of the company in
15 any meaningful way, was what I got out of your --

16 MR. RUBIN: I had a lot of understanding of the
17 structure and function of the company.

18 VICE CHAIRMAN THOMAS: Right. And when you're
19 looking for a CEO, you're going to look for somebody who
20 hopefully has and understands the knowledge of some of the
21 problems. We don't need to carry this out. All I'm saying
22 is I've got this problem with --

23 MR. RUBIN: Just to respond to your --

24 VICE CHAIRMAN THOMAS: -- multiple denials and
25 then, boom, you're in a position that's very significant.

1 MR. RUBIN: I don't think there are multiple
2 denials, Mr. Vice Chairman. I think what there was, was an
3 explanation of the affirmative role that the board played in
4 terms of the structure and function of the institution when
5 Mr. Prince stepped down.

6 I was then asked to be chairman of the board,
7 which I did, and we had, I think, a four- or five-week
8 search committee, and wound up with I think an outstanding
9 selection of new CEO.

10 VICE CHAIRMAN THOMAS: And I understand all that
11 but, Mr. Rubin, I guess what we're saying is that we can
12 talk about boards of directors, we can talk about structure
13 function, all we want in terms of corporate models.

14 Frankly, there are people in those positions,
15 and you have a higher confidence in some people than others.
16 Mr. Prince mentioned who he thought was outstanding. We've
17 interviewed some of them.

18 At some point you can't understand an
19 institution by simply following the lines of a structure
20 function model or even the dotted lines. And what we're
21 trying to say is it's really hard for us to believe,
22 especially on my personal knowledge of you, an involvement
23 in any institution that I'm aware you've been involved in,
24 of this ability to fall back to a structure -- structure
25 function model and argue about the box you were in. I have

1 never, ever seen you accept the outline, the frame or the
2 structure of a box.

3 MR. RUBIN: Well --

4 VICE CHAIRMAN THOMAS: Well, if you wanted to
5 accomplish something that you felt fairly strongly about,
6 and it's difficult for me to say we're finished, but I
7 wanted to end on a compliment.

8 MR. RUBIN: Let me respond to the compliment
9 because I think it's sort of a --

10 CHAIRMAN ANGELIDES: We'll make -- we'll make
11 this your response to the compliment will be the last word.

12 MR. RUBIN: Okay. It's a rather mixed
13 compliment.

14 VICE CHAIRMAN THOMAS: I reserve the right to
15 amend the compliment based upon his answer.

16 MR. RUBIN: No, I said in my -- in my opening
17 statement, Mr. Vice Chairman, that I had decided when I left
18 Treasurer I was never going to have an operating role again.
19 And that's precisely what I -- what we developed at
20 Citigroup. And that's the answer to your -- your -- your
21 compliment. Thank you.

22 CHAIRMAN ANGELIDES: And the record of today's
23 Commission and discussion is what it is, and I want to
24 thank, on behalf of the Commission, both of you for taking
25 the time, for your time with us today, your answers to the

1 questions. We appreciate it very, very much. Thank you so
2 much.

3 MR. RUBIN: Thank you.

4 CHAIRMAN ANGELIDES: We will re-adjourn at
5 12:30, members. We will recommence at 12:30.

6 -----(Session ended.)-----

7 CHAIRMAN ANGELIDES: The meeting of the
8 Financial Crisis Inquiry Commission will come back into
9 order. This afternoon session will be devoted to looking at
10 the Office of the Comptroller of the Currency with respect
11 to that office's oversight of Citigroup and, in a larger
12 sense, its oversight of financial markets particularly as it
13 relates to subprime lending and securitization.

14 We have two witnesses with us here today, Mr. John
15 Hawke, who is the former Comptroller of the Currency and
16 Mr. John Dugan, who is the current Comptroller of the
17 Currency.

18 And gentlemen, I'd like to start by doing what
19 we customarily do, both for witnesses who have come before
20 and will come after you, and that is to administer the oath
21 to both of you, if you'll please stand.

22 Do you solemnly swear or affirm, under penalty of
23 perjury, that the testimony you are about to provide the
24 Commission will be the truth, the whole truth and nothing
25 but the truth to the best of your knowledge.

1 MR. HAWKE: I do.

2 MR. DUGAN: I do.

3 CHAIRMAN ANGELIDES: Thank you so much. So
4 gentlemen, just one moment here.

5 Gentlemen, I'd like to -- I know that you've
6 submitted written testimony to us, and I think Mr. Dugan
7 you've get the record for the amount of information, even
8 though you did have a main statement. But I'd like to ask
9 each of you to start today by providing some brief oral
10 testimony, five -- up to five minutes each.

11 Mr. Hawke, I'm going to ask you to go first, as the
12 former comptroller, and then Mr. Dugan. So, Mr. Hawke, if
13 would you begin your testimony?

14 And if you could move that, not only turn it on,
15 but move the mic toward you, sir.

16 MR. HAWKE: Thank you, Mr. Chairman.

17 CHAIRMAN ANGELIDES: Thank you.

18 MR. HAWKE: And Mr. Vice Chairman and members of
19 the Commission, I am pleased to be able to participate in
20 the work of the Commission, and I hope I can say something
21 useful today.

22 I wanted to start by making two points. I
23 touched on it in my -- in my opening statement, but I think
24 they are very important. One, securitizations were really a
25 creature of the accounting rules. We -- we had seen

1 securitizations for many years. There was a time when they
2 were sort of one-off transactions, an entity that wanted to
3 increase its liquidity; to meet loan demand or credit card
4 demand would securitize a bunch of receivables and other
5 assets and go to market maybe once a year, twice a year,
6 something like that.

7 Securitizations evolved into a constant, everyday
8 method of raising the liquidity. And that process was
9 facilitated by the accounting rules, which allowed
10 institutions to treat assets sold as securitizations as off
11 their books, provided that certain accounting criteria
12 were -- were satisfied, basically that there were no
13 contractual indemnifications or liabilities.

14 And if those rules were met the institution could
15 treat the assets for financial accounting purposes as not on
16 their books and the regulators would do the same thing. The
17 regulators would not treat those assets as subject to
18 capital requirements.

19 That -- that might be okay if there were no
20 risks that resided with the institution after the
21 securitization. But what we have come to learn in a painful
22 way, particularly in more recent years, is that once the
23 bank securitizes assets, there are several different kinds
24 of risks that they retain.

25 On a simple level, they retain a liquidity risk,

1 because if their securitizations start to go bad, they may
2 have a harder time raising new liquidity in the marketplace.

3 But, more recently, what we've seen is that as
4 they were wholesale defaults on the mortgages that were
5 securitized, the trustees of the securitizations pools were
6 very aggressive in putting loans back to the banks that had
7 sold the loans, on the ground that representations and
8 warranties that had been given at the time of the
9 securitization had been breached, generally for some kind of
10 fraud.

11 And -- and there were tens if not hundreds of
12 thousands of loans that had been put back to banks, and that
13 has precipitated in enormous amount of litigation and
14 controversy at a time when banks themselves were under
15 tremendous pressures.

16 I don't think any of us anticipated that -- that
17 kind of risk in the process of securitization. And it
18 raises the question about whether we should not have some
19 capital requirements against assets that have been
20 securitized and that are treated by the accountants and by
21 the regulators as off the books to deal with those risks.
22 And I think that's a subject that is worthy of
23 investigation.

24 The other -- the other point is with respect to the
25 way we measure capital. We have -- there was an old head of

1 supervision at the Fed many years ago who, when asked how
2 many capital a bank needs, said, I can't tell you but I know
3 it when I see it.

4 And -- and we have evolved from that into a very
5 highly technical set of rules for allocating capital. The
6 Basel -- the Basel, as I sat on the Basel committee for six
7 years and the Basel committee rules are mind boggling in
8 their -- in their complexity.

9 And the -- the -- the one thing that we don't do
10 with -- with respect to these increasingly complex capital
11 rules is to measure capital, measure the value of capital
12 accurately.

13 We -- we treat assets for the most part based on
14 historical book values. Assets may get written down as a
15 result of an examination. But we don't really look at what
16 the -- what the true value, the true market value of the
17 assets on the books of the bank are, I realize that fair
18 value accounting is a very controversial topic, and I don't
19 think we need to go all the way to fair value accounting
20 to -- to satisfy the point that I'm making, but we have a
21 system of bank supervision that's built on the concept --

22 CHAIRMAN ANGELIDES: Could you wrap -- see if
23 you can wrap up in the next minute? I should have warned
24 you and I -- but is that yellow means one minute to go.

25 MR. HAWKE: Okay.

1 CHAIRMAN ANGELIDES: If you could wrap up in one
2 minute.

3 MR. HAWKE: I'll finish this very quickly. We
4 have a system of supervision that's based on the concept of
5 prompt corrective action, and that is that as capital levels
6 fall, it should be increasingly vigorous supervisory action.
7 But that whole concept fails if we're not measuring capital
8 accurately.

9 CHAIRMAN ANGELIDES: All right. Terrific.
10 Thank you very, very much.

11 Mr. Dugan, and let me just say, to start here,
12 because the Vice Chair always has a favorite phrase that
13 behavior has consequences, I actually want to thank you and
14 the OCC. Of all the entities we've dealt with, you have
15 been extraordinarily prompt in providing documents to us and
16 making available witnesses, and we appreciate it. We
17 understand you've done very well in that respect, so thank
18 you.

19 MR. DUGAN: Thank you. Chairman Angelides, Vice
20 Chairman Thomas, and members of the Commission, thank you
21 for this opportunity to address your questions regarding
22 national banks, subprime lending, federal preemption, and
23 the supervision of Citigroup, all of which focus on the
24 problems caused by deep losses on residential mortgages.

25 By the lack of adequate consumer protection

1 contributed to the record levels of these losses, there was
2 a more fundamental problem: Poor underwriting practices
3 that made credit too easy, especially by unregulated
4 mortgage lenders and brokers. These included stated income
5 loans, the lack of meaningful cash down payments, payment
6 option loans, and teaser rate adjustable mortgages.

7 In addition, without any skin in the game, brokers
8 and originators had every incentive to apply the weakest
9 underwriting standards that would produce the most mortgages
10 that could be sold to mortgage securitizers.

11 And, unlike banks, most mortgage brokers in the
12 United States were virtually unregulated. So there was no
13 supervisory check on imprudent underwriting practices.

14 The rapid increase in market share by these
15 unregulated brokers and originators pressured regulated
16 banks to lower their underwriting standards, which they did,
17 though not as much as unregulated mortgage lenders.

18 The OCC took a number of steps to keep national
19 banks from engaging in the same risky underwriting practices
20 as their non-banking competitors. That made a difference,
21 but not enough for the whole mortgage system.

22 All these factors produced the worst under --
23 underwritten mortgages in our history. When house prices
24 sharply declined, it led to record levels of delinquency,
25 default, foreclosures, and loss.

1 However, the weak lending standards that caused the
2 crisis were not the result of federal preemption of state
3 mortgage lending laws. If it had been, the vast majority of
4 subprime lending and Alt-A lending would have been done in
5 national banks and federal thrifts, but just the opposite
6 was true.

7 As described in my written statement, national
8 banks and their subsidiaries made only 10 percent of
9 subprime mortgages and only 12 percent of all non-prime
10 mortgages from 2005 through 2007.

11 Conversely, 72 percent of all non-prime
12 mortgages were made by lenders that were subject to state
13 law. Well over half were made by mortgage lenders that were
14 exclusively subject to state law. And it is widely
15 recognized that these were the worst underwritten loans with
16 the highest levels of foreclosure.

17 Now, I'm not suggesting that national banks
18 played no role in the subprime lending crisis. They did.
19 Some national banks originated poor quality, non-prime
20 mortgage loans, some purchased badly underwritten subprime
21 mortgage-backed securities, and some had significant
22 exposure to subprime mortgage risk that they did not
23 understand or anticipate, all of which produced very large
24 losses.

25 But the relatively smaller share of non-prime

1 mortgages made by national banks and their relatively better
2 performance belie the argument that national banks' federal
3 preemption caused the mortgage crisis.

4 Let me turn briefly to Citigroup: The critical --
5 rule -- role that subprime mortgage losses played in its
6 problems and the OCC's supervision of its national bank
7 subsidiary, Citibank. The overwhelming majority of
8 Citigroup's mortgage problems did not arise from mortgages
9 originated by Citibank, and indeed the bank's financial
10 performance throughout the crisis was consistently better
11 than it was for Citigroup as a whole.

12 Instead, the huge mortgage losses arose primarily
13 from the collateralized debt obligations structured by
14 Citigroup's securities broker-dealer with mortgages
15 purchased from third parties.

16 By far the largest exposure of Citibank to the
17 CDOs came from its liquidity puts that supported the CDO's
18 super senior tranches. In the summer and fall of 2007, the
19 25-billion-dollar exposure to the bank, from these liquidity
20 puts, came as a surprise to the senior management of
21 Citigroup and to the OCC.

22 Subsequent review and investigation showed this to
23 be both a risk management and an internal reporting
24 breakdown by the company. It also revealed some of the
25 supervisory problems caused by the legally segregated

1 responsibilities of different regulators and the undue
2 reliance on high credit ratings.

3 Citigroup, Citibank, the OCC, and other
4 regulators have since taken a number of steps to address
5 these issues.

6 In closing, there are many lessons to be learned
7 from the mortgage problems that precipitated the crisis, but
8 the one I would like to leave you with is this: I believe
9 the government should establish minimum common sense
10 underwriting standards for mortgages that can be effectively
11 applied and enforced for all mortgage lenders, whether they
12 are regulated banks or unregulated mortgage companies.

13 If we had had such basic across-the-board rules
14 in place ten years ago on income verification, down
15 payments, and teaser rate mortgages, I believe the financial
16 crisis would have been much less severe than it was.

17 Thank you very much.

18 CHAIRMAN ANGELIDES: Thank you very much. We
19 will now go to Commissioner questions. We will start -- I
20 will defer mine till the tail end, and we'll start with the
21 Vice Chairman.

22 VICE CHAIRMAN THOMAS: Mr. Chairman, I will
23 probably defer most of mine to the tail end. But I want to
24 respond briefly to a couple points.

25 EXAMINATION BY VICE CHAIRMAN THOMAS

1 VICE CHAIRMAN THOMAS: First of all, thank both
2 of you very much. In the business of regulation a lot of
3 folks come and go, and I'm pleased to see with just two
4 people we've got a broad scope of history during a period
5 when a lot of this was evolving. And that -- and that helps
6 a little bit based upon the perspectives that you present.

7 Over the last couple of days, one conclusion that I
8 have now locked down pretty firmly is that simplicity is not
9 conducive to maximizing income if you're involved in any way
10 on Wall Street. That's true to a certain extent in other
11 professions. I think magicians learned it a long time ago,
12 because you're fascinated with what they do until they show
13 you what you're doing, and then you say, that's just because
14 you practice it, but it ain't that big a deal.

15 I happen to think -- who was it, Therfer
16 (phonetic), I think said -- For every complex problem,
17 there's a simple answer, and it's wrong. So especially in
18 this world today, I understand and accept complexity.

19 But having something complex and something
20 convoluted for the purpose of having it be perceived what it
21 isn't are -- are two different things. And one of my
22 worries is -- and we're not responsible for setting up a
23 structure which allows us to advocate to Congress what it is
24 that ought to be the solution, thank goodness. But one of
25 the things that concerns me, and just a quick reaction,

1 because it's outside your area of expertise, but it came to
2 me in the comments that you just made at the end, and that
3 is I had been concerned for some time about the influence
4 or -- my impression is of the influence, others may or may
5 not agree, of the tax code, on the way in which people begin
6 dealing with their homes; homes rather than houses.

7 You get into the flipping business and the rest
8 I'm not concerned about that, but that the tax code really
9 encouraged people, arguably, to pursue the American dream
10 and wind up owning a home, but not the way it used to be
11 where you owned the home, it was better than rent because
12 you could get equity, and eventually you would have a
13 mortgage-burning party and you accumulated wealth in your
14 home.

15 In fact, there was some discussions that this was
16 one of the American ways of saving not available to other
17 societies to a certain extent, because they didn't own homes
18 nor did the government assist in owning homes to the degree
19 that the U.S. did and other societies.

20 But in 1986, on the tax committee, Ways and
21 Means Committee, behind closed doors, we fought a pretty
22 hard, tough battle because there was a desire and we, in
23 fact, agreed to remove consumer interest as a deductible
24 item on the tax form thereby damping down the consumer
25 enthusiasm, because the government would cover a piece of

1 the action in terms of the write-off on interest.

2 Wanted to do the same thing on mortgage
3 interest, not tied very directly and specifically to
4 improvement involvement with the house, and obviously it
5 turned out that you created an environment in which the very
6 creative folk in marketplaces would send you a check every
7 month which represented the accrued equity in your home for
8 that month so that you could spend it ostensibly on
9 something about the house. But, of course, it went right
10 back into consumer -- into consumption, totally negating,
11 and more so, the argument about not wanting to have interest
12 deducted on consumer demand and I think spiking it, and then
13 you had the cheaper money.

14 Do you folks feel, at all, in any way, that that
15 partially contributed to, assisted the environment in terms
16 of the problem that we now face?

