8-9-2010

Secretary Henry Paulson Follow Up From Wendy Edelberg

Wendy Edelberg

Kevin M. Downey

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Wendy Edelberg
Executive Director

August 9, 2010

Via Email & Mail
Secretary Henry M. Paulson
c/o Kevin Downey
Williams & Connolly LLP
725 12th Street NW
Washington, DC 20005

Re: Financial Crisis Inquiry Commission Hearing on May 6, 2010

Dear Secretary Paulson:

Thank you for testifying on May 6, 2010 in front of the Financial Crisis Inquiry Commission and agreeing to provide additional assistance. Toward that end, please provide written responses to the following additional questions and any additional information by August 23, 2010.[1]

1. In 2007 and 2008, how aware were you (and the United States Treasury) of the fragile and precarious state of Fannie Mae, Freddie Mac and housing markets in general? Did you make the full extent of your concerns known to the public at that time? Did worry about inciting panic in housing and mortgage-asset markets play a role in what you communicated to the public?

2. Please describe the role of over-the-counter derivatives in the financial crisis.

3. Did any of the following factors create systemic risk and if so, how?
   a. The concentration of derivatives in the hands of the large derivatives dealers;
   b. The interconnections between those dealers and/or other large financial institutions through derivatives contracts;
   c. Lack of transparency in the derivatives market.

[1] The answers you provide to the questions in this letter are a continuation of your testimony and under the same oath you took before testifying on May 6, 2010. Further, please be advised that according to section 1001 of Title 18 of the United States Code, "Whoever, in any matter within the jurisdiction of any department or agency often United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both."

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4. Were derivatives a factor in necessitating the rescue of a number of large institutions? If so, which institutions?

5. Were credit derivatives a factor in fueling the securitization of mortgages and other loans? If so, do you believe this in turn contributed to the housing and credit bubbles?

6. Were credit derivatives the primary cause of AIG's failure and the government's decision for its rescue?

7. Do you believe the structure of compensation packages in the financial system played a role in the financial crisis? (For example, did the fact that investment banks were not required to hold some of the securities they were underwriting play a role in causing the financial crisis?) What role did the fact they were allowed to hedge against these securities play in causing the crisis? Would this role have been different if compensation to employees included some portion of the securities that they participated in issuing or underwriting? Would this role have been different if investment banks were required to hold some of the securities they were issuing or underwriting (and prohibited from hedging this risk)?

8. What role, if any, do you believe the all-cash compensation or bonus system (e.g., securities issued being part of the compensation to those who participated in the deals) across investment banks played in causing the financial crisis?

The FCIC appreciates your cooperation in providing the information requested. Please do not hesitate to contact Sarah Knaus at (202) 292-1394 or sknaus@fcic.gov if you have any questions or concerns.

Sincerely,

Wendy Edelberg
Executive Director, Financial Crisis Inquiry Commission

cc: Phil Angelides, Chairman, Financial Crisis Inquiry Commission
Bill Thomas, Vice Chairman, Financial Crisis Inquiry Commission

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EDWARD BENNETT WILLIAMS (1920-1988)
PAUL R. CONNOLLY (1922-1978)

September 14, 2010

Via E-mail (wedelberg@fcic.gov)

Wendy Edelberg
Executive Director
Financial Crisis Inquiry Commission
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Dear Ms. Edelberg:

I write in response to your letter of August 9, 2010, which asks Secretary Paulson to answer a number of additional questions, following-up on his voluntary testimony before the Financial Crisis Inquiry Commission ("the Commission").

Question 1 asks Secretary Paulson to explain any concerns he had about the GSEs and the housing market in 2007 and 2008. In his public testimony before the Commission, Secretary Paulson explained the concerns he had throughout his tenure at Treasury with respect to the GSEs and the housing markets, including the actions he took to seek GSE reform. *See* Testimony of Secretary Henry M. Paulson, Jr., Hearing of the Financial Crisis Inquiry Commission (May 6, 2010) ("Paulson Testimony") at 7:18-21; 21:9-22:20; 23:5-24:4; 24:16-25:5; 51:24-54:3; 65:11-66:18; 111:12-22; 112:5-18. Secretary Paulson also addressed this topic in his recent book. *See* Henry M. Paulson, Jr., *On the Brink* (2010) at 55-60.

Questions 2, 3, 4, and 5 ask Secretary Paulson for his views on the role credit derivatives played in the financial crisis generally, as well as in the problems at AIG specifically. In his public testimony before the Commission, Secretary Paulson explained his view on how derivatives contributed to the financial crisis, including his opinion that these products did not create the crisis but magnified and exacerbated it. *See* Paulson Testimony at 40:4-41:8. In general, Secretary Paulson's view is that the interconnectedness of financial institutions through, among other things, derivative contracts was a cause of systemic risk, and the lack of transparency in the market for those contracts exacerbated that risk. With respect to AIG, the systemic risk posed by the failure of that entity was due in part to the to the extent of its derivatives contracts and the market uncertainty occasioned by a lack of transparency regarding the level of exposure an AIG failure would pose to its derivative counterparties. *See* Paulson Testimony at 96:21-97:18. Secretary Paulson addressed these issues in detail in his recent book. *See On the Brink*, *supra*, at 200, 204-05, 217-18, 220-223, 229-230, 233, 236-237, 241.

Questions 6 and 7 ask Secretary Paulson about his views on compensation in the financial services industry. Secretary Paulson has given his views on this subjects in his testimony before the Commission and in other public venues. *See* Paulson Testimony at 87:20-88:11. Generally, Secretary Paulson's view is that it is important that compensation systems create incentives that are consistent with the best long term interest of a company and its shareholders and do not promote excessive risk taking. Regulators need to work with the financial industry to set pay standards, but this can and should be done without regulators determining specific compensation levels. Instead, pay should be aligned with shareholder interests by ensuring that as an employee's total compensation grows, an increasing amount of it is given out as equity that is deferred—vesting and paying out later—and subject to being clawed back under certain circumstances. Senior executives should be prevented from selling most, if not all, of the shares they are paid; when they retire or leave, their deferred share payments should not be accelerated. Secretary Paulson discussed these views as well in his recent book. *See On the Brink*, *supra*, at 444.

Very truly yours,

Kevin Downey

Kevin M. Downey