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United States of America

Financial Crisis Inquiry Commission

Closed Session

Timothy Geithner

Secretary of the Treasury

November 17, 2009

***** Confidential *****

FINANCIAL CRISIS INQUIRY COMMISSION
COMMISSION SENSITIVE DOCUMENT

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CHAIR ANGELIDES: Good morning, Mr. Secretary. Thank you for coming by this morning. And we appreciate you having made the offer to come and talk with us on an informal basis at the front end of our work.

I think what we'd like to do here -- I know that you are on a tight schedule as always; your helicopter awaits; right? -- is, I don't know how long you plan to, you know, speak to us in terms of opening remarks, but we'd love to have as much time for questioning as possible, but we'd love to have as much time for questioning as possible but we'd love to hear your overview of, as we talked about, your perspective on the crisis and how we ought to do things.

SECRETARY GEITHNER: So would you like me to start?

CHAIR ANGELIDES: Sure.

SECRETARY GEITHNER: So I'll do, I don't know, eight minutes. Is that okay? I'll try to do it as briskly as possible.

CHAIR ANGELIDES: You can go to nine.

SECRETARY GEITHNER: You can interrupt me. You can stop me anytime. You can do anything. And thanks for --

CHAIR ANGELIDES: But we can't shout "You lie," though; right? Just to get it clear.

SECRETARY GEITHNER: That's fine.

So you guys have a list -- I saw some of the lists you presented that had 21 causes.

CHAIR ANGELIDES: 22.

SECRETARY GEITHNER: 22? Those are a pretty good list.

I want to kind of give you a hierarchy of what I think was most consequential. I'm not claiming perfect foresight. I'm not claiming unique wisdom. Obviously, I've got biases just in a prism of my past, like everybody else. But I think it's important for you to hear that from me, because you can view everything I say after this, when I get to do this more formally with you guys, and through this prism. Okay?

So I think my list has eight or something like that, or seven. So I'll go through them rather quickly.

I think you have to start with a basic recognition -- this is true for, in some ways, all financial crises -- is that you had this long period of relative stability, no history of significant falls in house prices. The memory of large recessions, deep recession crises has basically faded. And people everywhere just took a -- made a huge amount of consequential judgments on the expectation that the future would be as stable. Economists are talking about a great moderation. All are pure -- you know, we have a crisis every five years in the United States, but they seem pretty manageable, small. People thought it was really the end of the history -- you know, the end of this stuff. That's very consequential.

So a lot of the mistakes in ratings, in risk management, people deciding they're going to borrow a huge amount on the expectations that the earnings are going to rise further was based on that fundamental premise.

Second, not different, though, is the basic monetary policy, global imbalance thing. So monetary

policy around the world was too loose, too long. Real rates were very low for a very long period of time. You had this huge increase in wealth in emerging worlds, looking for some place to invest.

And the fact that a huge part of the world was shadowing a dollar fixed to -- basically running a peg against the dollar, and they were leaning against the appreciation pressures in the currency, meant they were accumulating U.S. assets that push U.S. industries down as the Feds tightened. That made the bubble in real estate much greater and much larger.

This was not -- people want to say this is a Greenspan monetary policy era. It's much more complicated than that. Because, again, as the Fed tightened, a whole bunch of other things pushed U.S. loan rates down that had a big impact on borrowing, on leverage and lending as to price bubbles. That's important.

Third. The third thing: The simplest way to think about regulatory failure in the United States is, I think, through the following prism: We had a banking

system grow up in the shadow of the real banking system that was huge in scale. So the parallel banking system -- "*shadowing*" is not the right word because it was all in the public eye -- but the size of banks -- and entities doing banking -- borrowing and lending affected banking functions, no different from a classic bank -- grew up alongside the banking system, funded very short, very vulnerable to runs. A huge amount of leverage, much more leverage than in banks. Terribly vulnerable to panics.

Now -- and this basically is the unifying theme for the investment banks -- for AIG, to some extent, for the guys who are sort of operating as quasi-thrift finance companies. Countrywide is the best example. Again, they were basically banks run with a huge amount of leverage liquidity risk. And when the world turned and people were unwilling to fund these guys, they came crashing down, putting a huge amount of pressure on the rest of the system.

Now, banks were -- I'm coming to banks because banks weren't like innocent victims of this at all. But

it's important to recognize that, because what we allowed in our system was risk to basically shift outside the banking system to a bunch of entities that were doing banking. And that got to be on a massive scale.

Now, you can look at all sorts of measures of that; but it was very, very large relative to the size of the banking system.

I'm going to go a little more briskly.

CHAIR ANGELIDES: You're doing fine.

SECRETARY GEITHNER: There's a whole set of things that are about incentives, which you guys will be excellent at going through. But it's very important to recognize that the incentives in the compensation structure, what the tax regime did to incentives to borrow, what the accounting system did for how you capture or did not capture obligations, other forms of regulatory arbitrage that were permitted or incited were hugely important to this.