17 MR. DUGAN: Well, I'm certainly no expert on the
18 tax policy, but I think there were a cluster of things that
19 encouraged homeownership that fed on each other to stimulate
20 demand --

21 VICE CHAIRMAN THOMAS: I haven't even discussed
22 the societal and the government desire for everyone to own
23 their own home, just like going to college, so you do
24 everything you can to allow access to that, notwithstanding
25 the fact not everybody ought to be able to participate in --

1 MR. DUGAN: But I think it's all part of that
2 pattern that created the intense desire and demand for
3 bigger, more mortgages and the -- also, as you said, the
4 easy access to home equity through home equity lines of
5 credit. Now there was a change. And it allowed much more
6 equity extraction to be used for consumption and that had
7 very significant effects. But it sort of fed on itself.

8 So I am no expert, but I think it did feed the
9 whole notion of greater and greater demand for mortgages,
10 mortgage credit that fed the securitization and the desire
11 as well.

12 VICE CHAIRMAN THOMAS: Thank you.

13 CHAIRMAN ANGELIDES: Ms. Murren?

14 COMMISSIONER MURREN: Thank you.

15 EXAMINATION BY COMMISSIONER MURREN

16 COMMISSIONER MURREN: Thank you both for your
17 very detailed and thoughtful testimony. I enjoyed reading
18 it and I, though, wanted to go back to some of the witnesses
19 that we've heard today and yesterday. I don't know, did you
20 have an opportunity to hear the previous witnesses?

21 MR. DUGAN: Some of it but my staff heard it and
22 I have been briefed on various aspects of what they say, so
23 some of it, but not every bit.

24 COMMISSIONER MURREN: Well, my general
25 impression was, from every single individual that we heard

1 from, was that in their view, as a company, as managers, and
2 as participants in their company and also in the financial
3 crisis, that during the course of performing their duties
4 and also the course of conducting business, that they felt
5 very strongly that their risk management systems and the way
6 that they dealt with risk and, you know, to use some of the
7 words was excellent, very good, best in class, almost to the
8 person, in fact, I think it was to the person, that they
9 really validated their own opinion of their risk management
10 policies and methodologies.

11 Does the fact that they all so strongly advance
12 it or believe it surprise you in light of your reports and
13 in light of what's happened?

14 MR. DUGAN: It doesn't change our view of what
15 we thought their risk management was at the time or how it
16 played out, I guess I would say. I think there were things
17 that they well understood about the risks they took, others
18 less so. We, on various occasions, pointed out problems.

19 I will say that when we pointed out problems to
20 them, they were by and large quite responsive to them. But
21 I also think that when the crisis hit, it revealed some
22 problems that were of significant concern to us, which we
23 did communicate to the company.

24 COMMISSIONER MURREN: There were a couple of
25 instances prior to the crisis too, where you had noted some

1 deficiencies in their risk management practices. Could you
2 comment? You said that they were very responsive in
3 remedying those things. Is that accurate or was it
4 complete?

5 MR. DUGAN: I think that is accurate. I think
6 what I was thinking about when I said that was we did a
7 review of their credit derivatives, trading business in the
8 bank in 2005, where we found a number of problems and
9 concerns.

10 And we downgraded our rating of the management
11 of that business and told them that they needed to fix
12 things if they wanted to get that assessment of them
13 improved.

14 They did curtail the risks that they were taking
15 and they did take a number of steps to fix that particular
16 problem. And we thought that is how the process is suppose
17 to work.

18 COMMISSIONER MURREN: One of the things that you
19 mentioned is that there are a number of different regulatory
20 bodies that govern the overall enterprise. And specifically
21 you mentioned that it was really not inside of the bank
22 company itself which you monitored, where the problems
23 arose, but rather other areas.

24 Could you maybe describe to us your interactions
25 with some of the other regulators? Because if I'm not

1 mistaken, and maybe you could comment on this, there was
2 some interest in utilizing the information that was produced
3 by the other regulators to be able to determine the safety
4 and soundness of the bank.

5 So to what extent did you or did others that you
6 interacted with make sure that information was validated and
7 also that the right questions were being asked?

8 MR. DUGAN: So of course, in the way the bank
9 holding company structure works, as I think you know, we
10 were responsible as the primary supervisor for the bank and
11 its subsidiaries. And the Federal Reserve was the umbrella
12 supervisor for the consolidated company and the non-banking
13 subsidiaries of the holding company.

14 And in some cases, those non-banking
15 subsidiaries were themselves broker-dealers, for example,
16 that were regulated by the SEC.

17 So that was a mixture of different regulators.
18 And also we had futures Commission merchants that were
19 regulated by the Commodity Futures Trading Commission.

20 We have, by long historical practice, a very
21 close working relationship with the Federal Reserve as the
22 holding company regulator. They see everything we do; they
23 have access to everything we do; it's quite transparent.

24 I believe what happens in the bank, and there is
25 tremendous amount of focus on what's going on in the bank,

1 it's a little murkier when we go outside the bank to deal
2 with issues that could effect the bank.

3 We rely on the Federal Reserve with respect to
4 the affiliates for which it has primary supervisory
5 responsibility. And as I said, we have a relationship where
6 we're constantly sharing information.

7 When you get to the securities broker-dealer, by
8 statute in the Gramm-Leach-Bliley Act, there are
9 restrictions on our ability to get information from those
10 companies and restrictions on when we could examine those
11 companies.

12 And I do think that did and has created some
13 issues in the process about not having as efficient and
14 integrated supervisory model as we should have, and that
15 showed up, in some ways, in the supervision of Citibank and
16 Citigroup.

17 COMMISSIONER MURREN: One of the notations that
18 we had made in the earlier conversation with witnesses was
19 regarding some of the creation of new products which they
20 would, of course, I believe, bring to the OCC to determine
21 if they were able to sell them; correct?

22 MR. DUGAN: Not necessarily. There's not a
23 prior approval requirement for new products with the OCC.
24 However, particularly in the wake of the Enron situation,
25 there was a tremendous focus put on making sure that

1 institutions had new product committees and the right
2 processes and the right due diligence and the right controls
3 to examine those new products.

4 And then we would periodically go and examine
5 those processes to make sure that on a test basis that they
6 were appropriately looking at them. So that's the way the
7 process worked.

8 COMMISSIONER MURREN: Okay. With that in mind,
9 when you think about -- and one of the reasons that we chose
10 Citibank to look at was the ability to shed light on
11 practices that might have been common throughout the
12 financial services industry.

13 MR. DUGAN: Right.

14 COMMISSIONER MURREN: In your opinion, with your
15 perspective, do you think that it was common for companies
16 to look at these products and to determine whether or not
17 they needed to meet regulatory capital standards? Was that
18 one of the ways they determined whether a particular new
19 product was attractive to them?

20 MR. DUGAN: I'm quite sure that that factored
21 into every decision. Much in the way that companies decide
22 on the profitability of a particular type of product is a
23 risk adjusted return based on the capital requirements that
24 are allocated to that, so absolutely, that is a factor that
25 people look at.

1 COMMISSIONER MURREN: Again, on a comparative
2 basis, when you look at across the financial services
3 industry, looking at a variety of different companies, when
4 you look at them, are there certain commonalities that they
5 all share in terms of their failures as we look back now,
6 things that they might have done differently?

7 MR. DUGAN: There are some, yep.

8 COMMISSIONER MURREN: And what would those be?

9 MR. DUGAN: So, for example, obviously in the
10 area that you're -- that this Committee is looking hard at,
11 in the area of complex structured financial products in the
12 CDOs, it was a surprise in the process, not just to the
13 management of Citi, but to the management of several other
14 companies, about the significant, sudden, and deep losses
15 created on these instruments.

16 And I think there was not a full appreciation, a
17 full examination of the -- of course, these were
18 extraordinary events.

19 But of the -- in many cases, situations where
20 companies have thought they had limited exposure to subprime
21 risk from their direct lending activities only to find out
22 that they had much more significant exposure than they
23 thought coming from the securities side and, particularly,
24 from the CDO side, we saw that in several instances.

25 I think the difference with Citi and with

1 several other institutions that we do not supervise is they
2 have so much more of it; it was so much bigger a
3 concentration, which caused a much more significant problem
4 when it hit.

5 COMMISSIONER MURREN: To the extent that the
6 regulators are also responsible to some degree for examining
7 that very issue, which is the concentration of risk, you
8 know, particularly as it relates to the holding company, in
9 a practical sense, how would that have been discovered based
10 on what you described as being a little bit murky in certain
11 areas?

12 MR. DUGAN: Well, I think in the case of the
13 structured products, I think it is fair to say that
14 Citigroup and its management, and I would say also the
15 regulators, derived a false sense of security by the very
16 high credit ratings on the super senior tranches, which
17 ended up causing the big losses, not the tranches below it,
18 which were riskier but which had been sold off, and
19 interestingly, they did not cause as much loss even to where
20 they were sold, because people used them and hedged them in
21 different ways.

22 And so I think that was something that people did
23 not adjust to or see as well as they should. I think the
24 thing that surprised us, as I mentioned in my opening
25 remarks here, was on the liquidity put. That was never

1 treated even as an exposure to subprime losses by Citigroup.
2 Even after problems started hitting and we began asking
3 questions, we weren't told about the magnitude that was
4 viewed as something that was an exposure of the bank. And
5 that was unique to that institution.

6 COMMISSIONER MURREN: And what do you think
7 explains that?

8 MR. DUGAN: I think that liquidity put is a kind
9 of liquidity support facility that is not unusual in the
10 sense that there were similar kinds of facilities provided
11 for asset-backed commercial paper conduits that had been
12 around for many years, that have worked well, and the actual
13 liquidity facility was viewed as so unlikely to be exercised
14 that it was not a significant risk.

15 And the fact was we did have an extraordinary
16 situation. And, by the way, it was not supposed to be there
17 for credit protection; it was only supposed to be there for
18 liquidity protection. So if you had losses in a pool of
19 assets, you couldn't exercise this liquidity put, or if you
20 had a downgrade, you couldn't exercise it.

21 But what happened in this circumstances was the
22 market started sensing things before the credit rating
23 agencies did, there was a run on the commercial paper, and
24 this seemingly liquidity only temporary facility ended up
25 being something that was permanent and ended up taking on

1 all the credit risks.

2 So it was partly an extraordinary event, partly
3 because it was similar to things that they had done before,
4 and partly was only tied to what was supposed to be the
5 safest asset in that particular securitization pool that
6 they never treated it as that kind of risk or -- and
7 calculated even the magnitude of it when they talked about
8 it.

9 COMMISSIONER MURREN: Would you also agree that
10 one more component might be that it's difficult to evaluate
11 the concentration of risk when you do have so many people
12 that are involved with analyzing the underlying assets and
13 liabilities of a variety of organizations, all of whom feed
14 back up into an umbrella holding company?

15 MR. DUGAN: It can be, but a good risk system,
16 of course, and you're exactly right in the sense that, you
17 know, they were analyzing their subprime exposure from
18 various other things and putting them together, and this one
19 they didn't put with it, and it turned out to be huge. And
20 so it was a breakdown.

21 COMMISSIONER MURREN: Thank you.

22 Mr. Hawke, I don't want to leave you out of my
23 questioning, so I wanted to ask you, from your perspective,
24 having been an observer of the financial services industry
25 for some time, what changes in the regulatory environment do

1 you think have influenced where we are today versus perhaps
2 a very early part of your tenure?

3 MR. HAWKE: I'm not sure that changes in the
4 regulatory environment, per se, were a major contributing
5 factor to -- to the crisis.

6 I'm one who believes, and a lot of people
7 disagree with me, that the regulatory structure --

8 VICE CHAIRMAN THOMAS: Mr. Hawke, can you pull
9 the microphone just a little bit closer? Thank you.

10 MR. HAWKE: -- that the regulatory structure
11 was -- was not a major -- major contributing cause. Nobody,
12 clearly nobody would have invented this structure if you
13 were developing a financial regulatory structure from
14 scratch.

15 But in my experience, it has worked -- it has
16 worked quite well. Not perfectly, by any means, but there's
17 a high degree of coordination among the agencies. And while
18 there are occasionally differences, today the system, I
19 think, works, it generally works quite, quite well.

20 There -- a lot of people attribute today's
21 problems to what they generally call deregulation, and they
22 focus on the Gramm-Leach-Bliley Act of 1999. I don't
23 believe that Gramm-Leach-Bliley was a contributing factor to
24 the crisis. The -- I think Gramm-Leach-Bliley ended up
25 turning out to be pretty much of a dead letter.

1 Once Citigroup's acquisition of Travelers was
2 validated by Gramm-Leach-Bliley there was very little
3 activity in the way of cross-industry acquisitions between
4 insurance and securities and banking, banking firms.
5 Paradox -- paradoxically, it wasn't until the crisis in over
6 the last year or so that -- that Gramm-Leach-Bliley became
7 an important factor in allowing companies like Morgan
8 Stanley and Goldman Sachs to become bank holding companies
9 where they couldn't have before that, but I don't think that
10 if you characterize Gramm-Leach-Bliley as a deregulatory
11 statute that it was a principal contributing factor to the
12 problem.

13 COMMISSIONER MURREN: Would it be fair to say
14 that it would make transparency better if though you were to
15 be able to perhaps regulate more strongly or at least to
16 reveal more about what the non-bank entities are doing in
17 the financial services sector?

18 CHAIRMAN ANGELIDES: Let me yield another five
19 minutes.

20 COMMISSIONER MURREN: Sure.

21 CHAIRMAN ANGELIDES: Five minutes.

22 MR. HAWKE: Oh, I think without question
23 that's -- that's right.

24 COMMISSIONER MURREN: Thank you. Just one final
25 question, really, on the -- the OCC reports on Citibank.

1 There were a couple of notations about their failures of the
2 regulatory structure there and I wonder how strongly you
3 took action in the face of those things.

4 Do you feel that as an enterprise that you have
5 what you need to be able to put the kinds of muscle behind
6 your recommendations or your observations that you need?
7 And you had commented earlier that you felt like they were
8 listened to when they were made by management -- when you
9 made them to management. Is that an accurate
10 characterization?

11 MR. DUGAN: Yes, it is an accurate
12 characterization. The fact is when we do have a cause -- a
13 course -- a cause to take action, we can do it quite
14 effectively. We have very strong tools that we can
15 exercise, do exercise, have exercised, in this circumstance,
16 to get the kind of change and action that we want.

17 COMMISSIONER MURREN: Okay. Thank you.

18 CHAIRMAN ANGELIDES: Thank you, Ms. Murren.

19 Mr. Wallison?

20 COMMISSIONER WALLISON: Thank you, Mr. Chairman.

21 EXAMINATION BY COMMISSIONER WALLISON

22 COMMISSIONER WALLISON: Let me start with you,
23 Mr. Hawke, if I may.

24 You were the Comptroller during the Clinton
25 Administration, latter part of the Clinton Administration,

1 and then through a portion of the Bush Administration. And
2 I think I'm following up a bit on Commissioner Murren's
3 question because I saw this somewhat broader.

4 Did you see any change in the way that
5 regulation was viewed in the Clinton Administration or the
6 Bush Administration?

7 MR. HAWKE: No, I did not, Commissioner
8 Wallison. As a matter of fact, I found that in both the
9 Clinton and Bush Administrations, the Treasury Department
10 was exceedingly sensitive about the independence, statutory
11 independence of the OCC.

12 And while we were obviously part of the Treasury
13 Department and found strength in being part of the Treasury
14 Department, I can't think of any instance where in either
15 administration we had intercession on the part of the
16 administration that was aimed at the way we conducted our
17 supervisory and regulatory activities.

18 COMMISSIONER WALLISON: So these concerns that
19 there was some kind of environment which did not favor
20 regulation during the Bush Administration, at least, that's
21 been one of the complaints, is it was not something that you
22 noticed when you were a regulator?

23 MR. HAWKE: As I said, I -- I don't think that
24 deregulation was a -- was a contributing factor, whether it
25 was Gramm-Leach-Bliley or anything earlier than that.

1 COMMISSIONER WALLISON: I'm sorry to just follow
2 this up again. And I want to talk about the environment,
3 the zeitgeist, if you will, about regulation, because we
4 read a lot, hear a lot about some notion that regulators
5 were not regulating during the Bush Administration. Did you
6 notice anything like that?

7 MR. HAWKE: No, as I say, we -- we kept a steady
8 course in our supervisory and regulatory activities. We had
9 extensive interagency discussions, but that is among the
10 banking, the financial regulatory agencies.

11 But I can't think of single instance where the
12 administration that happened to be in power at a particular
13 time attempted to influence our supervisory or regulatory
14 policy.

15 COMMISSIONER WALLISON: Thank you. Let me go
16 on to another subject. You noted in your testimony that
17 literally tens of thousands, if not hundreds of thousands,
18 of loans have been put back to banks in the securitization
19 process. That's really an important point, because many
20 people act as though this originating-to-distribute idea
21 means that no one has any liability after the loan is sold.

22 In fact, the banks or anyone else who has sold a
23 loan does have liability. And you were concerned about
24 that. The question I have, however, is wouldn't it be one
25 of the things that a regulator ought to look at when a bank

1 is holding loans that it is going to securitize to make sure
2 that the loan is a good-enough loan to pass a securitization
3 test?

