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## Lessons Learned: John Oros

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# Yale Program on Financial Stability

## Lessons Learned

John J. Oros

By Mary Anne Chute Lynch and Rosalind Z. Wiggins

*John Oros was managing director at the private investment firm J.C. Flowers & Co. (JCF) during the Global Financial Crisis of 2007–2009 (GFC); he is now an operating partner at the firm. In the fall of 2008, Oros worked as a senior member of the JCF team on projects involving Lehman Brothers, Merrill Lynch, and American International Group [AIG], as these firms were negotiating with lending banks, investment companies, and federal regulators to avoid collapse. Earlier in his career, Oros served as chairman of the Federal Savings and Loan Council from 1987 to 1989, during the savings and loan (S&L) crisis, when 747 S&Ls failed. This summary is based on a telephone interview conducted with Oros in May 2022; the full transcript can be accessed [here](#).*

**Regulators need to scrutinize established financial system risk management, underwriting, and governance processes, and question if they are still working.**

According to Oros, ensuring integrity of the financial system is not just the responsibility of the regulators but also of the individual market participants. In fact, many parts of the system are lightly regulated (such as nonbank mortgage companies), and it is the expected ethical conduct and internal governance procedures that are meant to establish integrity. Oros contended that the Global Financial Crisis was caused by the failure of discipline. In his view, many of the checks and balances in the financial system that were designed to ensure good credit quality failed because of conflicts of interest, competitive behavior, and excessive risk-taking, which could have been avoided. He noted:

The size of the originations of subprime mortgages, and the very, very sophisticated instruments that were created to fund those mortgages, and the lack of supervision by people who normally supervise the procedures of originating and securitizing mortgages failed. And the rating agencies all failed in their duties to properly insist upon adequate credit quality. Ultimately, they all failed.

... There were many signs that were leading up to the ultimate Lehman Brothers crisis all the way from late 2006, when Ameriquest, the largest subprime mortgage originator, essentially failed . . . There was First Franklin. There was New Century. These were institutions where, as early as Thanksgiving of 2006, were showing first payment default rates of 10% on subprime mortgages . . .

I believe there was a failure by those who were intended to bring discipline to the market to bring that discipline, principally the rating agencies—S&P and Moody's. Freddie Mac and Fannie Mae also failed to execute their responsibilities. Everyone was worried about market share. If [one rating agency] didn't give the triple-A rating, [the other] would. If S&P gave it and Moody's didn't, Moody's lost out. Freddie and Fannie were worried about losing [their share of the mortgage market to Wall Street and their securitization instruments] . . . A quest for market share became stronger

than the need to provide proper and adequate credit quality requirements and supervision for the structures.

The degree to which subprime mortgages supported triple-A-level securities was mind-boggling. In other words, the large percentage of securities that were backed only by subprime mortgages that were called triple-A was astounding.

One of our portfolio companies had a large business in creating securities, and we saw early indications of difficulties, and we, as early as March of 2007, exited those businesses, a year and a half before the Lehman Brothers crisis.

**To forestall failure, institutions must maintain adequate capital and retain some of the risk of the decisions they make. Regulations should see that they do.**

Oros was unwavering in his views on the necessity that banks and investment companies maintain sufficient capital to back up lending, and that they need to have an adequate stake in the credit decisions that they make. What happened in the GFC, as he described it, was a disconnect from these two fundamental factors:

The major problem with the financial crisis, the mortgage crisis, was that there was the ability to originate mortgages at a very high price and risk and sell that mortgage and that risk on. Ultimately, it didn't work, because everyone went to excess—Freddie Mac, Fannie Mae, the rating agencies, mortgage originators—all felt that they could originate the mortgage, sell the mortgage, and be done with it.

Fortunately, according to Oros, the regulatory changes made following the crisis seem to have been effective in fixing this problem. "Our financial institutions have never been better capitalized, and we are rich in high-quality mortgages, high-quality assets of various kinds," he said.

What we've come up with is a recapitalization of financial institutions, adequate capital standards, the Dodd-Frank Act, and the qualifying mortgage test, that all have been very, very important aspects of providing financial incentives, proper credit-taking, and taking credit responsibility for the types of assets that are originated, whether they're held on the balance sheet, or whether they're ultimately sold. Creating a higher standard of equity and creating a stake in the mortgages or securities, creating a responsibility for the creditworthiness of the mortgages and the assets of various types that are created was, I think, important.

... The financial system is in great health today. The US system is particularly strong as a result of steps taken after the financial crisis, I believe, to a great extent. Specifically, important lessons were learned—to increase the equity of financial institutions, to increase the risk sharing and responsibility for assets originated by those financial institutions, and to maintain good credit standards by originating institutions. That's what they did after the financial crisis. Those are good things.

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