Moral hazard: Moral hazards everywhere in financial systems, it's endemic. Of course, what we had

during the crisis makes it a bunch worse, going forward. The biggest source of moral hazard was in the GSEs, Fannie and Freddie. It was -- GSEs were entirely moral hazards.

It's hard to find in the rest of the system -- just even looking back over time, it's fairly hard to imagine anything ever anybody in the world said, "I was funding Lehman Brothers at that level because the expectation that government would come in and save Lehman from its sins." I don't think you'd find any sort of rational investor -- any sort of honest investor would have said that.

But you had a bunch of people, again, arbitrage the safety net, affiliate with banks or thrifts, get some funding advantage from that. So there's some moral hazard in the system. But it was overwhelming in the GSEs, but not just about the GSEs.

I think regulations and enforcement, I think it's just fair to say the mood of the time was a deep skepticism about the value of supervision and enforcement. And I don't think it was aggressive

enough.

I have some experience with this. And, you know, just remember, the conventional wisdom over time, just look, you go back two years ago, was that you had this -- we had erred too far in the other direction: That the rules were excessive and competition among enforcement authorities in the wake of Spitzer, et al., had gone too far, and the biggest threat to the vibrancy of our financial system was basically we were doing too much aggression on the enforcement side. I think the opposite was true, and there was just a deep skepticism about the value of the stuff and people were not aggressive enough in using authorities.

You guys -- you know, the best examples of this, of course -- well, the examples are legion. But the best example I think is just look at the way supervisory guidance is done. Supervisory guidance on subprime issued by the Fed did not come out until the peak had passed on subprime issuance.

If you look back at supervisory guidance issued over the previous two decades, a similar pattern.

It doesn't come until the peak has passed. It's very late.

Now, you can't prevent that completely because people don't have perfect foresight, people won't be preemptive in this stuff. But you want supervisors caught trying, not waiting until the damage is so acute, you have no choice but to act.

The final-final point, which is not so much about the cause of the underpinning -- underlying vulnerability in the system but mostly about why the crisis got so bad is, you know, we came into this crisis, the United States of America, with deeply inadequate tools for containing the damage. There are two -- to make it simple, there are two types of tools that we did not have as a country. One is for managing failure of large, complex institutions, we had it for banks and thrifts but did not have it.

The Secretary of the Treasury at that time, to his enormous credit, proposed legislation in the immediate aftermath of Bear Stearns to remedy that problem. Still don't have it today, although we're

hoping to get it today, soon. And it's, bankruptcy doesn't work for financial institutions. It's a complicated question, but I'm sure that's right. And lacking that authority made the crisis much more damaging than it should have been.

The other thing is the authority to contain financial panics. This was a classic financial panic. A crisis that involved, like, the failure of a couple firms because of just mismanagement are not hard to deal with. But broad-based financial panics, hundred-year floods are very hard to deal with. We learned this lesson, you know, with deep scars in the late 19th century, early 20th century. Put in place a lot of protections around that at that time, around the banking system. But because we allowed this enormous banking to grow up outside the banking system itself with no tools to contain panics there, there was much more damage than there should have been. I think Keith will remember this.

A remarkable thing: The only executive powers of the President of the United States in financial

emergencies, coming into this crisis, were to declare a national bank holiday and close markets. Not a credible way to run a country, particularly with the United States of America, the reserve currency of the world. And our banks, our institutions play such an enormous role in confidence globally.

And, of course, you've got to worry about that balance. We're trying to figure out a way to make sure we can kill institutions safely and contain panics more effectively without adding to moral hazard -- as you wrote today, Peter, a terribly difficult thing to do. But you cannot say credibly that you're going to prevent future crises by abolishing a fire station and promising you'll never act. It doesn't work as a basic strategy. We had a good experience, though, as a country, national - we had to run a basic test of that proposition last year. It didn't turn out so well for the country. It caused enormous damage.

Getting a better balance is hard to do, but you can't wish away the basic problem and assume that fires are caused by the fire station. And the United

States of America can, you know, protect the system of the future by hoping that guys don't make mistakes again on a massive scale.

That's my list.

CHAIR ANGELIDES: Terrific.

Let's do this then: Let's start with John and go around this way, and we'll keep going until the Secretary has got to go. We'll just keep going around the room.

COMMISSIONER THOMPSON: Well, like all of these things, there are early signs that got ignored, that had we acted upon some of those early signals, perhaps we could have mitigated the impact somewhat.

So what would, in your mind, have been the first two or three things that, had we acted upon, we might have dampened the impact of this?

SECRETARY GEITHNER: Well, I think, again, the overwhelmingly big things were the huge growth in borrowing by the U.S. household sector, the huge rising credit growth in the U.S. relative to the size of our economy, and the amount of that risk that ended up in

this shadow banking system, the parallel banking system.