4 MR. HAWKE: Well, I can -- I can't disagree that
5 that would, in an ideal world, have been something that
6 regulators might have done. Although my sense is that loans
7 pass through the books of banks during the heyday of
8 securitization quite rapidly.

9 They -- they -- they were not sitting around
10 for -- waiting for examiners to come in and look at them.
11 And I don't think anybody predicted this kind of response
12 from the securitization trustees when they started trying to
13 find ways to salvage the loans that were going bad in their
14 pools by putting them back to banks on the ground that there
15 had been some sort of fraud in the initiation of the
16 transaction and that the representations and warranties that
17 the bank had given at the time of the sale of the loan had
18 been breached.

19 COMMISSIONER WALLISON: Let me turn, then, to
20 the question that you mentioned, in fact, in your testimony,
21 and that is, fair value or mark-to-market accounting.

22 Would you favor us with your views on how that
23 affected the view of the condition of financial
24 institutions, particularly banks.

25 MR. HAWKE: Well, this is a highly controversial

1 subject, and I should say that I'm not an accountant, and I
2 probably should not delve into this but --

3 COMMISSIONER WALLISON: If we leave this to the
4 accountants, we'll never have a debate about this issue, so
5 please.

6 MR. HAWKE: My basic point, my experience in
7 this regard, is affected by my service as a director to the
8 FDIC, a statutory role for the comptroller. It seemed that
9 every time that a bank failed, and as we look back at the
10 last examination report before the failure, the bank showed
11 positive capital, but immediately after the failure it
12 showed negative capital.

13 And -- and one had to conclude that things
14 didn't change in a period of months so quickly. And my
15 conclusion from that was that the real value of the bank's
16 capital was not being adequately assessed, whether by the
17 regulators or by the rating agencies or the marketplace or
18 whatever.

19 And now, moving to full-blown fair value
20 accounting is, as I say, a controversial issue, people talk
21 about the volatility that that would create. But I think
22 the regulators who are implementing a system of prompt
23 corrective action have to -- which is what our system of
24 supervision is based on, have to know what the real value of
25 capital is. Otherwise prompt corrective action becomes a

1 fool's paradise.

2 By the time you're really ready to act capital,
3 real capital, may have already eroded. So the regulators
4 have to know what the real value of capital is.

5 COMMISSIONER WALLISON: True. Do you suppose
6 that the regulators or the market has a better idea of what
7 the real value of capital is when there is no market?

8 MR. HAWKE: Well, and that is a good question.
9 When there is no market I don't know that the market has
10 any -- any better way of looking at it than the regulators
11 do. There are ways, there are techniques for evaluating
12 assets for which there is no --

13 COMMISSIONER WALLISON: Discounted cash flow,
14 for example.

15 MR. HAWKE: Yeah, discounted cash flow is one of
16 them. And not every asset can be valued on a bank's books
17 with precision. But looking at real values is -- is
18 important. And my favorite example of this is the -- is the
19 situation in the savings and loan industry in the late '80s
20 and early '90s.

21 Everybody knew that when market rates were up
22 around 20 percent, and S&Ls had average yields on their
23 portfolios of 6 percent, that they were underwater, that --
24 that -- that it -- and there was no way you could earn your
25 way out of that. We had an insolvent industry.

1 Had the regulators -- and I think the regulators
2 were fully aware of that. Had the regulators acted on the
3 basis of what real market values were and had they done it
4 incrementally, as interest rates started to go up, instead
5 of waiting till the end, when it was just a cliff that you
6 had to dive off, the -- some of the impact of the savings
7 and loan debacle could have been avoided.

8 COMMISSIONER WALLISON: Thanks very much. Let
9 me go on to Comptroller Dugan.

10 You have, uniquely, served in both the Bush
11 Administration; you were appointed by George W. Bush; and in
12 the Obama Administration.

13 I'm going to ask you the same question I asked
14 Mr. Hawke, and that is, have you seen any significant
15 difference between the regulatory environment? I call it
16 the zeitgeist, that sense of whether regulation is important
17 or not important, in the Obama Administration than you saw
18 in the Bush Administration?

19 MR. DUGAN: No. I think -- I do think it's
20 fair, however, to say that the world changed when we hit the
21 crisis in how everybody was looking at this. I think the
22 Treasury Department ended up playing a much more significant
23 role because of the money it was distributing, so it became
24 much more active than would otherwise be the case. That was
25 true in the Bush Administration, under Secretary Paulson,

1 carried over to the new administration.

2 But in terms of, as Mr. Hawke said, about
3 interference, directing, we have very strict rules,
4 statutory firewalls that prevent interference with the
5 regulator, with the -- with the comptroller, even though
6 we're a Bureau of Treasury on regulatory matters, and that
7 has been observed in every case in both administrations.

8 COMMISSIONER WALLISON: You describe the
9 financial crisis as the result of the worst underwritten
10 mortgages in our history.

11 We've had a lot of focus on Citi here, and I'm
12 going to ignore Citi for the moment, because there have been
13 a lot of questions about that and there will probably be
14 more. But there are about 200 banks, small banks, at least
15 smaller than Citi, that are now failing. I don't suppose --
16 or have failed, already. There are 700 or so that are on
17 the list of the FDIC as possible failures -- I don't suppose
18 that all of these are -- are not national banks, that some
19 of these are national banks?

20 MR. DUGAN: Sadly, yes.

21 COMMISSIONER WALLISON: Sadly, yes.

22 Now, it seems to me that if there's one thing
23 that a regulator ought to be able to do is to make sure that
24 a bank has complete files on loans and that it is only
25 making prudent mortgage loans.

1 But we hear, at least, that most of these banks
2 are failing because the loans that they had made, and most
3 of these banks make mortgage loans, either commercial or
4 residential, but principally residential, and hold them on
5 their balance sheets. What is the reason that so many of
6 these banks made loans that are now seeming to be imprudent?
7 And what role could the regulators, particularly your
8 office, have played in preventing that from happening?

9 MR. DUGAN: Well, I want to be careful here,
10 because I was speaking about residential mortgage
11 underwriting, not commercial mortgage underwriting.

12 COMMISSIONER WALLISON: Right.

13 MR. DUGAN: When it comes to the banks that have
14 failed, there have been a number of thrift institutions that
15 that have failed because of residential mortgage problems.

16 But I think all of the national banks that have
17 failed, and certainly the overwhelming majority of
18 commercial banks that have failed, small banks, have failed
19 because of commercial real estate problems, not residential
20 real estate things. In those circumstances, while there has
21 been in some cases a decline in underwriting standards, it's
22 as true if not more true that the problem is a concentration
23 problem. It's a situation where they just have too many of
24 these loans on their book, too many eggs in one basket, if
25 you like.

1 And we did try to address this in regulatory
2 guidance that started -- it was a long interagency process,
3 that dated back actually to Mr. Hawke's era, and proceeded
4 very controversial.

5 We did finally come out with guidance that set
6 some benchmarks that were not hard caps on the amount of
7 concentrations that commercial banks could have in
8 commercial real estate lending. Very bitterly opposed by
9 parts of the industry as being too prescriptive and we
10 nevertheless finalized the rules. And, looking back on it,
11 I think I worry that it wasn't actually strong enough and we
12 should have done more.

13 And to your more general point, I do think there
14 is a notion, and honestly this was a little bit surprising
15 to me when I came from the private sector into the
16 government, that regulators don't set underwriting
17 standards.

18 And historically, that's not how things work.
19 It's more been a notion of if you have a willing lender and
20 a willing borrower, then they should be allowed to make a
21 transaction provided that it's done in a forthright manner
22 where people can -- consumers can understand the risk in a
23 consumer transaction and the lender understands,
24 appropriately measures, monitors, controls and manages the
25 risk of the transaction.

1 What I suggest in -- is that, given the
2 experience that we've gone through, that that paradigm
3 didn't work very well --

4 COMMISSIONER WALLISON: Mm-hmm.

5 MR. DUGAN: -- in the residential mortgage
6 space. And it's a place where there has been, if you like,
7 a market failure that does require more prescriptive minimum
8 government requirements. But critically they have to apply
9 across the board. If any one significant part can end-run
10 the others you can have problems.

11 COMMISSIONER WALLISON: One of your
12 prescriptions, I've read the material you've been writing,
13 and in your -- in your prepared statement is higher --
14 higher down payments, for example, for mortgages. I think
15 you were talking about a 20 percent possible down payment.

16 MR. DUGAN: I haven't actually thrown out a
17 number and it could vary in certain circumstances.

18 COMMISSIONER WALLISON: That's a very sensible
19 approach. I guess the question I'm going to ask you now, is
20 how do we bring that idea into an idea where we are
21 expecting our banks and other financial institutions, but
22 particularly the banks, to increase home ownership by
23 offering mortgages to people who cannot make a down payment?

24 MR. DUGAN: There is a tradeoff, undeniably a
25 tradeoff. If you put in we had a crisis in which credit was

1 too easy and too many people got loans because of weak
2 underwriting standards, if you strengthen those standards,
3 fewer people will get loans, that is the tradeoff.

4 But I think what the crisis showed us was that
5 people got loans that they couldn't handle. And that didn't
6 help anybody.

7 And what I would suggest is that's something
8 that the notice and comment process, how you do it is very
9 important to sort out, number one.

10 And, number two, I think there are different
11 kinds of programs that one could do in a very open and
12 transparent way with people of more moderate means, whether
13 it's through the Federal Housing Administration or through
14 the VA.

15 Which, by the way, has had more success by
16 holding to stronger underwriting standards, even of the
17 lower down payments.

18 So there is not a one-size-fits-all thought here.
19 It's just that we have to bring back some discipline to the
20 system and some common sense minimum underwriting standards.

21 VICE CHAIRMAN THOMAS: Yield the gentleman five
22 additional minutes.

23 COMMISSIONER WALLISON: Wonderful. Thank you
24 very much.

25 I'm glad you mentioned an open and transparent

1 way, because that, of course, is a really significant issue.
2 If we want to improve home ownership in this country then
3 there is an open and transparent way to do it, and that is
4 to provide some sort of government subsidy for, we'll say,
5 just to imagine it, down payments.

6 But what we did before, was we took institutions
7 that the government controlled in some way but didn't
8 actually fund, and said, and I'm talking here about Fannie
9 Mae and Freddie Mac, and we said to them, you distort your
10 underwriting systems and you produce these mortgages for us.
11 Hands off, we don't have to put anything in the budget
12 that -- that provides that benefit for the people we are
13 expecting you to help.

14 So open and transparent I think is a really
15 important issue here. And I'm grateful that you raised it.
16 I have one other question, I think, because there was
17 something in your testimony that really struck -- struck my
18 eye when I read it. You note that 22 percent of non-prime
19 loans, non-prime loans originated by national banks and
20 their subsidiaries subsequently entered the foreclosure
21 process, 22 percent, compared to a market average of 25.7
22 percent.

23 Now, I don't know, but I was fairly shocked by
24 the idea that 22 percent of non-prime mortgages in any group
25 of financial institutions would be in the foreclosure

1 process right now. That's -- that's quite extraordinary.
2 In terms of your knowledge of the industry, what's the
3 multiple over the usual number of -- of -- of mortgages that
4 are, or homes that are in the foreclosure process at this
5 stage of a -- of a -- a deflation of a bubble, we'll say.

6 And I would like, actually, Mr. Hawke, after --
7 after you've answered too -- because he has also a very long
8 experience in this business, to respond to that.

9 MR. DUGAN: Well, what I would say is we've
10 never experienced something like this before. We've never
11 experienced this kind of decline in house prices, including
12 the Great Depression. If we had had numbers at that time,
13 I'm betting that you would have seen an actual more
14 significant decline.

15 And I'm, I guess, a little numb to the numbers.
16 We've been collecting the most significant loan-level data
17 on mortgages through a mortgage metrics report that we
18 publish every quarter about this, and the trends for
19 subprime lending, less so for Alt-A, Alt-A lending, but
20 certainly there has been shocking and it's reached into the
21 prime space, as well.

22 I'd have to get back to you for the record about
23 historically what the multiples were, but it's an
24 eye-popping number. And it's even, in some ways, higher for
25 payment option mortgages, which in many cases were not

1 subprime mortgages, they're more in the Alt-A thing, but
2 some of the numbers in some of the states are just shocking
3 how much -- how much of them have gone to foreclosure. But
4 there are multiples of historical averages.

5 COMMISSIONER WALLISON: Thank you. Mr. Hawke?

6 MR. HAWKE: Commissioner, I don't have a
7 statistic. But I do have what may pass for an insight, and
8 that is that what -- what this reflects is faulty
9 underwriting, faulty underwriting, not just faulty
10 underwriting, but a basic corruption of the underwriting
11 process.

12 Underwriting a loan is not a mystical science.
13 The objective is to determine whether the borrower has a
14 sufficient income to pay interest and principal on a loan
15 without recourse to the collateral. And that's a point that
16 we made over and over again in the various advisories that
17 the OCC put out in probably half a dozen occasions in recent
18 years where we have made that point.

19 And the -- the -- the loans that were made on
20 the basis of stated income or -- or data that turned out to
21 be fraudulent or faulty don't -- don't reflect flaws in the
22 underwriting as such -- as much as they do a corruption in
23 the process, because those lenders that were -- that were
24 doing that really didn't care what the borrower's ability to
25 pay current interest and principal on the loan was, because

1 they were looking to the collateral.

2 And that was certainly true with the Alt-A and
3 other kinds of alternative mortgage instruments, as I
4 mentioned in my prepared statement.

5 Banks were not looking at the borrower's
6 ability to handle the fully amortized market rate of
7 interest-type obligations when the reset point came in those
8 transactions and -- because they were relying on the
9 immutable fact that housing prices only go up.

10 And it was that reliance on the value of the
11 collateral rather than the conventional type of loan
12 underwriting that -- that contributed to this high level of
13 foreclosures.

14 COMMISSIONER WALLISON: Thank you.
15 Mr. Chairman, I might have some questions at the end if we
16 still have time.

17 CHAIRMAN ANGELIDES: Thank you. All right,
18 certainly. Mr. Thomas has a quick question on this item.

19 EXAMINATION BY VICE CHAIRMAN THOMAS

20 VICE CHAIRMAN THOMAS: Just very briefly, I
21 understand you're focused on national, but in the discussion
22 with Mr. Wallison, there's community banks. I guess what I
23 want you to do is either confirm or deny my thinking, and
24 that is, with the growth of credit unions in terms of the
25 degrading of what banks could do on a somewhat of an

1 exclusive basis, savings and loans were really packaged on
2 originate-to-hold, as you got into this business as
3 originate-to-distribute on residential loans and then the
4 warehousing structure, about all that was left of some
5 community banks, as a business focus, was some of the
6 commercial lending. And they stretched that farther than
7 they should have, but is -- I mean, that's kind of where
8 they wound up, wasn't it?

9 MR. DUGAN: There is that issue; that is to say,
10 many of the retail loan products became more commodity-like
11 and scale businesses. And it was harder and harder for
12 community banks to compete.

13 A shrinking menu of things, and many,
14 particularly in places in the country which had high housing
15 development, in the sunbelt and the like, it became a very
16 principled source of business.

17 And that's the conundrum, of course.

18 VICE CHAIRMAN THOMAS: Sure.

19 MR. DUGAN: Is that if you start moving in
20 concentrations in that area, it's the basic bread and butter
21 of what they do, and so how you do that is a very difficult
22 problem.

23 VICE CHAIRMAN THOMAS: And at the same time,
24 commercial establishments looking for loans, the others who
25 were moving into the other products didn't have that much of

1 an interest, and so they found themselves, unfortunately, to
2 a certain extent, for a lot of community banks.

3 MR. DUGAN: That's right.

4 VICE CHAIRMAN THOMAS: Thank you.

5 CHAIRMAN ANGELIDES: Thank you. Mr. Georgiou?

6 COMMISSIONER GEORGIU: Thank you, Mr. Chairman.

7 EXAMINATION BY COMMISSIONER GEORGIU

8 COMMISSIONER GEORGIU: Just want to follow up
9 on something that Commissioner Wallison began, Mr. Dugan,
10 and that is that back in 2007, you stated a number of times
11 that subprime loans made by national banks in 2006 were
12 becoming delinquent at about half the rate of the industry
13 average; do you recall that?

14 MR. DUGAN: I -- I -- I -- I don't recall that
15 specific. I remember saying they performed better. But I
16 don't know. I don't recall that.

17 COMMISSIONER GEORGIU: Well, because in your
18 testimony on page 9, you now quote statistics showing that
19 the default rate for national banks for non-prime loans,
20 originated between '05 and '07 was about 86 percent of the
21 market average.

22 Does that mean that they -- the national banks'
23 relative performances -- has deteriorated, has worsened over
24 the last few years, in your view?

25 MR. DUGAN: I'd have to go -- I'd have to go

1 back and look at the original statement and compare the same
2 data set of the subprime, not just subprime and Alt-A. I'd
3 be happy to.

