United States of America

Financial Crisis Inquiry Commission

INTERVIEW OF

JOHN REED

Wednesesday, March 24, 2010

2:30 p.m. – 3:45 p.m.

***** Confidential *****

Financial Crisis Inquiry Commission

Wednesday, March 24, 2010

--o0o—

MR. BONDI: -- speak here. It is 2:30 on March 24th, 2010.

I am Brad Bondi with the Financial Crisis Inquiry Commission. And I'm joined by my colleague, Ryan Schulte.

Our general counsel, Gary Cohen, will calling in shortly, I believe.

Also --

MR. COHEN: He already has.

MR. BONDI: Oh, he has?

Hi, Gary, sorry.

Also on the line is Brad Karp and Susanna Buergel from Paul Weiss, representing Mr. Reed. And we have John Reed.

And, Mr. Reed, do you consent to the recording of this call?

MR. REED: I absolutely consent.

MR. BONDI: Thank you, sir.

MR. REED: May I correct one thing?

MR. BONDI: Yes, sir.

MR. REED: The lawyers for Paul Weiss may be representing Citicorp, but they're not representing me.

MR. BONDI: Oh, I'm sorry. Well, I thank you for the correction.

MR. REED: I mean, I'm a retired old Citi guy; but they don't work for me in any sense of the word.

MR. BONDI: Ah, I misunderstood then. Thank you, sir, for the correction.

Let me introduce ourselves. As I mentioned, we're with the Financial Crisis Inquiry Commission in Washington. We were established by Congress in 2009 is to investigate the causes of the financial crisis and to do a report that's due at the end of this year in December of 2010 on our findings, on the causes of the crisis.

We've been tasked to look into various areas, including institutions that failed or would have failed but for substantial government assistance.

We are grateful for your time here today, and we appreciate your time.

We will not keep you very long because I know, sir, you're in Boston.

MR. REED: Okay.

MR. BONDI: And so without further ado, I'd like to get your impressions on what you believe were the primary causes of the financial crisis.

MR. REED: Well, my own sense is, there were a

lot of bad mortgages made -- that is, mortgages made to people who didn't have a high likelihood of being able to repay them. These were packaged and put into security form and sold pretty broadly throughout the world.

And, obviously, as these began to appear to be going bad, all of a sudden there was a freezing up of markets that was a combination of two factors: One was the sense that some of these mortgages were not going to be paid off and, therefore, the securities in which they were embedded would not perform as they had anticipated; and, number two, the financial sector -- by which I mean the major trading houses in New York and some other parts of the world had leveraged themselves excessively. Capital was small as compared to their total balance sheet.

Very quickly, the market said, "Hey, there are going to be some losses here. Very difficult to ascertain just how much and where; and we don't think that the people holding the paper have enough capital, necessarily, to sustain these losses," and, therefore, there became a liquidity crisis. Because if you think that somebody with whom you have a lending relationship doesn't have enough capital to cover his losses, you obviously don't want to lend.

And so there was a drying up of interbank lending, if you will, or interbank financial-institution lending. And this was the essence of the crisis.

MR. BONDI: Mr. Reed, what role do you believe Wall Street investment banks played in the origination of subprime loans vis-à-vis securitization of those loans and warehouse lines of credit?

MR. REED: I think they were a big source of demand for securities that, you know, were backed by these subprime loans.

I don't have any personal knowledge that they originated these. There may have been some Wall Street firms that got into the origination business. I'm not personally aware of that. But certainly by creating a demand, there were tons of mortgage bankers and others who were quite willing to originate packages themselves. And so the demand did come out as the Wall Street houses.

I suspect that the biggest part of the origination came from other institutions, but I don't know that.

MR. BONDI: Do you believe that there was any failures in regulation or regulators leading up to the crisis or during the crisis?

MR. REED: Absolutely, yes. There would have

been two and a half, maybe three failures. I have to sort of count them.

Clearly, it was well-known that subprime and low-doc, no-doc mortgages were being originated. It seems to me that that's an alarm bell for the regulatory system.

You know, anytime you have low-doc, no-doc, subprime -- the name "subprime" virtually suggests that there's reason that one should look at it. So I fault the regulators for not having jumped in and taken a look at just what was being originated, and so forth and so on. And so I think there was clearly a regulatory failure at that point.

