**Friday, June 4, 2010**

**2nd Day – Commission Retreat**

**Commissioners Present: Phil Angelides, Bill Thomas, Peter Wallison, Brooksley Born, Heather Murren, Bob Graham, Doug Holtz-Eakin, Byron Georgiou, Keith Hennessey**

**Commissioners Absent: John W. Thompson**

**Staff Present: Wendy Edelberg, Beneva Schulte, Gary Cohen, Scott Ganz, Gretchen Newsom, Courtney Mayo, Rob Bachmann**

Phil: Scheduling Re-cap – hold days on Commission calendar. Derivatives working group will see if it can be squeezed down to a day. The TBTF fail hearing will be a single day. The remaining hearings are off. Lock in October/November dates (See Book production schedule!) Target November 15th for our deadline.

Forums in our hometowns – simple – no bells and whistles.

By next Friday – process memo on the book.

Bill 🡪 Heather’s importance on chapeters

Heather: yesterday’s discussion on process – difficult to do without first coming up with the structure of the report – chapters/groupings.

Bill: silence isn’t acquiescence.

Phil: by 1:00pm today – expressed views from Commission on the strong candidates for potential causes – then Bill/Phil/staff prepare an outline form for working framework of the report.

Byron: where does our conversation on securitization fit into this outline? Overriding theme?

Bill: Try to find a home for it in the structure we got.

Doesn’t think we can talk about baskets – but go through each number and have person that presented it – add names in terms of weight behind each point.

Bob: talk about causes and accelerators. Timing important. Propagating mechanisms/accelerating element.

PA: he looks to go through the list and determine what was a leading candidate for the trigger.

Bob: this topic will be assigned to a staff member for a development of fleshing out these themes.

PA: something that ought to be studied or determined as a leading potential cause.

Pass 1: who thinks its worthy of examination

Pass 2: who thinks it’s a underlying cause, trigger, accelerate, thematic

*Staff is preparing a list of institutions that would be covered for TBTF for debate by the Commission*

1. **Too much liquidity chasing higher returns** {PA: in the system} (No – no’s)
* Money flowing into the system
* Caused “irrational” behavior
* Cheap money – huge bets and new higher levels of risk taking
* Interest rates (particularly long-term)

{where international capital flows would be considered}

1. **Great Moderation** (Doug) {DHE: underlying condition – across the board there was a perception the world had changed – business cycles not like past, lower market risk, different mind from regulators, landscape, setting} (NOT worthy of consideration: Keith and Peter)
* Failure of pricing risk
* Greenspan put
* The ultimate moral hazard
* Contributed to regulatory environment
* Bad business cycles became a distant memory
1. **Why were warning signals ignored/not noticed/overlooked?** (Bob) [Bob: accelerate.] {All: Thematic}
* No entities focusing on signals (not rating agencies)
* Key players want to ignore
* Early warning entities not capable (accounting, profession, rating agencies…)
* Example of signal: FBI warning in 2004
1. **Failure of corporate financial risk management and governance in the financial sector** (John) [underlying condition] (No: Peter) (Phil thinks its underlying and trigger)
* Outsized compensation packages – tied to equity markets that were soaring
* Outdated models with new risk
* Long-term consequences not collaborated to short-term risks
1. **Loss of consequences for behavior** (Byron ) (Thematic)
* Lack of capital and leverage
* No “skin in the game”
* Individuals borrowed too much
1. **Capital and Leverage** (Heather) [accelerate, underlying condition]
* At every level: household, corporate, systemic
1. **Hyper-sensitive short-term liquidity model** (Keith) [underlying condition and accelerant ]
2. **Housing and commercial real estate bubble** (Doug) [a/*the* trigger]
* Should check other assets to see if there is parallel behavior
* Broadly defined
* Explosion of subprime lending
	+ Including predatory lending and fraud
1. **Securitization** [Byron] [accelerant }
2. **GSEs** (Keith) (yes – big)
3. **Failure of regulation/regulatory reform/policy** (Brooksley) [underlying condition]
* Government failed to prevent excesses
* Failure to regulate derivates and other products
* Failure to regulate shadow banking/markets
* Regulations were insufficient
* Ineffective oversight of markets and institutions

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| --- | --- | --- | --- |
|  | Markets | Products | Institutions |
| Regulations | X | X | X |
| Implementation | X | X | X |