4 COMMISSIONER GEORGIU: Would you mind doing
5 that?

6 MR. DUGAN: I'd be happy to do it.

7 COMMISSIONER GEORGIU: For us, and follow up in
8 writing so we can clarify that? The -- you know, there are
9 statutory protections administered by the Federal Reserve
10 under Section 23 of the Federal Reserve Act which limit the
11 amount of transaction between a commercial bank and its
12 affiliates in order to protect the commercial bank from
13 non-bank risks.

14 And while the Fed administers this Act, bank
15 supervisors have an interest, you know, obviously have an
16 interest in this subject, and I wonder whether the liquidity
17 puts that we've been discussing at Citigroup were
18 considered a possible 23A concern, in your view?

19 MR. DUGAN: I don't know that specifically, but
20 to be a 23A violation, it would have to kind of loan to one
21 borrower kind of concept, the amount of credit to an
22 affiliate that exceeded 10 to 20, 10 percent of your
23 capital, and that would be a big number with Citibank. So
24 I'm not sure that would be in addition --

25 COMMISSIONER GEORGIU: Well, the capital was

1 less than 100 billion dollars, I think, at any relevant
2 time.

3 MR. DUGAN: Right.

4 COMMISSIONER GEORGIU: And as it turns out,
5 they took 25 billion dollars of losses on liquidity puts and
6 a total of 30, slightly over 30 billion dollars on the 43
7 billion dollars' worth of collateralized debt obligations.
8 So it ended up being about a third, more or less, of their
9 capital. So it would meet that test, I would say, as being
10 significant.

11 MR. DUGAN: Let -- let me get back to you on
12 this, because A, I'm not sure whether we've looked at it in
13 those lights, but B, it also may be the case that when you
14 have a contingent liability like that, it's treated
15 differently than something that ended up being that kind of
16 loss to the bank. I just don't know the --

17 COMMISSIONER GEORGIU: Right. And then what
18 about the warehouse lines of credit that were provided by
19 Citi to customers of the investment banks, such as New
20 Century, that we heard from yesterday?

21 MR. DUGAN: Those would be subject to 23A and
22 23B. Well, are you saying to New Century? That would be
23 subject to the lending limits, that's -- because New Century
24 wouldn't have been an affiliate, so it's not 23A and 23B.

25 COMMISSIONER GEORGIU: Right. Right. No, that

1 would be with the lending limits and the concentration,
2 presumably, into this particular area.

3 MR. DUGAN: Right.

4 COMMISSIONER GEORGIU: I guess one of the
5 things that we were told, and if I can find it, by -- one of
6 your examiners told our staff that the CDO business at Citi
7 was managed outside the bank; it changed from an agency
8 business to a principal business. And we don't know that.
9 It's outside of our jurisdiction.

10 Gramm-Leach-Bliley would not let us really look
11 into that, yet the bank had these liquidity puts that were
12 not reported in any risk system that we had. If that was
13 the case, how serious -- I mean, obviously it was a
14 serious problem, how do we remedy that? I mean, is the
15 structure preventing us from -- preventing you, really, and
16 others responsible for getting it all the information you
17 need to assess the stability, the safety and soundness of
18 these institutions?

19 MR. DUGAN: I do think there's an issue here,
20 and there is language that is in the Gramm-Leach-Bliley Act
21 that makes it harder to get information from a functional
22 regulator, which is what the SEC is, with respect to a
23 broker-dealer.

24 And I say that not because the SEC was resistant
25 to providing things, but it creates asylum and talent. And

1 things that are done outside of the back are not as
2 routinely in the purview of examiners to see and touch and
3 feel and ask questions about and stir up.

4 And I think that we do need to have a better way
5 to get at that information on a consolidated integrated
6 basis. That is one of the things that was -- is in the
7 financial reform legislation and I think is a good thing.

8 COMMISSIONER GEORGIU: Okay. And it's in the
9 financial reform legislation, that's what, moving to --

10 MR. DUGAN: To remove that provision in the
11 Gramm-Leach-Bliley Act that put those kinds of restraints on
12 the functional regulator. And for functionally regulated
13 entity is now more easily subject to examination and
14 supervision, particularly by the Federal Reserve, as the
15 consolidated regulator.

16 VICE CHAIRMAN THOMAS: Gentlemen, yield on that
17 point, briefly?

18 COMMISSIONER GEORGIU: I'm sorry? Yes.

19 VICE CHAIRMAN THOMAS: In the House, past
20 version?

21 MR. DUGAN: I believe it's in the House passed
22 version and a version and in the Senate.

23 VICE CHAIRMAN THOMAS: And in the Senate. So
24 it's in both.

25 MR. DUGAN: I think, I think so, but we'll get

1 back to you on that.

2 VICE CHAIRMAN THOMAS: Yeah, thanks, well, I can
3 check it, I just want to -- I think it's in both.

4 COMMISSIONER GEORGIU: How much, if at all, I
5 mean, I guess I'll direct this to both of you gentlemen, if
6 at all did you understand that the collateralized debt
7 obligation exposure of Citibank when you were examining it?

8 MR. DUGAN: Well, my understanding is this: We
9 certainly knew that the broker-dealer was -- had a
10 structuring business, and that structuring business had
11 CDOs.

12 We knew early on that at times they were going
13 to use liquidity puts, but at the time when they first
14 started doing CDOs, the underlying collateral was not
15 subprime collateral.

16 COMMISSIONER GEORGIU: Was not, sorry, what?

17 MR. DUGAN: Was not subprime collateral.

18 COMMISSIONER GEORGIU: What were they using?

19 MR. DUGAN: Regular mortgages, prime mortgages.

20 COMMISSIONER GEORGIU: Right.

21 MR. DUGAN: And that was our understanding.

22 Later, we began to --

23 COMMISSIONER GEORGIU: But they were still
24 using low-level tranches of the -- of the subprime mortgage
25 securities, were they not?

1 MR. DUGAN: That was not my understanding of
2 what we knew initially about the business.

3 COMMISSIONER GEORGIU: Okay.

4 MR. DUGAN: -- Before.

5 COMMISSIONER GEORGIU: All right.

6 MR. DUGAN: And later they began to use
7 derivatives in a synthetic way to create CDO exposure. And
8 that business began to put some of the super senior
9 synthetic exposures in the bank.

10 COMMISSIONER GEORGIU: Right.

11 MR. DUGAN: We did learn about that; we did go
12 do an examination of our London branch office, our London
13 office of the OCC examined their London branch office, and
14 we did get a sense of the exposure there in the early months
15 of 2007.

16 Although, I will say that the exposure that we
17 ultimately got at the end of 2007 was quite a bit larger
18 than what we thought it was at the beginning of 2007.

19 What we didn't know, though, was that there was
20 a specific liquidity put on these CDOs. And we certainly
21 didn't know the magnitude of the exposure. And that
22 magnitude was never really reported.

23 And, you know, there -- there were liquidity
24 facilities, as I said before, that were with other kinds of
25 conduits, which were in the bank, which we would examine and

1 which we would know about. We wouldn't necessarily know
2 about every liquidity facility that was done.

3 But what I will say is during 2007 when problems
4 started to emerge and we began pushing and kicking the tires
5 harder, we weren't getting the answers that this was an
6 exposure, and it didn't show up until the crisis hit. And
7 that was a problem.

8 COMMISSIONER GEORGIU: Right. And, you know, I
9 don't want to belabor this, because I'm sort of tiring of
10 saying it again myself, but -- but -- and -- and I'm sure
11 everyone else is, but at some point this exposure -- well,
12 first of all, there is been a contention, and I think it was
13 from some people in the Fed, and the staff of the Fed have
14 suggested this to us and others, that really there was a
15 real regulatory and capital arbitrage game being played,
16 here with regard to these liquidity puts. Because in --
17 when -- in the commercial paper market basically most people
18 won't buy commercial paper unless it's backed up with a line
19 of credit that's unconditional so that they can roll it over
20 at the time and sell it.

21 And so if you -- if they gave you a 25 billion,
22 if they put a 25-billion-dollar line of credit,
23 unconditional line of credit on the bank books, then you
24 would see it, you would know it, people would have to hold
25 capital on it, and you would be looking at what their

1 exposure presumably was for having to honor that line of
2 credit. Would that be fair to say?

3 MR. DUGAN: Yes. But we'll go -- we'll go ahead
4 with your term.

5 COMMISSIONER GEORGIU: Okay. My point then
6 being, is that by putting on -- putting the liquidity puts,
7 using liquidity puts instead of a customary line of credit
8 to backstop this commercial paper, several things happen.

9 One is it's off-balance-sheet, more -- less
10 transparent to you, less clear to you that there is any
11 particular risk to the bank. And the capital, as I
12 understand, the capital is -- at least no more than
13 one-tenth of the capital is required that would have been
14 required had -- had the line of credit been --

15 MR. DUGAN: So here's how this works.

16 COMMISSIONER GEORGIU: -- flat out?

17 MR. DUGAN: That's right. When you have
18 liquidities facilities, and if -- and if it's a liquidity
19 facility that's less than one year in duration, the capital
20 rules say, and if it's truly a liquidity facility was the
21 argument --

22 COMMISSIONER GEORGIU: Right.

23 MR. DUGAN: -- that it was only there in case of
24 a temporary liquidity problem, not to back up credit losses,
25 then the current capital rules said 10 percent capital

1 charge, 10 percent credit conversion factor.

2 COMMISSIONER GEORGIU: Correct.

3 MR. DUGAN: If you had a full guarantee at a
4 hundred percent, then you have a hundred percent credit
5 conversion factor. It would be as if it were on your
6 balance sheet.

7 COMMISSIONER GEORGIU: Right.

8 MR. DUGAN: And, as I said, the argument was
9 that if you didn't actually have a credit guarantee but you
10 were only guaranteeing on a temporary liquidity basis, it
11 should only be 10 percent.

12 You are quite right that what the crisis showed
13 us was what was what was supposed to be a temporary
14 liquidity facility, once it got exercised, ended up
15 resulting in it being full credit support, and all of the
16 assets came back onto the balance sheet.

17 As a result, the Basal committee, with the full
18 support of the U.S. regulators has said that its credit
19 facilities can't be at 10 percent. They've got to be at 50
20 percent.

21 COMMISSIONER GEORGIU: Uh-huh.

22 MR. DUGAN: So it's not quite the same. And so
23 that process is working its way through the America
24 regulatory process.

25 But, in addition, this accounting change from

1 FAS 166, 167 is making it much harder as a general matter,
2 in the first instance, to take those conduits and get them
3 off-balance-sheet, at all.

4 COMMISSIONER GEORGIU: Right. Which is
5 another positive development.

6 MR. DUGAN: That's right.

7 COMMISSIONER GEORGIU: But I guess, to go back
8 to it, because I know Chairman Angelides has made this
9 point, is that it really only took a 5 percent drop in the
10 housing prices to trigger effectively a full recognition of
11 that 25 -- those 25 billion dollars of liquidity puts.

12 And, really, that was because the underlying
13 collateralized debt obligation was composed of all Triple-B
14 tranches of the underlying residential mortgage-backed
15 securities.

16 So those tranches were at the 7 percent and
17 below level of the originating security; that is, 93 percent
18 of the tranches were higher-rated, so obviously everything
19 within the collateralized debt obligation, even the ones
20 that were regarded as prime-plus or Triple-A-plus. I never
21 really got an A-plus. I don't know, really, quite what that
22 is. So when the underlying 7 percent-and-below-rated
23 security tranche no longer was getting any cash flow because
24 of the relatively modest diminution of housing prices and
25 the resultant defaults, then all of the upper-level

1 collateralized debt obligation failed and had to be brought
2 back onto the books essentially and written off, really, in
3 a very rapid succession there at Citi.

4 So -- and everybody who's testified here has
5 said that neither the regulators nor the risk assessors nor
6 the originators nor anybody else really regarded this --
7 this particular product as having essentially any risk of
8 default, anything more than a 10,000 to 1 chance of default.

9 And is that -- I mean, obviously, in retrospect,
10 we know that was not the case. But wouldn't it have been --
11 did any -- I guess let me ask it in a different way, because
12 I'm not being very articulate.

13 Did you or any of your people ever look into
14 these credit default obligations, I mean these
15 collateralized debt obligations and have any suspicion that
16 maybe they really weren't as solid as they were represented
17 to be?

18 MR. DUGAN: I think that we did think that there
19 was some pricing risk in one of our exams that we noted with
20 the CDOs in 2005. But I don't think there was a fundamental
21 question of the kind you're suggesting that the super senior
22 exposure didn't have quite a remote level of risk.

23 The other thing I'll mention to you, though, is
24 the further thing they would say is, if there were a
25 downgrade, a credit downgrade as a result of the 5 percent

1 drop, the liquidity put could not be exercised; it wasn't
2 there to take into account.

3 What happened was confidence got lost before
4 there was a downgrade, investors started to run, that was a
5 true liquidity event, not a credit event, the liquidity put
6 got exercised, and it was supposed to be on a temporary
7 basis, and once the, you know, the liquidity squeeze went
8 by, they would be able to resell and roll --

9 COMMISSIONER GEORGIU: Right, of course, they
10 never --

11 MR. DUGAN: -- them over. It never happened.

12 COMMISSIONER GEORGIU: Of course it never
13 happened.

14 MR. DUGAN: Of course it never happened, right.
15 So the point is --

16 COMMISSIONER GEORGIU: Right.

17 MR. DUGAN: -- that what was styled and put
18 forward as an extra protection proved to be illusory.

19 COMMISSIONER GEORGIU: Right. So in -- so what
20 are we -- what's to be done about that?

21 MR. DUGAN: Well, I think what I said was,
22 number one, there's much greater -- much more suspicion
23 about credit facil- -- liquidity facilities, in general.

24 We -- the U.S. had -- used to be under the
25 original Basal rules, it got a zero risk rating --

1 COMMISSIONER GEORGIU: Right.

2 MR. DUGAN: -- and we were the ones who put it
3 at 10 percent. Basal's bumped it up to 50 percent, and as I
4 mentioned, the accounting rules have changed to make a bunch
5 of these securitizations not possible.

6 COMMISSIONER GEORGIU: Right. One more
7 question.

8 CHAIRMAN ANGELIDES: Yes, I'll yield two
9 minutes.

10 COMMISSIONER GEORGIU: Thank you.

11 I don't want to go too far into the accounting
12 rules, but can we all agree with regard to mark-to-market
13 that whether you believe in it or don't believe in it, one
14 thing we can all agree on is that you're not permitted to do
15 it on the upside and not on the downside?

16 MR. DUGAN: I guess that's right. Although, I
17 must say I disagree with Jerry on the mark -- the fair value
18 accounting point, but yes.

19 COMMISSIONER GEORGIU: But I mean but we saw
20 historically at several companies, not in the financial
21 business, at Enron, for example, where they --
22 mark-to-market, a number of assets that they characterized
23 as having increased in value quarter by quarter, this was a
24 significant element of their recognition of income, so
25 you're not -- I mean, you certainly ought not to be

1 permitted, as a financial institution, to mark it up but
2 never to have to mark it down.

3 MR. DUGAN: And I don't think that was the case
4 in this instance. Once it was in the trading book, it was
5 being marked and going up and down, and that's why you had
6 the very sudden, precipitous losses --

7 COMMISSIONER GEORGIU: Right.

8 MR. DUGAN: -- in the fourth quarter of 2000 --

9 COMMISSIONER GEORGIU: And to follow up just on
10 the capital issue there, isn't it also the case that if it's
11 in your trading book, there's very little capital required
12 to sustain it?

13 MR. DUGAN: So if -- so if you hold the piece,
14 not if you sell it.

15 COMMISSIONER GEORGIU: But if you hold the
16 piece, right?

17 MR. DUGAN: If you hold the piece and it's on
18 your books, it's treated as a securitization exposure. And
19 the way super senior exposures were treated, actually, was
20 the same, whether it was in the trading book or the banking
21 book.

22 You are right, however, that in many cases, the
23 trading book valuations were way lower than what the banking
24 book was, and that was true for a number of securitizations.
25 It's one of the things we pushed very hard to change,

1 already, at the basal committee, because to prevent that
2 kind of arbitrage, that also is making its way back into the
3 U.S. capital.

4 COMMISSIONER GEORGIU: Right. I mean, we've
5 got somebody from the Fed who told us that if it was kept on
6 the trading book, the capital requirement was something like
7 70 -- the regulator -- the leverage was 750 or 800 to 1.

8 MR. DUGAN: That's true.

9 COMMISSIONER GEORGIU: That's how little --

10 MR. DUGAN: But you also have to remember there
11 was a leverage ratio that applied on top of that, so it's a
12 matter of risk-based capital, that's true, but there was a
13 much higher piece --

14 COMMISSIONER GEORGIU: Right.

15 MR. DUGAN: -- that applied, just as a straight
16 on balance sheet.

17 COMMISSIONER GEORGIU: Okay, thank you,
18 Mr. Hawke wanted to respond to that and then I'm done.

19 CHAIRMAN ANGELIDES: Go ahead and respond.

20 MR. HAWKE: Just very briefly I want to clarify
21 my position, and that is, I'm not an advocate of going to
22 full market value accounting for all purposes.

23 I look at this in the context of the process of
24 prompt corrective action. But what the regulators are
25 supposed to be doing is taking increasingly stringent

1 supervisory action. As a bank's real capital approaches
2 zero. It's a protection against insolvencies.