Now, those are people -- it's not people were unaware of those at the time. They were looking at them all. But it was a happening boom, so they rationalize them as a sign of structural changes that are healthy and good. And I would say those are the most serious ones.

Now, you, of course -- but there's a bunch of others. Again, if you look at just what happened to underwriting standards, you looked at basic practices and consumer credit mortgages, and you watched -- the great thing to look at is what happened to the share of consumer credit that was underwritten by banks versus non-banks, and you watch over time, banks were 80 percent, they became 50 percent because, again, what happened was --

CHAIRMAN ANGELIDES: Of consumer credit?

SECRETARY GEITHNER: Yes, I'm not sure if it's mortgage or consumer or both or "and," but it's just moved outside the banking system.

VICE CHAIRMAN THOMAS: With the tax structure,

starts mortgage winds up personal interest, well, you can play the game.

SECRETARY GEITHNER: Exactly. If people refinanced all their consumer debt, their credit-card debt with mortgages when the house prices made that possible. But that was as good -- that was a rational financial strategy. But overall borrowing went up very substantially over that period of time.

CHAIR ANGELIDES: Okay.

Brooksley?

COMMISSIONER BORN: Mr. Secretary, you talked about the regulatory gap that was created by failure to supervise the shadow banking institutions. Do you think that the regulatory gap and no government oversight of the OTC derivatives market played a role?

SECRETARY GEITHNER: The way -- I should have said it a little, slightly differently. I think there are these two gaps in the system. One is around institutions like, you know, AIG, major investment banks, the Countrywides of the world. The other was around what you might call "markets." And the way the

derivative market evolved and the way the secured lending, the securities lending, tri-party repo markets evolved, you had a system where contagion was going to spread much more broadly when institutions were at risk.

And derivatives were part of that because, as you know, because the stuff wasn't essentially cleared, and all the risk was bilateral, and people had thousands of counterparties and tens and tens of thousands of positions and huge gross notionals. They didn't really understand directly what their exposure would be in the event of default of a major institution. And that caused a much more brutal pull-back in risk than you would normally have had even in an acute panic. And that fed on itself. It caused the classic margin spiral, de-leveraging spiral. So I think that was part of it.

But it's not for the reason many people talk about because, in fact, the direct exposure these firms had in their derivative positions, their exposure to hedge funds, was pretty modest relative to capital. They actually managed overall exposure relatively

carefully relative to capital. There was just panic-inducing behavior from the way the weakness spread across the system, both through the funding mechanism and in some sense in the derivatives markets.

COMMISSIONER BORN: Largely, because of a lack of transparency?

SECRETARY GEITHNER: I think part of it is that; but, again, derivatives -- if the monoline insurance companies and AIG were not allowed to -- were not able to write huge amounts of protection with no capital to back it up -- when I said about capital, I meant among the regulated in the areas -- if they had not been able to overwrite those commitments, it would have been a less serious crisis -- a much less serious crisis. And that's just a more simple thing. It's not about derivatives so much as being no capital to back a commitment. It doesn't need a fancy -- it's not a fancy product or even so much oversight of derivatives. It's just the regulatory authority responsible for those institutions did not force them to hold capital against their commitments. Just like the regulators over the

GSEs didn't force them to hold capital against their obligations.

CHAIR ANGELIDES: All right, Keith?

COMMISSIONER HENNESSEY: The stress test, it worked. I've heard two explanations as to why. One is that a common informational base provided investors with the information they needed to invest. And the other is that if you were one of the -- what was it, 20 or 21 who got money last fall, and if you were one of the 21 who were part of the stress test, you now have an implicit guarantee.

How do we distinguish between the two reasons why?

SECRETARY GEITHNER: My own view is the -- will be former. And the best test of that is the following: If it had been the latter, it was just a sense of the basic guarantee to hold the system together, which we worked very hard to foster because we thought that was going to be the least cost, ultimately, and more effective.

You would not have had these guys being able

to raise capital on the scale they did, private capital, because the investors would have been living as they were last year, with the fear of progressive further dilution and they would have been unwilling to put the capital in. Because they would have known that there's some risk ahead still, losses would still grow relative to capital, and they'd be diluted again.

So my view is we -- if what had happened is that -- if it was all just about the implicit commitment or the explicit commitment to hold the system together, then you wouldn't have needed -- these guys wouldn't have been able to raise capital, they wouldn't have needed to raise capital. Well, that's my view. They can't know for sure.

But I have a slightly different explanation than what you started out with. I think it was a combination of the fact that we basically effectively committed to put a floor under an economy that was falling off the cliff; and to hold the system together. We provided catastrophic insurance which governments have to do. That's what we exist to do. Secretary

Paulson took a -- and the Fed took a huge step to do that over the course of the fall. It was incomplete. That was very helpful. That, combined with forcing disclosure and forcing to go raise private capital to cover the hole created by the disclosure, I think was what made it work.