Second, would be allowing the banks to get to be capitalized as they did was also something that regulators should have jumped in on. There was an awful a lot of off-balance sheet stuff, that as soon as practice had been bucked, it had to come back on to the balance sheet. So you've got to ask yourself whether it should have been off-balance balance sheet to start with or not.

And the regulators, for some reason -- because when I was working, the regulators were tougher than that on capital -- seemed to allow the industry to become decapitalized. I think they probably made the

mistake of, you know, taking a look at what is, quote, called "risk-adjusted capital," end quote. And since the securities were, in theory, highly rated, they presumably didn't think that they attracted much in the way of capital requirements. This was bad logic.

First of all, I think the concept of risk-adjusted capital is fundamentally flawed. I understand that it has been embraced and accepted by the Basel Agreements, et cetera, et cetera; but I have always thought that it was a flawed concept, and I still think it's a flawed concept.

And so I think the first regulatory failure was on the origination side; the second was on the capital side. And the thing that I say a half -- because I'm not totally sure -- I believe that under the Basel Agreements, the central banks of each country are responsible to sort of have some degree of committee about the effectiveness of the rating agencies.

If that is true -- and you can check it legally -- then the Feds certainly didn't pay any attention to what the rating agencies were doing because they certainly didn't do their job.

MR. BONDI: And with respect to the rating agencies, do you believe that the rating agencies played a significant role in the financial crisis or a role or

no role in the financial crisis?

MR. REED: I think they were a significant role because had they not granted the ratings they did, whole process of securitization and selling would have been quite different.

And so, you know, they were a necessary condition for this securitization process to reach the level and scale that it did. And so you have to say that they failed in the only responsibility that they have, which is namely to provide accurate ratings for would-be investors.

MR. BONDI: What regulations would you say are necessary for banking now or in the future?

MR. REED: More capital.

MR. BONDI: Uh-huh.

MR. REED: When you say "banking," I mean also security firms.

MR. BONDI: Uh-huh.

MR. REED: Some kind of limitation on counterparty risk lines. In other words, it seems to me that you're going to have to either have specific capital allocations associated with counterparty lines or to simply put a limit and say that the total of your counterparty lines with any signi- -- any single financial institution can't exceed, for example,

15 percent of your capital or something of this sort.

In other words, the exposure through counterparties, the intrafinancial sector exposure was the thing that, you know, sort of ground to a halt.

And, you know, these institutions have very large exposures to each other. Some institutions felt that they had offset this by using these insurance contracts, the CDS, the swaps. But the fact of the matter is, they didn't look at what stood behind the swaps.

I mean, had AIG failed, I'm not 100 percent clear what would have happened to all of the swaps that they had underwritten. And I suspect that's why the government didn't allow them to fail. But the point is, the regulation, first is going to have to regulate capital more stringently. I personally think risk-adjusted capital is an improper way to approach it.

Secondly, you're going to have to put some limitation on counterparty exposure. And you, obviously, are going to want to move to have some types of instrument traded through exchanges because that limits the actual exposure between counterparties.

And beyond that, you can get into the structure of the industry and so forth and so on, about which I have opinions, but which is probably not as

central and the other things I mentioned.

MR. BONDI: Mr. Reed, I listened to your -- I read your testimony, rather, to the Senate Banking Committee from February 4th, 2010. And I've asked that you elaborate on a statement you made.

You said, and I quote, "The industry should be compartmentalized so to as to limit the propagation of failures and also to preserve cultural boundaries."

And I believe you're talking about the banking industry, but correct me if I'm wrong.

What did you mean by that statement about it "should be compartmentalized to limit the propagation of failures and to preserve cultural boundaries"?

MR. REED: Well, it seems to me that if you and I were taking a blank piece of paper and saying, how could we structure the industry so that, on the one hand, it could serve the public as it's intended to, and yet, on the other hand, to be more robust, if you will, i.e., less likely to produce what I would call catastrophic failure. Catastrophic failure is where the failure of one element propagates around and has an impact on the real economy.