3 And from a supervisory point of view, I think
4 it's important to know what the real value of capital is on
5 the downside. The -- I've heard arguments about -- about
6 the upside. I've also heard arguments that as a bank's
7 assets deteriorate in value the -- their liabilities
8 increase in value, which is an anomaly, but that -- that's
9 not completely relevant for prompt corrective action
10 purposes.

11 COMMISSIONER GEORGIU: Okay. And -- and I take
12 it you would agree with Dr. Greenspan's suggestion yesterday
13 that it, particularly for institutions as complex as Citi --

14 CHAIRMAN ANGELIDES: I will yield you another
15 minute.

16 COMMISSIONER GEORGIU: I'm sorry. As complex
17 as Citi that we need much more capital and higher capital
18 and liquidity requirements; is that fair to say?

19 MR. DUGAN: I have testified, generally, that
20 systemically important institutions, particularly
21 institutions with trading requirements, need higher capital,
22 generally.

23 COMMISSIONER GEORGIU: Mr. Hawke?

24 MR. HAWKE: I would agree with that.

25 COMMISSIONER GEORGIU: Okay. Thank you. Thank

1 you, Mr. Chairman.

2 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin?

3 COMMISSIONER HOLTZ-EAKIN: Thank you,
4 Mr. Chairman.

5 EXAMINATION BY COMMISSIONER HOLTZ-EAKIN

6 COMMISSIONER HOLTZ-EAKIN: Thank you, gentlemen,
7 for taking the time to come today. I'm going to begin with
8 some well-trod ground, and I apologize for that, but I
9 wanted to ask you in particular, Mr. Dugan, some questions
10 that I asked the Citi grant -- Citibank panel this morning.

11 And so, Mr. Dugan, the OCC's current examiner in
12 charge of Citibank said that when he first came into
13 Citibank in October 2007, he quickly determined that
14 Citibank's entire risk management structure needed to be
15 revamped, and he embarked on a course of action to require
16 Citibank to change its entire risk management structure. Is
17 it reasonable to infer from that judgment that the prior
18 risk management structure of Citibank was deficient in some
19 respect?

20 MR. DUGAN: I think what I would say is that
21 when we had the crisis, it revealed things that were not
22 apparent when we didn't have the crisis.

23 And, in particular, we were quite concerned that
24 the risk management was not sufficiently independent from
25 the line of business, and that in a couple of very

1 significant cases, it had agreed to increase limits and ramp
2 up risks in ways that we did not think was appropriate,
3 particularly with the problems that were apparent on the
4 trading side as opposed to the loan side, that that was a
5 serious, significant thing that needed to be addressed.

6 COMMISSIONER HOLTZ-EAKIN: Had there been
7 previous OCC reports that suggested deficiencies in the risk
8 management structures at Citibank?

9 MR. DUGAN: There were, as I mentioned earlier,
10 earlier reports where we did raise significant objections on
11 risk management, downgraded them with respect to particular
12 businesses, as we did with the credit default swap business,
13 and which they then responded and took steps to address.

14 But it was not a situation where we had
15 criticized the whole structure and believed it should be, as
16 I said, that was more a thought that came out of the
17 deficiencies that were revealed in the crisis.

18 COMMISSIONER HOLTZ-EAKIN: Okay. Just so I
19 understand the details, you did, in fact, issue a downgrade
20 to the risk management rating in the past?

21 MR. DUGAN: With respect to the particular
22 business that we --

23 COMMISSIONER HOLTZ-EAKIN: With this particular
24 business?

25 MR. DUGAN: Yes.

1 COMMISSIONER HOLTZ-EAKIN: And you were
2 satisfied with the Citibank response in this instance?

3 MR. DUGAN: Yes.

4 COMMISSIONER HOLTZ-EAKIN: The 2007 report does
5 say, regarding the role of the boards in particular, that
6 traditionally the board has been provided limited
7 information on the material risks impacting this legal
8 entity. Consequently they have been unable to become fully
9 familiar with the risks assumed within the bank. Isn't
10 that a serious charge against the bank's board of directors?

11 MR. DUGAN: It is, but you have to understand
12 this in context. What we were talking about now is the
13 bank, the board of directors of the bank. And I think Citi,
14 like some other companies, was running the whole
15 organization by line of business and not paying as much
16 attention, as we would like, to the legal entity of the bank
17 and separately having it have the right risk reporting that
18 is particular to that bank. And it gotten too far away from
19 it. The new EIC, when they came in, was particularly
20 focused, has continued to be particularly focused on that,
21 and the company has moved in that direction.

22 COMMISSIONER HOLTZ-EAKIN: In fact, their
23 response was to say the company is proud of its board
24 processes both at the parent and the bank level.

25 What's your personal opinion of the

1 effectiveness of the board both prior to and after your
2 review?

3 MR. DUGAN: I think we believe that the board,
4 at the bank level, and we had believed this for quite some
5 time, needed to be more independent and operate as a more of
6 an independent rather than them being staffed with too many
7 insiders on the bank board.

8 And so we did believe that that was some step
9 that absolutely needed to be taken, particularly, as I said
10 before, when we became aware of this breakdown that occurred
11 in the internal reporting in connection with the liquidity
12 put and the huge liability that came back onto the bank's
13 balance sheet as a result of what happened.

14 COMMISSIONER HOLTZ-EAKIN: Thank you. I know
15 you've answered a lot of that before, but they were asked
16 the same questions.

17 MR. DUGAN: Yes.

18 COMMISSIONER HOLTZ-EAKIN: This morning's
19 discussion about Citi was intended to talk about the
20 industry as a whole, and so I guess what I would ask you is
21 was Citibank unusual in any of these regards or was this
22 typical of the risk management challenges and internal
23 reporting and monitoring facilities that are in the industry
24 and for national banks as a whole?

25 MR. DUGAN: Citi was unusual in our large bank

1 experience because the bank was a smaller proportion of the
2 overall company than is typical, even for our very largest
3 banks.

4 So it was less than half of the assets of the
5 overall company, until recently, when they began downsizing.
6 So they had a huge non-bank piece of it, and that affected
7 the culture and the way things were done in ways that were
8 different, historically, than some of the other institutions
9 that we supervised.

10 COMMISSIONER HOLTZ-EAKIN: So is it a fair
11 characterization to say that on net, they were below the
12 industry standard for management of these risks?

13 MR. DUGAN: It was different. As I said before,
14 I think we felt they had a firm grasp of risks that they
15 were -- understood a bunch of things, but that their
16 appetite got bigger, and that appetite to take more risks
17 spilled on risks that they thought they understood well,
18 turned into some very big bets on things that created quite
19 large liabilities, not just for the company as a whole, but
20 for the bank, and that was different.

21 COMMISSIONER HOLTZ-EAKIN: Thank you. I wanted
22 to turn to another oversight issue, which is, we understand
23 that the OCC came in at the request of OFHEO, now FHFA, in
24 the summer of 2008 to review Fannie Mae.

25 What can you tell us about the risk management

1 system and capital levels of Fannie Mae compared to national
2 banks of similar size?

3 MR. DUGAN: So we were asked by the Fed to go
4 into both Freddie and Fannie. And to -- we didn't do an
5 examination, this is important, and we did not review what
6 they would be like under their legal structure and their
7 legal capital requirements.

8 We were asked to say if this were a bank what
9 would its capital requirements be; how would they look? And
10 we had our expert retail examiners work on that review.

11 And where we came out, and just by some very
12 simple arithmetic bolstered by the results of what we did, I
13 think it's fair to say that they would have been treated as
14 significantly undercapitalized at that point. Based on
15 Fannie Mae and Freddie Mac, all their mortgage-backed
16 securities get a hundred percent credit guarantee, and in a
17 bank world, all of that stays on the balance sheet.

18 If you have us back to your point that was
19 raised earlier by Commissioner Georgiou, if you have a
20 hundred percent credit guarantee, it's on your balance
21 sheet.

22 And by statute, the rules for Fannie and Freddie
23 and their risk-based capital rule had a credit conversion
24 factor that was far reduced on that, presumably under the
25 theory that mortgages just weren't as risky, but that's just

1 not the way we would do it. And had that come on the
2 balance sheet in the denominator, in the numerator they were
3 allowed to count more of deferred tax assets as an asseting
4 capital than a lot more than we would allow.

5 Now you put the two of those together, plus the
6 fact that the way they did their reserving practices, their
7 credit reserving mortgages was considerably less rigorous
8 than what we would do on the bank's side; it was a
9 significant effect on their capital position.

10 COMMISSIONER HOLTZ-EAKIN: Did these findings
11 surprise you in any way?

12 CHAIRMAN ANGELIDES: I'm sorry, could you repeat
13 what you said? I somehow didn't hear it, could you repeat
14 that question?

15 COMMISSIONER HOLTZ-EAKIN: Did these findings
16 surprise you in any way?

17 MR. DUGAN: I don't know that we were surprised
18 in the sense that, you know, it was a company that was
19 totally and a hundred percent in the mortgages business, and
20 mortgages were having trouble, and we knew statutorily they
21 had a regime that had a lower regular capital ratio than we
22 did. I think that the question that the Federal Reserve and
23 others were asking us is just what is your view so that they
24 can take that into account in the subsequent policy actions
25 that they took.

1 COMMISSIONER HOLTZ-EAKIN: One of the unique
2 features --

3 VICE CHAIRMAN THOMAS: Are going to continue
4 that line of questioning or are you going to shift to
5 something else?

6 COMMISSIONER HOLTZ-EAKIN: It's related.

7 VICE CHAIRMAN THOMAS: Okay, because then I want
8 to get in on this at the end.

9 COMMISSIONER HOLTZ-EAKIN: I would never leave
10 you out.

11 VICE CHAIRMAN THOMAS: And I -- and I got time
12 to give.

13 COMMISSIONER HOLTZ-EAKIN: Okay. One of the
14 unique features of Fannie Mae and Freddie Mac is in the fact
15 that your banks and others can hold unlimited amounts of
16 their securities and their portfolios under the presumption
17 that they are as riskless as treasuries.

18 Knowing that they were, in fact, not, because
19 nothing about this examination surprise you, did this give
20 you any concern about the safety and soundness of those
21 which you supervised?

22 MR. DUGAN: Well, it is, you know --
23 statutorily, they have always received a favored position in
24 what they can be invested in because of the
25 quasi-governmental status of the institutions.

1 And it did have effects on institutions that
2 caused the failure of a number of banks, including several
3 that we supervised, smaller ones, so, yes, it was a concern.

4 COMMISSIONER HOLTZ-EAKIN: And did you express
5 this concern to other regulators or in any way attempt to
6 change this treatment?

7 MR. DUGAN: We have not taken; the write-downs
8 were occurred, and it was more in the -- preferred stock was
9 where the big hit was taken when that got wiped out. That
10 was the part that got done, but we have not changed the
11 capital rules on that.

12 COMMISSIONER HOLTZ-EAKIN: I yield to the Vice
13 Chairman.

14 VICE CHAIRMAN THOMAS: Thank you, and it will be
15 on my time, and you can have some more if you want.

16 COMMISSIONER HOLTZ-EAKIN: Okay.

17 EXAMINATION BY VICE CHAIRMAN THOMAS

18 VICE CHAIRMAN THOMAS: I want to put this in
19 context, because I was going to talk about this later, but
20 it's kind of a preview of coming attractions for tomorrow as
21 you indicated. But you were asked to look at Fannie Mae and
22 Freddie Mac after the conservator?

23 MR. DUGAN: Before.

24 VICE CHAIRMAN THOMAS: Before?

25 MR. DUGAN: Oh, well, let's say, yes, before the

1 conservatorship.

2 VICE CHAIRMAN THOMAS: And -- and you were
3 requested to come in by?

4 MR. DUGAN: The Federal Reserve, who was
5 conducting the exam, and they wanted help from our expert
6 retail credit examiners because we have a tremendous amount
7 of retail credit experience in the national --

8 VICE CHAIRMAN THOMAS: And did it reflect, at
9 all, in your opinion on the regulatory structure that they
10 were ordinarily operating under? Any -- I don't want to use
11 the term deficiencies, but perhaps undermanned or anything
12 else about OFHEO or FHFA?

13 MR. DUGAN: I guess that wasn't the way we were
14 looking at it. We were trying to help; there was obviously
15 a very --

16 VICE CHAIRMAN THOMAS: But the only reason
17 you're asked to help is because the folks who are supposed
18 to row the boat can't.

19 MR. DUGAN: And I think they -- the reason why
20 I'm hesitating is they had a different regulatory structure
21 and a different mandate and a different set of rules that
22 they were operating under.

23 And we weren't asked to look at those rules and
24 say, are you deficient? We were asked to say, now, if this
25 were a bank, how would you treat it? And so we were happy

1 to provide that because that's an expertise we had.

2 VICE CHAIRMAN THOMAS: And why do you think you
3 were asked to look at it that way, which, after all, was
4 different than the way it was supposed to operate under
5 while on regulatory structures?

6 MR. DUGAN: I think there was concern by -- at
7 the time by the Federal Reserve and by the Treasury
8 Department about the ongoing solvency of the companies. And
9 they wanted to get some other judgments about that from
10 different regulators who had expertise with these kinds of
11 instruments.

12 VICE CHAIRMAN THOMAS: You know the old jag
13 about going across the suspension bridge, and you don't want
14 the troops to march in step, you want to break that pattern,
15 is it your observation, would you be willing to say, that
16 it -- it wasn't just the size, but obviously it was the
17 lockstep, the single theme of Freddie Mac and Fannie Mae in
18 terms of what they were involved in was a concern? Or was
19 is it just the sheer size and what was deteriorating around
20 them?

21 MR. DUGAN: I don't know that I can comment. I
22 mean I think, as I said before, a company that's a hundred
23 percent in the United States mortgage business when it has a
24 crisis in home values that drops the value of those
25 mortgages is going to raise concerns at any time. The same

1 thing happened, you could say, with the thrift industry, not
2 once, but now twice. And the largest of those institutions
3 had very substantial strains on them as well and ultimately
4 had to be taken over or acquired.

5 VICE CHAIRMAN THOMAS: And when you're dealing
6 with people, helping them get a mortgage to own a home on
7 the way up, it's all good, and more is better until?

8 MR. DUGAN: Yeah, as I said before, I mean, I
9 think we had a whole cluster of things that cause us to
10 loosen our underwriting standards when times are good in the
11 name of home ownership.

12 Of course, Fannie and Freddie did have some
13 statutory down payment requirements, but in what happened
14 and how those were done over time, they proved not to be
15 adequate protection for what later happened.

16 VICE CHAIRMAN THOMAS: Just very briefly, you
17 were asked to intervene?

18 MR. DUGAN: Yes.

19 VICE CHAIRMAN THOMAS: Did you -- did you
20 consider it a positive experience, and was there some
21 cross-fertilization of knowledge and understanding, although
22 people are talking about Fannie --

23 MR. DUGAN: Yes.

24 VICE CHAIRMAN THOMAS: -- and Freddie Mac not
25 being there anymore?

1 MR. DUGAN: Yes.

2 VICE CHAIRMAN THOMAS: For you, in your
3 particular area of expertise and responsibility?

4 MR. DUGAN: Yes. I mean I think it was -- we
5 were -- I think we were appreciated the recognition of our
6 expertise in this area. And we learned things by looking at
7 this quite unusual institution.

8 And I think there was coordination not just
9 between us, and cooperation between us and the Federal
10 Reserve, but also with the then-Office of Federal Housing
11 Enterprise Oversight, which is now the GSC regulator of
12 FHFA.

13 VICE CHAIRMAN THOMAS: One last question. We're
14 worried about what the structure needs to look like, where
15 and how we can deal with this, and people are talking about
16 a super agency or reinforcement in the smaller.

17 Do you have any sense that if you've got some
18 folks who have a type of speciality, given the complexity
19 and the blending of what's going on, that it might be useful
20 to have some folk who aren't so locked into a narrow area
21 but that you can be called on, when necessary, so that your
22 expertise is unique, but you don't have to replicate it in
23 whatever regulatory structure is available?

24 And that might be a part -- partial model that
25 might be useful, the cavalry coming to the rescue, when and

1 if it's necessary.

2 MR. DUGAN: I think it is a good idea to tap
3 into areas where particular agencies may have some
4 comparative expertise or things to contribute in other
5 areas, and so not just this area, but when we did the senior
6 supervisors group in the wake of the -- in the heart of the
7 crisis and looking at lessons, it's the same kind of ideas.
8 There are things where agencies can go outside their normal
9 zone to help out in other areas. I'm all in favor of that,
10 you raise a good point.

11 VICE CHAIRMAN THOMAS: And the downside, of
12 course, is it's almost always after the fact.

13 MR. DUGAN: Unfortunately, yes.

14 CHAIRMAN ANGELIDES: Before we move on,
15 Mr. Thompson, I believe Mr. Holtz-Eakin.

16 MR. HOLTZ-EAKIN: Briefly.

17 CHAIRMAN ANGELIDES: I'm going to grant you two
18 minutes.

19 EXAMINATION BY COMMISSIONER HOLTZ-EAKIN

20 COMMISSIONER HOLTZ-EAKIN: Briefly, Mr. Hawke, I
21 wanted to ask you essentially the same questions. You had
22 the, I guess, the good luck to serve prior to the housing
23 bubble and -- and financial crisis.