CHAIR ANGELIDES: Heather?

COMMISSIONER MURREN: Thanks.

You had mentioned incentives and compensation and performance as one of the contributing factors. And I know there's been a pretty robust discussion around the CEO compensation.

Do you think we should be having the same discussion about the regulators and the supervisors, and how they are measured for their performance?

SECRETARY GEITHNER: I think something is wrong in the basic craft of supervision in the United States. But I don't think it's because of the classic forms of regulatory capture, of economic regulatory capture, in the sense that protections exist against it, post-employment restrictions, arrangements and things

like that are pretty good.

Now, they're not paid very much, they don't get much training, they don't spend any time in the market. They've got a much less sophisticated understanding of the institutions they're supposed to supervise than they would need to do it effectively. And so I think you need to -- need a long effort to try to improve the basic craft of supervision. It was allowed to erode over time.

The issue I began with, that having a long period of stability over that crises does tend to erode the quality of supervision because you're not used to fighting wars.

But I think, you know, we're doing a study of supervision. And as part of that study, we're forcing the supervisors to take a broad comprehensive look and report and disclose what their procedures are for managing conflict, post-employment restrictions, the other [unintelligible] investment, and those kinds of things, so people can look at them and see the common basis, see if they're tough enough.

So I think -- I think something's -- it's obvious it's, like, not strong enough, not good enough. But I think it's probably not about, you know, those classic forms of conflict.

If you let firms choose their regulator, okay, if you let them flip their charter from a Fed-supervised banks to an OTS-supervised thrift, if you let them shift the form of the instrument they're creating for their client, to take advantage of a lower tax treatment or more effective regulatory capital treatment or a lower jurisdiction, then you undermine all the basic protections that supervisors are supposed to defend and protect. And it's very hard for them to lean against that basic structure.

Again, if you fund your supervisors with fees on the institutions, and institutions can choose who their supervisor is, it's not a stable dynamic.

So I think those things are likely to be more powerful. But I would be -- nothing would make me happier than to have a bunch of generals come in and figure out how to improve the basic craft of supervision

and make it tougher again.

CHAIR ANGELIDES: All right, thank you.

Monetary policy: So what's changed today if, in fact -- you know, if, in fact, we were awash in money, too much liquidity, emerging markets, investing in our economies? I assume it means that when those periods occur, we have to have extraordinary vigilance. But what's changed in that underlying equation today?

SECRETARY GEITHNER: Do you mean, how to keep this problem from repeating?

CHAIR ANGELIDES: Yes, given that, in your mind, it's one of the driving forces. Not to say it can't be mitigated, but it is a driving force, apparently so.

SECRETARY GEITHNER: I think -- you know, you've got to -- there's sort of three things that have to happen in parallel: One is in the -- I know you're going to talk to the Chairman, but I think among central banks, having been a central banker, they're going to have to -- the basic doctrine of central banking is going to change, and people are going to recognize that

you can't just focus on what's happening, consumer prices and consumer price expectations. You have to look at broader measures of asset prices and credit.

Easy to say that, but it means that policy, I think, will move to a more pragmatic approach. And maybe that will leave you with a little more preemption, when you don't see inflation signs of big, huge distortions but you see them in other things.

The second thing is, you need to -- the global -- what kind of is the global monetary system, which is the exchange rate policy of the rest of the world. They're going to have to change, and they're changing quite dramatically.

Basically, everybody that matters in the world now is pretty close to floating against us. Not floating fully, freely floating, but allow much more flexibility in their currencies against us.

Two big exceptions that are on a meaningful scale. One is China, and that, of course, is going to have to change; and the other is the large part of the Gulf economies, major oil exporters, basically run today

against the dollar. Those are a little more unique and special. Those may be sustainable. But for the vast part of the more rapidly growing, emerging world, it's been shadowing the dollar.

We've had the necessary condition, not a sufficient condition for the change, which is most of them move to much more flexible currencies already. And China is left increasingly isolated. It's hard for them to be as flexible as they need to be with China following the dollar where it is. So that's going to have to change.

The last thing is just on the regulatory framework. You know, you need to have tougher capital standards applied more broadly across the system. And that will make -- that will mean -- you'll have future booms in credit, future booms in real estate; but you need to make them less damaging to the system. And the only way to do that, I think, is really to make sure that the system runs with less leverage and less liquidity risk, less panic, less run risk.

CHAIR ANGELIDES: All right, Bill?

COMMISSIONER THOMAS: I've had and will have a lot of conversations with my former colleagues that are still friends.

It's very hard for some of them to be in a room and have someone come in the room and say, "You have to do what's on this sheet of paper or the world as you know it will end."