* E.g. Glass-Steagall
* Regulatory arbitrage
1. **Mark-to-Market Accounting** (Peter) [ (staff requested memos from …. – Commission wants to see) {Brooksley thinks the institution, not the action]. On the list – Keith with two questions – is it a cause and what recommendations do you have for fixing it – send to SEC, FASB, all Peter’s institutions. PA: not causal but ) No, cause at all: Brooksley, Byron, Bill, Bob, etc. – have others look into the matter.
* Writing down mortgage–related assets to current market prices made institutions appear weak
* Spreads the mortgage crisis
1. **Over-the-Counter derivatives (**Brooksley) (accelerant in most respects (trigger when AIG collapses) (graphics needed) (Peter – should look at it but doesn’t think it is a cause or accelerant)
* Lack of federal regulations
* Role of CDS with respect to securitization (by AIG and others on AAA tranches)
* Use in synthetic CDOs
	+ Including CDS
* Equally relevant: role of OTC derivatives (millions of contracts with trillions national value)
	+ Counterparty risk
	+ Leverage
	+ Lack of transparency
* Added to panic and freezing of markets
1. **Complex and exotic products** (Phil) (Bill – was it the products or the use of the products that was bad?) Peter: naked short selling – fails. Demand for exposure to these risks.
* In housing
* In financial markets
* Opacity and leverage
* Betting and amplification
1. **Rating Agencies** (Bill) (accelerant)
* Gatekeepers
* How did this system evolve?
1. **Lack of Transparency** (Peter) (stress test memo – Wendy to provide) (accelerant)

**Too big to fail and lack of resolution authority** (Keith) (underlying condition? Trigger?) Keith – correlated risk. what will happen? Probability? Moral hazard) (Peter thinks this item should not be examined) Byron thinks Bear should have been able to fail; Peter: should have been able to fail if market was stable. Policy makers are very risk adverse. Brooksley thinks Lehman/Bear should have been saved b/c of interconnections) (Byron’s Enron’s example and market condition. CIT failure. Large institution could not fail in an unhealthy market.

* Policy makers believed they had to step in
* Moral hazard
* System not robust
1. **Effectiveness of policy in face of globalization of financial system** (Bob) (Bob: fold into #1 – essential question is the degree of the liquidity – drop it and assume as sub-issue in #1, but put regulatory arbitrage under regulation) (Brooksley: everyone does not fully recognize the globalization of the financial system – this is a basic theme) (Be surgical – Phil) (not eliminated/subsumed)
* Large international institutions in certain countries buying toxic vs. assets
* International regulatory arbitrage
* Coordination of global financial policy
* International contagion
* Global financial markets
* Comparative analysis
1. **Scale, size and power of financial sector** (Phil) (keith: large financial sector could distort policy or distribution; or create problems to economy as whole – tease 2 apart. )(Phil – policies/actions of significance that were causes) Keith: GSE’s. look through the list on where. Piece 1: influence of financial sector on policy. Separate size and scale. Heather: one is regulatory capture of political influence, 2 would be the size the financial sector represents in the overall economy which would go under TBTF. Phil: how much was borrowed and by whom? – no reasonable research on “why” expended. Phil: find certain facts – very helpful – how much we borrowed, by what means, and for what purpose (to the extent the data is available).
* By force and design?
* Outsized effect of financial crisis on economy
* Stop things? Make things happen? Change over time?
* Not a monolith
* Influence of GSEs
* Influence of biggest i-banks and biggest BHCs
	+ Look at pivot points

Byron: statute says we need to look at tax structure

Bob: Question – what is the timeframe of our inquiry? Germany collapse after our collapse- effectiveness of our responses to the collapse? Current stage of the crisis? (is the crisis over or ongoing?) Brooksley – global and domestic causes in the US.

PA: our statute is to look at the causes of the crisis – only comment on a response if it was causal or accelerated the crisis.

Byron: staff – go back to the outline you prepared and try to identify such issues we haven’t discussed – re-review and potentially include in the book.

PA: work plan – take a look at it – update accordingly; staff – identify things we didn’t talk about today – things in the final report? Do a new outline for this report and incorporate the discussion in today/ contextual items? Coherent way – QUICK.

Peter: wanted to put priorities on these things – worried we won’t get to everything.

Bill: receive revised outline, individuals rank things,

Staff: based on today – give us the definition of the crisis.