24 Are you surprised by what you hear about the
25 state of risk management, risk exposures, that we learned

1 about at Fannie Mae and Freddie Mac?

2 MR. HAWKE: Well, I have to say, yes. The -- I
3 never had an occasion to look at the risk management systems
4 at Fannie Mae and Freddie Mac before.

5 COMMISSIONER HOLTZ-EAKIN: So do you think you
6 would have benefitted from the ability to examine the
7 underlying economic riskiness of these entities before
8 allowing your banks to hold large amounts of their preferred
9 stock and securities?

10 MR. HAWKE: Oh, I think undoubtedly had -- had
11 we had more information about Fannie and Freddie, it would
12 have helped in our assessment of investments that our banks
13 had and their obligations.

14 COMMISSIONER HOLTZ-EAKIN: Thank you.

15 CHAIRMAN ANGELIDES: Mr. Thompson?

16 COMMISSIONER THOMPSON: Thank you, Mr. Chairman.

17 EXAMINATION BY COMMISSIONER THOMPSON

18 COMMISSIONER THOMPSON: If I might, I would like
19 to shift the focus of the discussion, just a bit.

20 If we were to go back to the very first round of
21 hearings that we had, Commissioners Bair and Schapiro
22 commented about the effectiveness of their agencies and
23 their execution of their role, and when asked while
24 regulations or more regulations would be helpful, would
25 existing regulations, if well-executed, would they have

1 blocked or stopped this activity or effect? The answer was,
2 it was, in fact, a supervisory failure. So my question --

3 MR. DUGAN: Pardon? Sorry?

4 COMMISSIONER THOMPSON: It was a supervisory
5 failure.

6 MR. DUGAN: Okay.

7 COMMISSIONER THOMPSON: So my question of you
8 is, were there things that OCC could have done in this
9 process that might have forestalled or at least identified
10 some of the risk? And do you feel that, perhaps, there were
11 some shortcomings in OCC's execution?

12 MR. DUGAN: So I would say, there were some
13 things we did and saw in a timely way and other things less
14 so.

15 So when I first came to the agency, our
16 examiners were getting very uncomfortable with what was then
17 called exotic mortgages, payment option mortgages and the
18 like, and not only the offering of them, but the layering of
19 the risks over that with stated income and some other
20 things.

21 And so we became very active in that area,
22 early. We got out with speeches and then, ultimately, with
23 guidance. We applied that guidance quite strongly in a
24 horizontal way to our banks, and we basically did not have a
25 payment option mortgage, exotic mortgage problem in our

1 system.

2 I regret that we didn't act sooner on stated
3 income mortgages, more generally. And a year later I gave a
4 stronger speech in the context of subprime mortgages. But
5 that, the stated income there, the low-doc mortgage area was
6 a place where we just lost our way, not just the OCC, but
7 all the regulators did.

8 And it's something that not only was wrong, in
9 and of itself, but it was an invitation to fraud in the
10 actual doing of the business, because it invited people to
11 lie about their income, which many people did, and it was an
12 unhealthy thing that we should have acted sooner and
13 stronger.

14 And it goes back to the point I made earlier
15 about we needed to be more muscular about imposing
16 underwriting standards.

17 I think the other piece of that, though, is what
18 I said before. There was a constraint on doing that, and
19 there was a constraint even when we did it with the
20 nontraditional mortgages that you had to get the consensus
21 of all the other regulators, that took time, and you couldn't
22 get this huge chunk of the mortgage system that was operating
23 outside of federal purview. And industry participants would
24 say, we wouldn't mind doing this if you apply this across
25 the board, but if you don't and you apply it individually,

1 you'll take us out of this business.

2 And that is an inappropriate -- now we went
3 ahead with that, but it's a powerful argument at times for
4 businesses. And so that's why I feel so strongly that
5 having -- going back to common sense underwriting standards
6 but doing it in a way where you can apply it across the
7 board is so important.

8 COMMISSIONER THOMPSON: Well, you comment on
9 your agency's ability to keep pace with the innovation.

10 MR. DUGAN: I think that's always something that
11 we struggle with, to try to maintain the expertise, we work
12 very hard at this. We do it by how we train our existing
13 people, but continually trying to renew it with external
14 training and hiring industry hires who have expertise in
15 particular areas.

16 I think in many parts of what we did during the
17 crisis, actually, in some of the most complex areas, that
18 supervision proved very effective. And, you know, I wish
19 that we were in a better spot with the super senior things,
20 of ABS CDOs, but honestly, not only did we not see it, but
21 nobody in the industry saw it. The only difference between
22 those who had a lot of losses and those who didn't are the
23 ones who piled into that in huge ways.

24 COMMISSIONER THOMPSON: How stable are the exam
25 teams themselves that are a part of the review process, the

1 attrition rates, skill levels, experience? Can you comment
2 on that?

3 MR. DUGAN: Yes, I can. We spend an awful lot
4 of time on this as well. We have excellent stability rates,
5 although we always worry about the demographic of an aging
6 examiner force, as so many companies have. We embarked on a
7 very significant hiring process, which actually began in
8 former Comptroller Hawke's tenure that I continued in ours
9 to really make sure we were getting a pipeline of people.

10 We were worried that a whole generation of
11 seasoned examiners that had been through the '80s would
12 retire and we wouldn't be able to replace that expertise.
13 But we found a way to do that by having this crisis. So now
14 we're training all our young examiners. And so we're now
15 able to get this --

16 COMMISSIONER THOMPSON: Whoops.

17 MR. DUGAN: -- knowledge transferred, not
18 exactly the way we would have done.

19 So the OCC has the very high esprit de coeur.
20 It is partly because of very focused mission, all we do is
21 supervision. And if you look actually at surveys of best
22 places to work in the federal government and even in the
23 United States, we rank high and we prize that. We work hard
24 at it.

25 COMMISSIONER THOMPSON: Some say that the

1 back-and-forth between the public and the private sector for
2 some of the people who are in oversight or supervisory roles
3 creates an inherent conflict. Do you agree or disagree with
4 that?

5 MR. DUGAN: I disagree.

6 COMMISSIONER THOMPSON: Given that you're
7 from --

8 MR. DUGAN: Well, I am, but I am one person. I
9 was a lawyer. I was in private practice. And I think it's
10 good to bring some expertise coming in. We do hire people
11 from the private sector as well, from time to time.

12 Although I will say, the core of our examiners
13 is made up of people who come out of college and worked
14 their way up through the ranks, get commissioned as a
15 national bank examiners and then find their way. I honestly
16 don't think that is an issue, at least in our supervision.

17 MR. HAWKE: Can I -- yeah, I'd like to -- since
18 I've been in and out of the government several times in my
19 almost 50 years in Washington, I have a very strong view on
20 that. I think -- I think -- I think it is enriching both to
21 the private sector and the public sector to have mobility in
22 and out of -- out of government.

23 The -- the notion that people come out of
24 government and immediately start trading on their experience
25 and go back and exercise significant influence over their

1 colleagues is just wrong, in my experience. If anything, if
2 you go back to your old agency after the period of
3 quarantine is over, you're likely to be under a heavier
4 burden than somebody who hasn't been there in the past.

5 But in any -- in any event, I think that people
6 who have been in the agencies, understand the agency's
7 concerns and problems, and can transmit that to the private
8 sector, and people who come into the government from the
9 private sector can bring perspectives and experience that
10 are very valuable.

11 So I think arguments about the revolving door are
12 frequently, generally misplaced.

13 COMMISSIONER THOMPSON: Okay, good. It's
14 encouraging to hear that OCC would be considered one of the
15 best places to work in government. Does that mean that you
16 don't have challenges attracting talent?

17 MR. DUGAN: No. I mean, I will say that I have
18 been very impressed with the talent that we've been able to
19 recruit from colleges across the country. And I always
20 worry when we get into the areas that you were talking about
21 earlier, the more complex areas, can we find people, but I
22 think we have been able to attract the talent.

23 And honestly, when you get into a recession and
24 people don't have jobs, you've got another pool of talent of
25 people that are willing to come on and take the job.

1 And there are benefits. And I don't mean that
2 just in the monetary sense, benefits of being -- of working
3 for the government that aren't the same as being in the
4 private sector that people value.

5 COMMISSIONER THOMPSON: All right. Thank you
6 very much. I yield the balance of my time.

7 CHAIRMAN ANGELIDES: Thank you, Mr. Thompson.
8 We need a break? Ms. Born? Mr. Thomas is asking for a
9 five-minute break.

10 VICE CHAIRMAN THOMAS: Yes.

11 CHAIRMAN ANGELIDES: Oh, just five -- for the
12 gentlemen.

13 VICE CHAIRMAN THOMAS: You don't have to direct.

14 CHAIRMAN ANGELIDES: Okay, for Mr. Thomas,
15 Mr. Thomas needs a break. Five minutes we'll come back with
16 Ms. Born. I'll have some questions. And if any of other
17 commissioners have follow-up questions, we can -- let's make
18 it five minutes, no more than. So run, gentlemen.

19 (Recess.)

20 CHAIRMAN ANGELIDES: We will -- the meeting will
21 come back to order. Ms. Born.

22 COMMISSIONER BORN: Thank you very much.

23 EXAMINATION BY COMMISSIONER BORN

24 COMMISSIONER BORN: And thank you both for
25 appearing before us and helping us with these difficult

1 issues.

2 Mr. Dugan, in your testimony, you point out the
3 different levels of regulations for banks and some shadow
4 banking institutions, and I wanted to ask you about that.

5 In your view, has the growth of
6 lighter-regulated shadow banks in the shadow banking system
7 created competitive pressures on traditional banking
8 institutions?

9 MR. DUGAN: Absolutely. I mean, I think in the
10 mortgage crisis, it was a particular example of this. When
11 you had the dramatic increase in mortgages that could be
12 securitized and never touch a regulated institution, you had
13 a big growth in that part of the market.

14 And the standards that were going on in that
15 kind of market began to influence the standards that our
16 regulated lenders were doing. And that was also true, I
17 might add, even in things like the leveraged lending market,
18 where we were seeing a disconnect between the standards that
19 banks would -- we would hold to if they were holding the
20 loans on their books and the ones that they were selling for
21 distribution to third parties.

22 And that is precisely why, when I came back to
23 the notion about underwriting standards, it's critical that
24 you can't just apply them to the regulated side. You got to
25 do it across the board.

1 COMMISSIONER BORN: Are there -- it also raises
2 a question, I think, of whether or not this has put a
3 pressure on the banking regulators to permit the banking
4 institutions they supervise to engage in a greater range of
5 activities.

6 And we've been told through testimony that, in
7 fact, the semi-repeal of Glass-Steagall by the Gramm-Leach-Bliley
8 Act didn't really change that much because there have been a
9 lot of -- of big range of activities that banking
10 institutions were permitted to engage in. And I wondered if
11 this competition from the unregulated or under-regulated
12 shadow banking system had had some -- played some role in
13 that kind of erosion of the separation between investment
14 banks and banks.

15 MR. DUGAN: I don't think so much. I mean, I
16 think, over the years, well, let me put it this way. I
17 think that over the years, as markets changed and the kinds
18 of ways that institutions provided credit intermediation
19 services changed and moved more towards standardization, in
20 many ways, began to mean that financial intermediation could
21 be done by investment banks that have -- with clients that
22 previously could only be done by commercial banks.

23 So the pigeonholed roles began to change as a
24 market mechanism, as you suggest. And then in order for
25 banks, banking organizations, to compete in credit delivery

1 services, they did need to have that greater ability to be
2 in the securities business.

3 And I think that was a market pressure, it was a
4 real market pressure, and that over time caused legal
5 interpretations and changes to standards and piecemeal
6 adoption by Congress, and finally, it was really more of a
7 ratification, as Mr. Hawke said: The full separate --
8 full -- full ability to affiliate between commercial banks
9 and investment banks was adopted. So I think it was in
10 response to changes in the marketplace.

11 COMMISSIONER BORN: Well we, as a Commission,
12 will be looking more deeply into the role of the shadow
13 banking system and the impact it's had on banking regulation
14 and also the role it's played, if any, in the financial
15 crisis. And I hope that we'll be able to, you know, have
16 more interaction with OCC on that --

17 MR. DUGAN: Sure.

18 COMMISSIONER BORN: -- as we go forward.

19 It's occurred to me that, for example, the
20 growth of money market funds must have impacted
21 significantly on commercial banks' deposits.

22 MR. DUGAN: Absolutely. Yes. That -- no, that,
23 you're absolutely right. There are a number of places that
24 things have come up that have put pressure on the regulated
25 sector that there has been response over the years.

1 I think one of the interesting things, I
2 wouldn't call them shadow banks, but investment banks were
3 certainly regulated quite differently at a consolidated
4 level than commercial banking organizations were, and I
5 think that did prove to be a problem in the crisis that
6 led -- they were much more highly levered, the problems
7 really started outside in that part of the sphere, and they
8 had more problems dealing with confidence issues.

9 And the result of the crisis is, of course, the
10 investment -- independent investment banking industry ended,
11 and they either were failed, taken over, or became bank
12 holding companies. And so they're now more inside that same
13 tenet and subject to a more level part of regulation.

14 But the differences were more of an issue
15 leading up to the crisis than they are now.

16 COMMISSIONER BORN: Except I think you have
17 indicated that there's still some siloing?

18 MR. DUGAN: Yes.

19 COMMISSIONER BORN: With the broker-dealers and,
20 I assume, the FCMs, as well, being primarily supervised and
21 regulated by the SEC and the --

22 MR. DUGAN: Yeah. And I think that still is an
23 issue, but more I just meant at the holding company as
24 opposed to the functional level.

25 COMMISSIONER BORN: Do you think there should be

1 a move toward more consolidated standards for regulating the
2 entire structure of the financial institution?

3 MR. DUGAN: I think you need consolidated
4 supervision of any systemically significant financial
5 institution. I think that's at the heart of the lessons we
6 learned from the crisis, certainly at the heart of the
7 administration's proposal, which I support.

8 COMMISSIONER BORN: Let me ask in another area,
9 we have heard a lot about the issue of regulatory arbitrage
10 between banking supervisors, the OCC, the OTS, the Fed, the
11 state banking regulators, since, as I understand it, banks
12 have the ability to change their charters, and also OCC,
13 among others, depends on the banking, the fees paid by your
14 banks in order to fund your operations. And I wondered
15 whether there's any validity to this concern.

16 And I wanted to ask you whether, in your
17 experience, such regulatory arbitrage actually occurs? For
18 example, have you felt pressure to change standards or to
19 permit activities, because another banking supervisor is
20 doing that?

21 MR. DUGAN: The answer's no. I have not felt
22 such pressure. I do think that on occasion, there have been
23 circumstances where institutions have flipped charters,
24 changed charters in ways that I don't think are appropriate.

25 I think it's one of the reasons, and this was

1 something I strongly supported, that the banking regulators
2 got together and adopted a document that said you couldn't
3 avoid a supervisory action by switching regulators.

4 We had something like that. Frankly, there were
5 a number of them where they left the national banking system
6 to go to the state banking system far more than coming the
7 other way.

8 But in terms of that being a systemic problem,
9 it certainly was not and it has not been. And I have not
10 felt any pressure at all to change as a result of that kind
11 of pressure.

12 COMMISSIONER BORN: Do you think there's a need
13 to address that issue further?

14 MR. DUGAN: Well, I think --

15 COMMISSIONER BORN: Beyond, you know, your
16 suggestion of cooperation?

17 MR. DUGAN: Well, I testified on regulatory
18 consolidation before, you know, it's -- it's fond of
19 quoting, actually, Jerry Hoffman, the subject where it says
20 it's something that no one would design in theory, but it
21 works okay in practice.

22 I don't think it was the root cause of a bunch
23 of problems, but on the other hand, could we use some
24 regulatory consolidation; would it be a better system?
25 I think the answer is yes.

1 But I don't think it's critical that you go to
2 one regulator to address that issue, either as a matter of
3 supervisor efficiency or to avoid the kinds of inappropriate
4 charter arbitrage that you're talking about. There is some
5 talk about doing that -- not some talk, there are proposals
6 to do some regulatory consolidations that are in both; the
7 House-passed bill and the Senate Banking Committee
8 passed version, and I think making progress in that area
9 is appropriate.

10 MR. HAWKE: Can I just add one point on the
11 question of regulatory arbitrage? And the -- the -- as the
12 Comptroller says, banks convert back and forth all the time.
13 The -- I always gave the mandate to our examiners that they
14 should -- they should be as vigorous as they needed to be to
15 make sure that their banks were operating in a safe and
16 sound manner without regard to the possibility that the bank
17 might decide to convert to another charter.

18 The OCC has adequate resources to fund its
19 operations without having to worry about -- about individual
20 banks. And I should say that one of the aspects of this
21 dynamic is that the state-chartered banks have a very
22 significant subsidy from the FDIC and the Federal Reserve
23 with respect to their examination costs, because all of the
24 costs of their federal regulation are absorbed by those
25 agencies. So they pay, on average, about half of what

1 national banks pay.