And so the question is, yes, I think you can make that case on a couple of obvious ones. And you can completely choose not to do this now because it's really still developing. But the CIT situation, as you go down the list of those that we have to save -- I don't like "too big to fail" -- consequences of not saving them, are we really looking at the CIT situation as a 51-49, near the bottom, and it probably should have been a 49-51? Because I --

SECRETARY GEITHNER: Do you mean CIT back in the fall or CIT in the summer?

COMMISSIONER THOMAS: Even back in the fall, if you look at the business model, it was so dependent upon other things happening. And I don't see the world

ending like some others. So how do you wind up making that decision?

Of course, in hindsight, there a lot of easy answers. I'm trying to explain to them at the time that these guys come to you and say, "We've got to do all of this."

SECRETARY GEITHNER: Well, basic judgment made by the Secretary in the fall, which I completely supported, was to make sure that you put a lot of capital into the system quickly on a very broad scale; and that, you know, crisis management is about a kind of terrible choice, Bill, which is to say, which mistake -- you're going to make mistakes in either direction. Which mistake is easier to correct for over time? Which mistake causes less damage? You're making choices in the fog of ignorance and uncertainty. You have to choose. You can't just sit there and say, "Gee, it seemed kind of hard."

And I think that at that time, given the scale of the panic and the amount of damage it had already done and was still doing -- because the momentum was

overwhelming -- was to decide you were going to err on the side of holding the system together.

When we decided to push capital into the major institutions, and not just guarantee them but push capital in, we decided that we're the United States, we've got 9,000 banks. You have to make capital available in similar terms to institutions that meet some minimal test of viability. And the system that the Secretary put in place and the Chairman put in place was to let the supervisors make the judgment, you know, and who was on the right side of a line about basic viability. And that line was moving.

COMMISSIONER THOMAS: So the longer you waited, the fewer you had?

SECRETARY GEITHNER: But I did not -- I was not prepared to put more money in CIT this summer. I didn't think it was necessary. The system was stable enough, it could handle it. And I'm not sure that judgment was right because it does cause -- you know, the market doesn't move very quickly in a recession this bad to take up the lost credit capacity of CIT.

CIT was a very dominant lender in parts of the small business community. So I'm not sure that was the right decision to do it. But -- and I'm not saying it doesn't mean it was the wrong decision to do in the fall. It's just that at that point I think we had to make a choice, given the stakes there, given the degree of damage caused by the panic, to err on the side of trying to hold the system together so there's a firmer foundation. We had stopped the free-falling activity. We had taken out the acute fear of deflation, financial collapse, global depression. And once you had that foundationally in place, you had a little more flexibility to let the rest of the system go.

Now, I think most -- we allowed a lot of trauma and a lot of failure in our system, not just running up until the fall of last year, but even after that. And we -- you know, our financial system is smaller today, it's much less leverage -- the weakest parts of the system have gone away. They don't really exist in a fundamental sense. And that's a great strength of our system. It's not so fun to live with;

it caused a lot of damage. But, you know, we were up here --

COMMISSIONER THOMAS: We can heal faster.

SECRETARY GEITHNER: You can heal faster if you did, I agree.

We were here, we needed to get to here. We just didn't want to get there by going like this. So we weren't trying to hold it up here. So people were just trying to make sure that adjustment happened with less risk of catastrophic collateral damage to the innocent. And I don't think we got that judgment right until starting last fall.

CHAIR ANGELIDES: Senator?

COMMISSIONER GRAHAM: First, thank you very much for this time.

Last night we had an interesting discussion, among other things about the Pecora Commission and what lessons did we learn. One of the things that David Moss said that was not covered by the Pecora Commission was an evaluation of the effectiveness of government actions during the --

SECRETARY GEITHNER: During the crisis?

COMMISSIONER GRAHAM: -- period of the early '30s.

So I'd like to ask some questions about what the metrics you would suggest we should use if we choose to evaluate the effectiveness of government action? And I'd like to ask if you could apply those metrics particularly in what's become one of the most sensitive aspects of this crisis, and that is employment, decisions made before the crisis, during them; and as it runs through, how should we evaluate the government decisions specifically as they've affected jobs?

SECRETARY GEITHNER: That's a complicated question. Of course, you can't look back and do justice to the choice because you don't know what would have happened in the absence of the actions, you don't know all that.

My own views on this are -- and this was a classic financial crisis combined with a recession, the severity of both made the whole outcomes much worse.

In that context, almost all economists would

say, you can't solve it just with monetary policy. Because of the weakness of the financial system, you have to have very, very substantial support through fiscal policy, taxes, and investments. There is no way out of it without that. It has to come alongside monetary policy. And, of course, you've got to make sure there's capital in the financial system and you contain the panic.