2 So national banks have, and particularly smaller
3 banks have an incentive to move to state charter to take the
4 benefit of that subsidy.

5 COMMISSIONER BORN: Thank you very much.

6 CHAIRMAN ANGELIDES: Mr. Thomas?

7 EXAMINATION BY VICE CHAIRMAN THOMAS

8 VICE CHAIRMAN THOMAS: We talked about -- we
9 talked about your brief involvement with Fannie Mae and
10 Freddie Mac, and I don't think we scored the circle, but we
11 just got into it with that discussion when Commissioner
12 Wallison was talking to you about any potential pressure or
13 slanting coming from either Democrat or Republican
14 administration since both of you saddled, and your answer
15 clearly was no.

16 I would ask you if there was any of that coming
17 from Congress, except I want to put this on the record, as
18 far as Fannie Mae and Freddie Mac, Congress would have no
19 worry because their oversight structure is funded through
20 the appropriations process. And if they don't feel a degree
21 of responsiveness, they have a direct course of action.

22 You clearly do not, as you indicate, Mr. Hawke,
23 because you get it from the funds of those that you oversee.
24 As a structure, as a degree of independence in terms of
25 decision making or esprit de coeur and the rest, I mean it's

1 got to be, to a certain extent, isn't it, from the way in
2 which you're funded versus OFHEO and Fannie Mae and Freddie
3 Mac living or dying based upon Congress's willingness to
4 offer appropriated funds. Did you feel that when you had
5 that temporary oversight work with Fannie and Freddie, or do
6 you have any comment on that? Because we're going to talk
7 to them tomorrow and I would like a little preview if you
8 have any.

9 MR. DUGAN: Really, I don't have any. I didn't
10 have any experience with that aspect of it.

11 VICE CHAIRMAN THOMAS: Well, just let me ask
12 you, if you had your druthers, would you rather have it come
13 out of appropriated funds?

14 MR. DUGAN: This is what my son refers to as an
15 IQ test, and I'm hoping I'm going to pass. Yes, we --

16 VICE CHAIRMAN THOMAS: Actually, it's called a
17 pain test rather than IQ.

18 MR. DUGAN: Well, there's a long history of
19 this, actually, and the regulators were once partly
20 appropriated, some were and some weren't, and the Federal
21 Reserve never was. And it was historically a very important
22 piece of our ability to have and hire -- have the necessary
23 resources and hire the people we need and to have the budget
24 flexibility to maintain our independence with respect to
25 this very highly regulated industry.

1 And even in those days, it was a -- it has
2 always been the case, it's true of state bank regulators,
3 has been forever funded with the fees, sometimes still went
4 through the appropriations process.

5 But I believe it is a very important part of our
6 independence to not only be funded through those fees, but
7 not go through the congressional appropriations committee.

8 VICE CHAIRMAN THOMAS: And then you're only down
9 to the criticism or accusation that Mr. Hawke addressed on
10 the revolving door, that you're the lackeys of the ones who
11 pay your fees, and I would probably rather fight that
12 argument than deal with the appropriations process.

13 MR. DUGAN: I think that's right. And if you
14 look at the record --

15 VICE CHAIRMAN THOMAS: Exactly.

16 MR. DUGAN: -- it's just not that many people
17 who actually -- I mean, there are some, and we have ethics
18 rules we are careful about, and that's all you need to do
19 it.

20 VICE CHAIRMAN THOMAS: Arm's-length is all you
21 need to do. Thank you, Mr. Chairman.

22 CHAIRMAN ANGELIDES: Great. So I have a few
23 questions about your oversight of Citi, and then I have a
24 couple of policy questions.

25 The first is, I think, wonders --

1 VICE CHAIRMAN THOMAS: Before you start that --

2 CHAIRMAN ANGELIDES: Oh, I didn't see -- yeah, I
3 didn't see, Mr. Wallison. I'm sorry. I don't always look
4 to my right, Mr. Wallison. It's not a natural for me.

5 COMMISSIONER WALLISON: I'm always on your
6 right.

7 CHAIRMAN ANGELIDES: Go ahead, Mr. Wallison.

8 EXAMINATION BY COMMISSIONER WALLISON

9 COMMISSIONER WALLISON: I just really had one.
10 One question for Comptroller. You note that the federal
11 standards are very important in preventing predatory
12 lending. And one of the things that we are trying to track
13 down is the degree to which predatory lending was
14 responsible for the poor quality of the mortgages that were
15 in the market.

16 I know we've made a number of requests to
17 various people who have appeared before us and people who
18 haven't in looking for data on this information on this, on
19 this subject.

20 And so if -- if your office has any, or know
21 where we can find it, we would appreciate seeing any of
22 that. But I'd like to ask you directly, Comptroller Dugan,
23 how much predatory lending do you see in the course of your
24 work and the work of your examiners and others? How many
25 cases have you had where you've had to bring an enforcement

1 action or counseled an institution about predatory lending?
2 So we can get some sense of how much of this is really going
3 on.

4 MR. DUGAN: There is a definitional question, of
5 course. There's no single definition of predatory lending.
6 But we took, as an agency -- actually, Mr. Hawke can speak
7 to this even better than I, because it was in a bunch of the
8 early guidance and actions that we took were during his
9 tenure as comptroller.

10 But we made very clear that predatory lending,
11 whether it was in the mortgage space or the credit card
12 space, was not something we would tolerate; things like
13 loans flipping, equity stripping types of mortgages, the
14 really abusive practices were things we cracked down on. We
15 had to -- we took some enforcement actions in the area,
16 where it was necessary, but honestly, those practices never
17 really took root in the national banking system.

18 We had more questionable practices in the
19 subprime credit card space. And we did have to take a
20 series of enforcement actions with respect to mono-line
21 subprime credit card lenders to the point where we basically
22 ran them out of the national banking system.

23 And I do think it's important, however, that
24 there is a distinction between predatory lending and other
25 kinds of subprime lending. And I think, unfortunately,

1 sometimes and particularly as a result of the crisis, people
2 tend to think of all subprime lending as bad and predatory,
3 and that is not the case.

4 You can also have very poorly underwritten
5 subprime loans that are not predatory, and I think that, in
6 fact, was the heart of the losses that we saw, not -- there
7 are consumer protection problems in some of those as well.
8 There's an important distinction.

9 We can get to you, for the record, the number of
10 enforcement actions we took for unfair and deceptive
11 practices and provide the guidance that we've provided.

12 COMMISSIONER WALLISON: And also more than
13 simply the -- the number of enforcement actions?

14 MR. DUGAN: Correct.

15 COMMISSIONER WALLISON: But, in fact, rather,
16 the counseling that you've had to done with banks so we can
17 get a sense of how pervasive it is in this large system that
18 you regulate.

19 MR. DUGAN: Absolutely.

20 COMMISSIONER WALLISON: Thank you.

21 MR. HAWKE: Could I just add to that?

22 COMMISSIONER WALLISON: Sure.

23 MR. HAWKE: I believe the commission has a
24 document dated February 21, 2003, which was a statement that
25 we put out on -- on predatory lending and where we tried to

1 define it, and we said in that that the OCC did not have
2 reason to believe that national banks or their operating
3 subsidiaries generally engaged in predatory lending
4 practices.

5 And we had requested both from consumer groups
6 and from state law enforcement people that they inform us of
7 any such examples. And we really got nothing.

8 Having said that, predatory lending exists, and
9 we -- we -- I know on tours that I have taken in suburban
10 neighbors of Chicago, for example, we've seen evidence of
11 it, and it comes back to a point that I've made several
12 times about the way loans are underwritten.

13 The essence of predatory lending is making a
14 loan without regard to the borrower's ability to repay, with
15 reliance being placed on the value of the equity in the
16 property, because the predatory lenders have -- are really
17 interested in stripping equity that people have built up in
18 their homes.

19 And that's why there's such a much higher degree
20 of foreclosures with respect to predatory lending, really,
21 true predatory lending, as I've defined it, than other types
22 of lending.

23 And that's the reason why we have emphasized, on
24 so many occasion, the importance of underwriting practices
25 that look at a borrower's ability to, through their regular

1 resources to handle the interest and principal payments on
2 loans without regard to the collateral.

3 If that very fundamental principal of loan
4 underwriting is observed it is a cure for a lot of the bad
5 things that we've seen.

6 COMMISSIONER WALLISON: Good. Thank you.

7 CHAIRMAN ANGELIDES: Mr. Georgiou, do you have a
8 quick question?

9 COMMISSIONER GEORGIU: Yes, just a quick
10 follow-up on that point.

11 EXAMINATION BY COMMISSIONER GEORGIU

12 COMMISSIONER GEORGIU: Mr. Hawke, you testified
13 about your guidance that you issued in 2003 in this regard,
14 regarding predatory lending, that they ought not to
15 originate predatory loans, but the OCC never issued any
16 guidance saying national banks shouldn't make loans to firms
17 to facilitate predatory lending.

18 I mean, I would -- and I guess I would really
19 direct the question, in part, to -- to Mr. Dugan. On
20 page 10 of your testimony, you noted that the 33 billion in
21 the short-term loans provided by national banks to subprime
22 lenders in 2006 called warehouse financing was a small part
23 of all the warehouse financing.

24 But isn't there a question about whether you
25 ought to have issued guidance with regard to that

1 warehousing; in other words, they may not have originated
2 the predatory loans themselves but they facilitated the
3 origination of the predatory loans by providing warehouse
4 financing to entities that many people regard as having
5 engaged in predatory lending?

6 MR. HAWKE: We did, Commissioner, on -- on that
7 same date that we put out that other guidance; we put out a
8 statement on avoiding predatory and abusive lending
9 practices in brokered and purchase loans.

10 And we did address there the need for banks, the
11 national banks, to use diligence when they make or purchase
12 loans that are originated through the mortgage brokers or
13 other intermediaries.

14 COMMISSIONER GEORGIU: But make or purchase
15 loans, but what if they didn't, what if they just
16 facilitated, they didn't make them themselves or even
17 purchase them, but they permitted them to be made by
18 providing extensive warehouse financing?

19 MR. DUGAN: And I think on that point, this is a
20 difficult area, I will acknowledge this, because you don't
21 control the lending of a lender that you lend to, and you
22 don't examine them for their banking practices.

23 And some people are legitimate subprime lenders
24 and others are not. And it's hard to issue something that
25 says that banks can't make loans to other businesses unless

1 they all abide by the same practices that are required by
2 the banking laws. We never viewed the scope of our things
3 as going quite that far but --

4 COMMISSIONER GEORGIU: Understood. Okay.
5 Well, thank you, and if you want to -- if there's anything
6 you want to supplement to us on that --

7 MR. DUGAN: I would say that, as I noted, my
8 testimony was still quite small percentage of the overall
9 industry that were funded by national bank warehouse loans.

10 CHAIRMAN ANGELIDES: All right. Let me see if I
11 can run through these, quickly, with your help.

12 EXAMINATION BY CHAIRMAN ANGELIDES

13 CHAIRMAN ANGELIDES: Based on your experience,
14 big picture, Citigroup too -- an institution like Citigroup,
15 too big to regulate?

16 MR. DUGAN: No, I don't think that. I think
17 that the issue is not so much size, as whether the
18 complexity is, and what they're doing prevents risk
19 management challenges, and I don't think they're too big to
20 regulate.

21 CHAIRMAN ANGELIDES: Any sense?

22 MR. HAWKE: I -- I -- I agree, we had 45 full
23 time on-site examiners at Citi, and the Fed had another
24 dozen or so, and I -- I think that they -- they were
25 involved in virtually every aspect of the bank's business.

1 CHAIRMAN ANGELIDES: What about the issue of
2 essentially leakage of their business lines to non-bank
3 entities? Were there very substantial losses?

4 MR. DUGAN: Well, is it something that can be
5 addressed, is that what you're saying? I think we had some
6 issues that obviously got identified in the crisis. We need
7 to address them. We can address them through better
8 coordination with the other regulators and with the
9 consolidated regulators.

10 CHAIRMAN ANGELIDES: All right. Second question
11 is, internal risk management, is it a second line of defense
12 or first line of defense? And there's actually an
13 interesting -- it caught my eye because of the wording.
14 There's an OCC staff memo to the file, September 27, 2004,
15 one of the employees, a guy named Bruce Johnson, who wrote,
16 who was on the Citi. I don't know if he was the examiner,
17 the chief examiner.

18 MR. DUGAN: No, not the examiner.

19 CHAIRMAN ANGELIDES: Yeah, he did a memo. It
20 was called -- and one of his concerns was called relativity
21 and the boiling frog theory.

22 I explained that I was concerned that management
23 committees, such as CMAC, which is what we referred to
24 earlier in the day, the committee within Citigroup that
25 approved new products, which are too closely types of

1 products may become too conditioned, not perceived subtle
2 changes over a longer period of time, much like what had
3 happened in real estate in the 1980s.

4 I explained that occasionally, seeing the most
5 extreme deals to David Bushnell, who was here chief risk
6 officer, and Randy Farmer, who was a good practice, and help
7 them occasionally dip their fingers in the pot to ensure the
8 water was not getting too hot. I guess I would ask you,
9 what's your subsequent internal risk management at Citi?

10 MR. DUGAN: Well, as I said earlier, it was
11 something where I believed and we believed before the crisis
12 that they were smart, that they generally understood the
13 risks they had, that where we did identify problems, they
14 did respond to those problems. And sometimes we did
15 identify some significant problems.

16 But it wasn't until the crisis and we saw more
17 pressure put on the system, that it revealed other problems
18 that were more significant as we saw them, in particular the
19 closeness between the risk management and the lines of
20 business.

21 CHAIRMAN ANGELIDES: And the lines of business,
22 yes.

23 VICE CHAIRMAN THOMAS: On that point, and this
24 may be an unfair characterization, were they better at
25 selling risk management than performing it?

1 MR. DUGAN: I can't speak to that, and as I
2 said --

3 VICE CHAIRMAN THOMAS: Well, it was your
4 impression that they were doing a good job, and it was based
5 on your independent examination?

6 MR. DUGAN: Yes, at the time -- at the time and
7 that they would respond to things that we were bringing to
8 their attention. They had a bunch of issues. They had a
9 number of things that happened to them that they had to
10 respond to problems. They were under documents in ways that
11 other institutions weren't. We had to keep working through
12 those with them more so than with other institutions.

13 VICE CHAIRMAN THOMAS: Thank you. Mr. Chairman?

14 CHAIRMAN ANGELIDES: Yes. So, actually, apropos
15 of that, the OCC had actually issued some warnings to Citi
16 with respect to complex products. And in the course of the
17 run-up, you know, you had noted, I think, in January of '05,
18 that inner earnings and profitability growth were taking
19 precedence over risk management and internal controls.

20 You had warned that -- I think you had been
21 concerned about the bank's ability to perform future
22 business. I think I would ask you, and let me actually tail
23 onto this, I would ask you, do you think you did -- you
24 identified some problems, I noticed earlier on, about
25 internal controls and their growth. On reflection, and this

1 builds on something I think Ms. Murren and I were talking
2 about, I don't know if it was in public session or a
3 conversation we had, about whether your examinations really
4 were like audits, where there was acidulous follow-up, to
5 make sure all those things were identified, that you stayed
6 on them to make sure that they're correct, do you think --
7 it looks as though you spotted some problems; maybe you
8 didn't quite understand the depth of what they might become,
9 but do you feel you did an adequate job of following up or
10 do you, on reflection, feel like there should have been more
11 deliberate and consistent follow-up on some of your findings
12 in '05?

13 MR. DUGAN: No. I believe we followed up quite
14 rigorously on that, we have a quite good system for that
15 where we identify problems, particularly when we identify
16 them in a way that would generate a supervisory letter; we
17 go back to test to make sure that they've complied with
18 that, and so I think what I would say is where the places
19 where we identified and pushed them, they responded. And we
20 made sure they responded. We followed up on that.

21 They, over the years, had more of those than
22 other companies did, and we needed to -- to do that more
23 than we should have and, as I said during the crisis, some
24 things happened that weren't revealed and that -- that
25 particular examination, that gave us pause in other areas.

1 CHAIRMAN ANGELIDES: I guess in 2009 there was
2 an inspector general report about two failed institutions
3 OCALA National Bank and first National Bank, in Nevada,
4 where the inspector general, you know, it's always easy to
5 look back, said that, I guess, the problems were spotted
6 early on, and there wasn't formal enforcement action.

7 Now, there hasn't been an IG report with
8 Citigroup, but you're convinced that you did everything you
9 could to make sure these things, these problems didn't
10 metastasize, that you acted early enough?

11 MR. DUGAN: You know, I never say that, given
12 all that's happened, that we shouldn't have done more,
13 sooner, with the benefit of hindsight. There are things,
14 definitely, that we perhaps should have leaned harder on
15 them, better reporting around the whole area of contingent
16 problems to the banking institution.

17 I mean, I'm certainly not going to say we were
18 perfect. I think the kind of thing you pointed out in your
19 report, there, is different, it's a smaller institution,
20 it's a different kind of thought. And we address that
21 separately and you have to take these on their own cases.

22 And I will say that this institution, as I
23 mentioned earlier, because it came, was put together over a
24 period of time in a quite idiosyncratic way.