Because it was hard to know how bad this was going to be, overwhelmingly, the major burden for the first stage of the crisis was all monetary policy in the Fed. It was never going to solve it.

Fiscal policy moved, again, much to Paulson's credit but didn't come early enough, forceful enough, or well-designed enough; and it wasn't done on a globally coordinated basis, frankly, until very late last year. And then all the things we did fiscally leaked and it made them much less powerful. And, of course, I think as you already said, I think we escalated late on the containment panic front.

Now, the unemployment question is much harder.

I think that, as Bill said, that, you know, the way our economy works -- and it's completely different from what you're seeing in Europe where unemployment has not risen very much but productivity growth has basically gone flat or negative -- in our system, you see the opposite response, which is that you see very, very deep initial cuts in employment, you see a lot of failure happen across the system, productivity growth rates went up incredibly rapidly. You could say that's positive for how quickly we came out of this.

Most of America doesn't think it's so terrific. Very hard to sustain. That's the basic choice of the structure our economy produces. And because we don't run a system where we force job-sharing and we constrain the ability of companies to fire, that's the kind of outcome we get.

Now, as you know, the big error that lots of economists made was in not seeing how bad unemployment would get, even if growth -- recovery growth is actually doing better than what the consensus was. It bottomed earlier, probably came back a little stronger than the

consensus earlier in the year. Unemployment much, much worse because of that. And I think that's because people underestimated the extent to which you'd see businesses do the short-term brutal thing rather than retaining their employment base.

And the question is, was that avoidable? Would it have been possible to avoid that rise in unemployment? And I don't know. I just don't know.

And right now, of course, we're debating whether we have -- how much latitude we have to bring it down more rapidly than it can come down. But when you have a -- you know, when you have -- you've had a long period where huge parts of the American economy, consumers borrowed a huge amount of income and savings were at a negative for a period of time, that's going to produce a long period of adjustment to that which is necessary, unavoidable, fundamentally healthy. But that, too, itself is going to make growth slower and make unemployment higher, longer.

And I don't know -- you cannot push money into the system now as a way to solve that problem. I mean,

it's not a problem that you can solve by having the -- in a responsible way, the deficits of 10 percent of GDP now by trying to directly just hire a bunch of people, write a bunch of checks. It's just not something you can do. We have limited scope to do that now which is a tragic thing, but it's a constraint produced by reality.

VICE CHAIRMAN THOMAS: Could I just sharpen his question?

CHAIR ANGELIDES: Sure. Just really quickly. I just want to make we sure get around, though.

VICE CHAIRMAN THOMAS: Does it have anything to do with the fact that a lot of the problem was in the home-building and the mortgage area, and that there are an awful lot of jobs there and, to a very great extent, this is probably one of the bigger gray areas of our economy in counting who's working and who's not, notwithstanding --

SECRETARY GEITHNER: Construction is much more employment-intensive --

VICE CHAIRMAN THOMAS: -- it goes through the system.

SECRETARY GEITHNER: Construction, much more employment-intensive than manufacturing, not quite as much as services, of course.

VICE CHAIRMAN THOMAS: No.

SECRETARY GEITHNER: And so if you have the correction after a long period of overbuilding, it's going to make unemployment rise.

VICE CHAIRMAN THOMAS: And it's not going to come back?

SECRETARY GEITHNER: And it will take a -- some of that won't come back.

CHAIR ANGELIDES: Byron.

COMMISSIONER GEORGIOU: Thank you, Mr. Secretary.

I wonder if you might identify what you consider some of the most serious unintended consequences of the actions of the Treasury and the Feds to resolve the crisis? In particular, whether you think the consolidation of power, financial power in a few institutions that are left standing and were provided with extraordinary assistance creates a systemic risk

that we need to worry about?

SECRETARY GEITHNER: I think you got the question right.

I don't actually think that our system is looking too concentrated now. And I think the hard thing is about the riskiness of the institution, and risking damage to the economy is not really essentially a function of size. Again, just look at Bear Stearns and Lehman and Countrywide. They were small institutions.

The big challenges, what we've done to future expectations about government support when it gets ugly, which is about moral hazard, and that's why the big test of policy is still to come in some sense, which is how effective are we going to be to put in place a set of reforms that walk back some of that moral hazard. And that's the debate we're all living with now.

And you could say there's three ways to judge policy responsible crisis. One is, how much avoidable damage do you allow to happen or prevent to the innocent, you know, to the basic fabric of the economy?

Vital businesses and institutions, how expensive it is, how much do the taxpayers ultimately have to pay for cleaning up the mess?

And the third check is, how effective are you at walking back the huge distortions created by the interventions to contain the fire? And that's about new rules. And, you know, we've attested that to come. You've got the right question.

It's important, you know, to remember that our entire banking system today, even with the investment banks now called "bank holding companies," is one time CDP. It's five times CDP in the UK, eight times in Switzerland, three to five times or two to three times in continental Europe.