25 CHAIRMAN ANGELIDES: Meaning Citigroup?

1 MR. DUGAN: Yes, Citigroup.

2 CHAIRMAN ANGELIDES: There was a set of
3 acquisitions?

4 MR. DUGAN: Yes, it was a very large investment
5 bank with a very powerful impact on the culture where that
6 was not a traditional commercial banking culture, then that
7 was something that we continually had to deal with, that was
8 different.

9 CHAIRMAN ANGELIDES: Well, that leads to my next
10 question, but I think you answered it, which is, was the
11 investment bank culture beginning to predominate the state
12 banking.

13 MR. DUGAN: I would say the answer is yes.

14 CHAIRMAN ANGELIDES: Hmm?

15 MR. DUGAN: I would say the answer is yes.

16 CHAIRMAN ANGELIDES: Okay. Couple more
17 questions, the OTS?

18 MR. DUGAN: Yes.

19 CHAIRMAN ANGELIDES: Leakage, arbitrage, how big
20 an issue?

21 MR. DUGAN: Between?

22 CHAIRMAN ANGELIDES: For example, Countrywide,
23 didn't Countrywide go from OCC to OTS? Isn't that their
24 path?

25 MR. DUGAN: You would have to ask -- I -- it was

1 in the wake of our nontraditional mortgage guidance that we
2 were spearheading that they -- it was not long after that or
3 in the context of that that they flipped their charter.

4 The institution said that they were changing
5 their thoughts and didn't want to be a diversified
6 institution, wanted to concentrate on mortgages, and the OTS
7 was who had more expertise.

8 CHAIRMAN ANGELIDES: I know you have colleagues
9 but do you think it's a significant issue, charter flipping,
10 potential risk, real and potential?

11 MR. DUGAN: Well, number one, I think most of
12 the regulatory proposals now have OTS being pulled together
13 in that kind of thought. Number two, I think the
14 significant issue, the thing that we took about people
15 leaving because of regulatory actions also helped address
16 that, so I don't think it's as significant a risk.

17 CHAIRMAN ANGELIDES: Okay. I took it from your
18 earlier remarks, but I just want to be clear, you thought
19 there should have been national standards on subprime high
20 cost --

21 MR. DUGAN: Yes.

22 CHAIRMAN ANGELIDES: -- risky loans? So I take
23 it that you believe the Fed, Federal Reserve, should have
24 adopted much more comprehensive rules under HOEPA?

25 MR. DUGAN: I think if they would have done

1 that, it would have made a difference.

2 CHAIRMAN ANGELIDES: Mr. Hawke, do you agree.

3 MR. HAWKE: Yes.

4 CHAIRMAN ANGELIDES: Thank you. Final, I think,
5 set of questions, trying to go quickly, members, here.

6 I want to talk about preemption, because I -- we
7 really haven't touched this today. And I want to touch it
8 because I do think it's worth touching.

9 In our first hearing, Attorney General Lisa
10 Madigan of Illinois was in the door here testifying before
11 us, and I think you know it's no secret that states all over
12 the country did not agree with your decision to preempt.

13 MR. DUGAN: That I'm well aware of.

14 CHAIRMAN ANGELIDES: And I was a state official
15 in California and, while I was not directly involved in
16 those, I followed very closely the legislative efforts in
17 California.

18 Now, you state that national banks and their
19 subsidiaries, which are both regulated by the OCC, made only
20 10 percent of all subprime loans made in 2006 was subprime
21 loans being defined as loans with FICO scores 620 or below,
22 people can cut that out of different places, so depending on
23 where you cut it, it can be somewhat higher.

24 MR. DUGAN: I want to be clear on this. When we
25 had the interview, we talked about this, and we went back

1 and I wanted to make sure we were clear exactly how we got
2 to the number before, how we got to it now; that's not the
3 definition. We could use that definition but that's not the
4 definition.

5 CHAIRMAN ANGELIDES: It is not?

6 MR. DUGAN: It is not the definition.

7 CHAIRMAN ANGELIDES: Thank you very much,
8 we'll -- is there a short definition?

9 MR. DUGAN: Yes, it's what the -- in our -- in
10 the database is the loan, the premier database, that it's
11 called loan production corporation, I believe, or loan
12 production something, it's for --

13 CHAIRMAN ANGELIDES: Is it loan performance
14 data?

15 MR. DUGAN: Loan performance data, okay. Thank
16 you.

17 A combination of that with our supervisory
18 mortgage metrics that we collect information on and it's all
19 spelled out exactly, but it's basically it's what lenders
20 identify.

21 CHAIRMAN ANGELIDES: Self-identification?

22 MR. DUGAN: As prime and subprime.

23 CHAIRMAN ANGELIDES: Self-identification?

24 MR. DUGAN: Yes.

25 CHAIRMAN ANGELIDES: All right. We'll look at

1 the data. But -- but I just want to point out, I mean, in
2 the big picture, here's what some would argue, and I want to
3 put it on the table that you tied the hands of the states
4 and then you sat on your hands.

5 So Lisa Madigan told us or attorney or General
6 Madigan, I guess is the term to use, first of all, there is
7 this real issue of warehouse lending, and it's not directly
8 related to preemption, but national banks were facilitators.
9 They extended warehouse lines to 21 of the big 25 biggest
10 subprime lenders.

11 But in terms of at least the data that was
12 provided by Ms. Madigan, which was from the national
13 consumer law center, that when you add up national banks and
14 thrifts, because I think you really have to look at
15 preemption, not just in terms of national banks, but
16 national thrifts, and there's operating subsidiaries, their
17 data shows that I believe in 2006, 31 percent of the
18 subprime, 40.1 percent of the Alt-A, 51 percent of the pay
19 option and ARMs and interest-only adjustable rate loans were
20 made by national banks and thrifts and their subsidiaries,
21 so not inconsequential.

22 Critics also point out that you only brought 13
23 consumer-related enforcement actions from 2000 to 2006, and
24 only one of those involved subprime mortgage lending.

25 Two of the largest subprime lenders weren't

1 national banks, Countrywide, until they shifted over, and
2 National City, which did its work through First Franklin.
3 So I want to put that on the table.

4 MR. DUGAN: So --

5 CHAIRMAN ANGELIDES: And I'd like perhaps both
6 of you, actually, much of this happened under Mr. Hawke.

7 MR. DUGAN: So let me go first and then --

8 CHAIRMAN ANGELIDES: Okay.

9 MR. DUGAN: So in terms of those numbers --

10 CHAIRMAN ANGELIDES: I'm looking at you and
11 Mr. Hawke, because I want you both to address it, because I
12 think it's a very significant issue, and I would add this;
13 let me just say this. In the end, I would also like you to
14 tell me why you think that the public interests -- because I
15 know it develops, why it was better served, even if it was
16 10 percent, 20 percent, or 30 percent, was the public
17 interest best served by handcuffing state actions which
18 would have been supplemental to any enforcement actions to
19 the federal government.

20 VICE CHAIRMAN THOMAS: Mr. Chairman, could we
21 get a brief overview of the point that you're making? But I
22 would very much like to have you take a little time and put
23 it in writing.

24 MR. DUGAN: Yes.

25 VICE CHAIRMAN THOMAS: So we have a

1 better understanding --

2 MR. DUGAN: Sure.

3 VICE CHAIRMAN THOMAS: -- of it as we go
4 forward?

5 MR. DUGAN: I would be happy to do it, as a
6 matter of fact --

7 CHAIRMAN ANGELIDES: And that is my last
8 question.

9 MR. DUGAN: Okay.

10 CHAIRMAN ANGELIDES: Unless you really, unless
11 you trigger five more.

12 MR. DUGAN: We actually did put it in writing.
13 And it's in my testimony and it's in an appendix.

14 VICE CHAIRMAN THOMAS: Ahh, okay.

15 CHAIRMAN ANGELIDES: But I would like you to
16 address it here for public record and public watch.

17 MR. DUGAN: To the extent I need to supplement
18 it, I certainly will.

19 CHAIRMAN ANGELIDES: And, again, I believe this
20 was done in your -- when you were comptroller; right,
21 Mr. Hawke?

22 MR. HAWKE: It has been by all --

23 CHAIRMAN ANGELIDES: It is mutual
24 responsibility? Okay, good.

25 MR. DUGAN: So, on the numbers, there are

1 different numbers that have come out, and we wanted to
2 address these because we believed that the numbers that we
3 cited are the best, most accurate, most rigorous, and so the
4 appendix that we attached to the testimony explains in great
5 detail exactly how we got our numbers and why they're
6 different from other numbers, including the numbers you
7 cited in the testimony. So it's in there and we would be
8 happy to respond further if you have further questions.

9 Let's see, the second question was?

10 CHAIRMAN ANGELIDES: One is about the numbers,
11 but I think the second and biggest question is, was this in
12 the public interest and why?

13 MR. DUGAN: Okay.

14 CHAIRMAN ANGELIDES: And again, going back to
15 whether the number -- again, it didn't include thrifts, but
16 whether it was 10 or 20 or 30 or 40.

17 MR. DUGAN: So, since we have an appendix in
18 here on why we believe that preemption and uniform national
19 standards is a good thing and has been a good thing; it's
20 been in place since the Presidency of Abraham Lincoln; it's
21 how national banks operate in the banking business, and
22 there is a great value in being able to have a common set of
23 standards that apply regardless of the state in which you
24 operate so that you don't have 50 different sets of rules,
25 50 different sets of disclosures, 50 different types of

1 enforcement actions brought on different kinds of standards.

2 We believe that produces more efficient products
3 and services delivered to people. And it's important. Of
4 course, you have to have high consumer standards and
5 consumer protection standards, and we understand that. I
6 think one of the things that the new legislation puts in
7 place, which I support, which is to have a strong federal
8 agency to write consumer protection rules that apply across
9 the board.

10 But the point is to have a set of uniform
11 national standards, that's always been something that's been
12 viewed as a benefit to the delivery of financial services,
13 products and services to consumers, that's point one.

14 Second --

15 CHAIRMAN ANGELIDES: Can I ask you one question
16 on that point one, though?

17 MR. DUGAN: Yes.

18 CHAIRMAN ANGELIDES: And that is, and maybe you
19 can address this, was the standard high enough effectively?
20 Was it high enough on reflection, and was the standard high
21 enough in terms of the products which were offered?

22 MR. DUGAN: And I would say the answer is yes.
23 In some particular areas, that could have been higher,
24 that -- but, generally speaking, I think the answer is yes.
25 I think there are places where we needed higher standards to

1 apply across the board. And let's call it credit card
2 rules, for example, where we did not have that authority.

3 CHAIRMAN ANGELIDES: But even with default rates
4 that are 86 percent of the market average, that's pretty
5 darn high. It's not that differential.

6 MR. DUGAN: Well, what I would say is we're
7 going through the worst housing recession in our country's
8 history.

9 CHAIRMAN ANGELIDES: No, but I'm just being
10 relative. You're saying -- I think what you said was that
11 from `05 to `07, the default rate for national banks for
12 non-prime loans between `05 and `07 was 86 percent of the
13 market average, so give me a breakdown.

14 MR. DUGAN: What I'm saying there is -- I'm not
15 saying that all the underwriting for those loans was good, I
16 think I said that at the outset, I think there are things
17 that we should have had that were stronger, but I think it's
18 also difficult to trace the differences in the rules between
19 the different persons as how much of that has accounted for
20 it, but the other thing I would say is I don't accept the
21 proposition that the states should spend all their time
22 trying to bring enforcement actions under state law against
23 national banks where you have this huge shadow banking
24 system that's not touched by federal regulations, where you
25 have the biggest problem, and the states are not addressing

1 that issue adequately.

2 And that's where those resources should be
3 directed, to the shadow banking's system of unregulated
4 people. People say you can't have too many cops on the
5 beat; my answer is, yes, you can, if you don't have an
6 adequate number of cops in total.

7 We've got people who can monitor the national
8 banking system, and we should be held accountable for it,
9 but the parts where we have problems with the states, we
10 haven't handcuffed the states' ability to go after and deal
11 with problems in the state-regulated state institutions that
12 issue mortgages.

13 And I think if there were more attention paid to
14 bringing that level of compliance up to what not just
15 national banks but state banks that are also federally
16 regulated are, we'd have a better across-the-board system.

17 CHAIRMAN ANGELIDES: All right. Mr. Hawke, do
18 you want to comment on this?

19 MR. HAWKE: I certainly do, Mr. Chairman. First
20 of all, I think it has to be appreciated that preemption is
21 not something we invented or was discretionary with the OCC,
22 it's a constitutional doctrine that has been the law of the
23 land since 1819.

24 And it basically states a very simple principle,
25 that the states do not have the constitutional authority to

1 regulate or interfere with the activities that Congress has
2 empowered federally created entities to exercise. That --
3 that -- that has been a doctrine that has carried through
4 our history.

5 And I think, I'm sure I'm right, that with every
6 preemption issue that has come up, in my knowledge, that has
7 been subject to court review, the courts have upheld that
8 principle.

9 Congress can change that, if it sees fit, and it
10 could subject federally created entities to state law, but
11 if it hasn't, then I believe that it's our obligation,
12 having taken an oath to defend the Constitution, to -- to
13 enforce the Constitutional principle of preemption.

14 Second, I -- I think it's very misleading to
15 look at formal enforcement actions as -- as -- as the
16 measure of -- of what an agency's record is in -- in dealing
17 with consumer issues.

18 And we have -- and the Comptroller's testimony
19 lists a number of formal enforcement actions. But that's
20 the extreme. When a matter gets to a formal enforcement
21 action that -- that -- that reflects a fairly serious
22 conduct.

23 An enormous number of problems, consumer
24 complaints, are handled every day in the bank examination
25 process. Every time examiners go into a bank if they

1 find a violation of consumer laws, they cite the bank for
2 it, and if the bank doesn't fix it, the regulators come in
3 with an enforcement action.

4 Besides that, the OCC has what I consider a
5 world class ombudsman's operation that fields literally tens
6 of thousands of communications from consumers every year.

7 And the ombudsman feeds that back through
8 examiners into the banks. And if there's merit to the
9 complaints that the consumers have raised, we get fixes. We
10 get fixes without a lot of formal action. The fixes get put
11 in place generally with very little formality or other kinds
12 of controversy. If a bank resists and wants to fight about
13 it, then we fight it and it results in a formal enforcement
14 action.

15 CHAIRMAN ANGELIDES: All right. In the
16 interests of my fellow Commissioner's time, there is one, I
17 think, question that I'll just pose to both of you to be
18 answered in writing. And I just want you to reflect on
19 this.

20 So here's what struck me about this. I
21 understand, and I do not dismiss, and I appreciate the
22 quality of your answers on this issue, and certainly, you
23 know, the importance of the Constitution.

24 So -- but when you see, I think, 26 states
25 actively trying to deal with this, because they saw an

1 on-the-ground problem, there's a fascinating article you may
2 or may not have seen from the Columbia Journalism Review
3 about whether or not the press saw the coming financial
4 crisis.

5 The only reason I mention it is there's a piece
6 of the article that talks about how much press coverage
7 there was from 2002, 2003 as states were actively trying to
8 fight deceptive unfair lending across the country, the
9 boiler rooms, the aggressive lending. I guess I would, in a
10 question, probably posed to both of you, given the ground
11 reality that you have state officials all over the country
12 concerned about the level of unfair deceptive lending, I'm
13 going to ask you both to consider what might have been
14 deficient therefore in national -- in national enforcement
15 that would have led them to believe it was such a para- -- a
16 matter of such paramount concern.

17 MR. HAWKE: Well, I should say, Mr. Chairman,
18 that we asked state law enforcement officials on many
19 occasions to refer to us any evidence that they had or any
20 incidences they had of national banks involved in conduct of
21 the sort that you described. And we got zero.

22 And we asked consumer groups for the same thing.
23 We even asked the state attorneys general to enter into a
24 memorandum of understanding with us where we could share
25 information and cross-pollinate on enforcement actions.

1 And until very recently, with Comptroller Dugan,
2 they refused, they refused to do that, so we did not have --
3 we did not have evidence emanating from the states or from
4 consumer groups that national banks were --

5 CHAIRMAN ANGELIDES: Right. And I don't want to
6 cut you off. The full response, in writing, if you could
7 definitely do that for the record. All right, Mr. Thomas?

8 VICE CHAIRMAN THOMAS: We'll definitely want
9 what, when, written in terms of those contacts that you
10 mentioned, Mr. Hawke, because this is a -- everybody was
11 involved after the fact. I would like a real timeline in
12 terms of who, when, and how.

13 CHAIRMAN ANGELIDES: Be very helpful. Any
14 other --

15 VICE CHAIRMAN THOMAS: Thank you for your
16 testimony.

17 CHAIRMAN ANGELIDES: Any other Commissioners?
18 Hearing none, we'll adjourn today and we will meet here at
19 9:00 A.M. And just to tell the Commissioners, we will be
20 out of here without fail, tomorrow, at 3:00 because of the
21 travel schedules of several Commissioners. So we will be
22 done prior to 3:00 tomorrow, 9:00 A.M. here in this room.
23 Thank you very, very much for your time, your answers to our
24 questions.

25 (FCIC Hearing adjourned at 5:28 P.M.)
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