We were actually quite good at containing overall leverage in the banking system relative to those economies. So losses for us are going to be a much smaller fraction of GDP, probably less explicit cost to the taxpayer on a significant scale than was true elsewhere, which is promising. But the big test again is how effective we are in changing the rules to dial

back the moral hazards created by these actions.

CHAIR ANGELIDES: All right, Douglas.

COMMISSIONER HOLTZ-EAKIN: I want to go back to the beginning and speaking of the GSEs where the clear moral hazard were completely unnoted at the time. But what I'm curious about is your view on the degree to which them having a dominant position because of the policy function and their big --

SECRETARY GEITHNER: Now or in the past?

COMMISSIONER HOLTZ-EAKIN: In the past and going in, how much did they contribute to lowering of the original *[unintelligible]* their role in the precipitation of this crisis?

SECRETARY GEITHNER: See, I don't -- I don't really think that that's a big part of the story. But I'm not sure.

If you look at the quality of their basic assets that they -- their guaranteed portfolio, it's very good. Much better than banks.

Their retained portfolio, they bought a bunch of stuff, probably because they were pushed by Congress

to buy a bunch of stuff, that may have facilitated -- that was a big portfolio, and I'm sure we may have facilitated that. But I think if you look at the scale -- I have to go back and look. If you look at the scale of that stuff that was originated in the United States, and where that ended up, you know, a lot of it ended up in German banks and in the special vehicles, it was a bunch of European banks. And a bunch of that ended up much more diffused around the world.

Would it have been possible with the GSEs that were buying some of that stuff? I don't know, it's possible. That's a good question. I haven't looked at the relative magnitude of it.

CHAIR ANGELIDES: Peter?

COMMISSIONER WALLISON: I'm tempted to ask you where we agree, but I won't. Not now.

SECRETARY GEITHNER: Okay, that's your question. That's your question.

VICE CHAIRMAN THOMAS: He was tempted, I was resisting -- He's resisting the temptation.

COMMISSIONER WALLISON: Here's my question --

it's really a two-part question.

SECRETARY GEITHNER: Uh-oh.

COMMISSIONER WALLISON: Why did you rescue Bear Stearns and not Lehman, and why did you allow Lehman to fail and then rescue AIG?

SECRETARY GEITHNER: Okay. Simple -- again, this is something that Secretary Paulson and Bernanke talked about extensively, as have I. It's a simple but not accepted argument. The fact that your asking it today still shows how little basic acceptance we basically have.

COMMISSIONER WALLISON: I'd just like to get it on the record.

SECRETARY GEITHNER: Well, all of the statements have been on the record, so let me give you my perspective on this.

The Fed doesn't have the authority to put capital into institutions. The Fed's authority is very limited in lending against collateral.

If it's unique and exigent and the responsibility of the Reserve Bank -- in this case, it

was me, and I agreed that it had adequate collateral.

In the Bear Stearns case, Bear Stearns is absolutely systemic. It was like, you know, Stage 1 of the panic, but it was, like, an overwhelmingly powerful panic at that point.

Because we had a willing buyer who could basically assume the -- take over the firm and assume liability of the firm, with us lending a modest amount against a -- actually, pretty good collateral, we had a solution to avoid a catastrophic default.

Lehman was completely different. Different for two reasons: One is the scale of the financial panic globally was much more powerful at that point, every other institution was weaker. There was no willing buyer large enough, really, to take over the vast bulk of the obligations of the firm.

BofA and Barclays are good examples. They were the ones who came closest. They were not willing in the end, partly because they weren't strong enough to do it. And that left a hole in Lehman's -- and the hole in Lehman's balance sheet was much, much bigger than

Bear Stearns. The Fed could not fill that hole by lending, by putting capital in, and could not responsibly guarantee the liabilities. We didn't have legal authority to guarantee liability, and we were not willing to lend into a run. Just like we were in the Bear Stearns case, lending to a run. We lent for 24 hours in the Bear Stearns case, really, just to get them to the point where they could buy.

AIG -- inconceivable to me, going into the weekend, that we should or could do anything about AIG. I was completely against it. I thought it would be a mistake, not necessary. But I thought about it a lot. I spent a lot of time over that weekend when we were doing this, looking at the way the insolvency regime would work for a global insurance company, and looking very, very carefully at the alternatives and what their basic balance sheet looks like. And I think there were three things that were sort of clear in the end.

One was that it would be a terrible mess, much worse than Lehman. Because they had Lehman-type risks for the entire system, but they also were an insurance

company. They had written a huge amount of contracts. They would have the classic retail insurance panic that would have, in our judgment, made it much worse. So it was -- I learned something about it over the weekend. Interesting. The insolvency regime had no capacity of managing. It would have been just a terrible nightmare. Remember, it's 80 countries, 50 states. Not designed for this. We spent a bunch of time with the insurance people, the experts on how this thing would work, it was a terrible, terrible mess. I can't be sure, but that was our basic deduction.

The other thing was, in the eyes of many people, their underlying insurance companies, which are generating a lot of earnings over time, made the whole company basically probably conditionally solvent if they could be funded. So we could make the argument, legal argument, that we had the ability as the central bank because we were lending against collateral. Congress had authorized that in 1930, or nineteen-whenever, when they did that. And as long as there was enough collateral to lend against, we had real companies

operating businesses that were generating a huge amount of earnings over time, huge market share.

Lehman was like -- you know, it was like a bunch of people. It was going to go away in a heartbeat. It was already bleeding at an accelerated rate. So it made the legal options available to the Fed different in the end. So that's the simple -- that's the simple explanation.

COMMISSIONER WALLISON: Just to follow up then. The nub of my question was, why did you rescue Bear Stearns? That is, what is the impulse for rescuing a Bear Stearns, not the power to rescue.

SECRETARY GEITHNER: It wasn't --

COMMISSIONER WALLISON: -- and then same with Lehman and --

SECRETARY GEITHNER: For two reasons: Because it was systemic and because it was an option for doing so. So if it needed both, okay -- if it wasn't systemic, we would have been indifferent to it. If it was systemic but we had no option, we wouldn't have done it.

COMMISSIONER HOLTZ-EAKIN: Can you give us a metric of systemic?

COMMISSIONER WALLISON: Yes, what do you mean by "systemic"?

SECRETARY GEITHNER: "Systemic" is, as you guys know, I'm sure better than anybody, nobody knows what's systemic. It's completely -- you can't say it --

COMMISSIONER WALLISON: What's the rest --

SECRETARY GEITHNER: I know, but you can't say it -- there's no objective standard of what is systemic. It's a --

COMMISSIONER WALLISON: Well, what specific things did you think would happen, is the big question. What would happen if Bear Stearns had failed? What would have happened?

CHAIR ANGELIDES: And then we'll make this the last follow up so we can proceed.

SECRETARY GEITHNER: It was a very high probability at that time that what you saw after Lehman would have happened after Bear. It was exactly because of that fear that led us to work hard. We could have a

gun there to try to figure out how to avoid that.

Because I thought at that point we were already in the midst of a pretty full-scale power to run on the system.

And we did not believe -- you know, classic doctrine is:

Let the guys fail, protect the innocent, you draw a firebreak around the thing, you protect the solvent.

So we did -- you know, massive lending by the Federal Reserve against collateral, against the major non-bank counterparties in the system. Not powerful enough.

And, again, you saw that after Lehman. You saw -- even with a huge expansion of basic protections on funding, for other institutions, you saw the entire system basically come undone because people started pricing the probability that all other institutions would fail.

But you're absolutely right, there's no objective standard of what's systemic. It's only a judgment you can make at the time. Terribly vulnerable, in retrospect, to be looking and say, "Gee, it turned out pretty well. How did you know it was systemic," or

it could have been more damaging. No objective standard. You just have to look at broad measures of fear/risk.

And, again, you had -- in the United States, you had people starting to take their deposits out of very, very strong banks, long way removed, distance and risk and business from the guys on Wall Street that were at the epicenter of the problem.

And that is a good measure, classic measure of insipient panic.

CHAIR ANGELIDES: All right, what's your schedule like at this point?

SECRETARY GEITHNER: I've got to go.

CHAIR ANGELIDES: Okay, let's do this then, and a couple of things -- thank you so much for joining us this morning, as you indicated -- and we're respectful of your other duties -- we want to take advantage of this as a start, not to say we're going to have you back here every month. But we, I'm sure, will want to ask you more and more extensively and likely in a public session also.

One thing I would like to ask is if we can submit some written questions to you, we'd like to be able to do that, and I think to supplement today's discussion.

SECRETARY GEITHNER: I'm assuming and hoping we're going to get to do this in a public session more than once.

CHAIR ANGELIDES: Oh, yes. We can do it once a month -- we can schedule regular conversations with Tim.

But thank you very much.

SECRETARY GEITHNER: You guys have excellent questions. Very good.

VICE CHAIRMAN THOMAS: Could we just put on the record now that the questions we send to him and the answers that come back are still under the understanding that this is just between us and nobody can do anything with it?

CHAIR ANGELIDES: Sure, absolutely. And at the point that we --

VICE CHAIRMAN THOMAS: And restate that periodically.

CHAIR ANGELIDES: Good.

SECRETARY GEITHNER: I think what you're doing is very important. I think, you know, to pass the test of serious countries is, can you go back and look at these things with a fresh, cold eye, and do an honest assessment of what went wrong. And I'll do anything what I can to make it helpful.

(End of closed session with Secretary Geithner)

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