So if we were trying to, you know, create such a system, I personally, based on my experience in running such organizations, would suggest that I would

keep your major repository institutions separate from those institutions whose primary business is intermediating the capital markets on behalf of customers. And this is sort of the old glass ego. You could rewrite it somewhat differently, if you wanted, to reflect modern practices. But it seems to me you clearly do want institutions whose primary line of business is to intermediate capital markets on behalf of customers; and you clearly do want depository institutions who primarily lend to consumers and to the business community for working capital needs.

I say "working capital" as opposed to the "capital, capital." So they're not issuing equity, they're not issuing bonds, but they are making loans or providing credit for working-capital purposes.

I would create a separation, in part because the risks associated with intermediating the capital markets are quite different than those associated with more traditional bank lending. And I'd just as soon keep the two fundamentally separate.

And secondly, there's a big cultural difference. If you run under on a *[inaudible]* that's primary businesses, intermediating the capital markets, you soon become very market-oriented, you're going to be a trader, and you're going to take positions for your

own account. Because if you're in the markets all the time, you tend to do this. You have the market knowledge and the expertise. And the sets of people who understand these kind of market, and the cultural is quite different than the kind of culture that exists in a traditional banking institution and lending institution.

And the two, if they're put together -- and there are many firms today -- Bank of America plus Merrill Lynch is an amalgam of these two different cultures -- and I'm not talking about Merrill Lynch, the brokerage firm, I'm talking about Merrill Lynch, the capital markets activity -- if you put them together, the capital markets activity tends to have a big impact on the way the company is run, both from a risk point of view, from a compensation point of view, a sort of personnel policies that exist and so forth and so on.

And if it were up to me -- and there are many people who are knowledgeable who have different opinions -- but if it were up to me and I had a blank piece of paper, I would segregate the industry into compartments so that you did not have institutions that had both of these functions within them.

MR. BONDI: There's some, Mr. Reed, who argue that the genie is out of the bottle, so to speak, in our

global economy, with European banks and others becoming large and conglomerated.

Is that something you believe is achievable on a global scale or achievable even on a domestic scale? And could you elaborate on your views on whether the genie is out of the bottle, so to speak, on that point?

MR. REED: I'd say it's achievable on a domestic scale. I don't think you're going to convince the Europeans to go away from their concept of a universal bank. And, you know, I wouldn't waste a lot of time trying to do so.

There's nothing that says the structure in the United States needs to be the same as the structure of the industry every place else.

I think you'll find in Japan, that this kind of separation does exist, and you have the *[inaudible]* who are basically -- you know, they took over Lehman, and they're basically dealing with capital markets; and then you have the traditional large Japanese banks that are not.

And, you know, the Japanese banks are perfectly able to survive in a world that has different configurations elsewhere.

So, you know -- and I don't actually know the structure in Singapore, but I would guess that it's more

Japanese style than it is sort of continental style. So the idea is, you could have differences that are differences by countries certainly exist.

You are going to want to have big Wall Street firms that can compete globally. And there's no question that our Wall Street firms can do this. They can serve customers globally. In fact, I think they probably dominate the business on a global scale.

That doesn't mean that every bank in the United States needs to compete on capital market activities globally. They could compete in the banking business.

For example, I would point out to you that before the merger of Merrill Lynch with the Bank of America, the Bank of America group, which was a perfectly good bank and so forth and so on, competed on a global basis but did not have the capital markets activity associated with Merrill Lynch.

I believe that there's no genie that needs to be kept in bottles or released from bottles. I think you look at the structure of the industry from the point of view of the functions that you would hope it will perform for your economy. You do have to look at global competitiveness.

I ran Citibank from, I guess, 1984 until the

merger with Travelers. We had no capital markets capability to speak of. We competed internationally with everybody. We had no problems doing so. Earned a perfectly decent return for our stockholders; and, therefore, you know, I don't think the world has changed, and they could go back to that configuration and continue to do equally well.

MR. BONDI: And, Mr. Reed, turning to Citigroup, Citigroup has been described as an organization with many different cultures.

Could you speak to the challenges that you witnessed at Citigroup with respect to the various different cultures during your tenure at Citi?

MR. REED: Yes. I think your comment is correct.

By the way, the business involves different cultures.

The retail business is a single culture, which is very consumer-focused, very much, you know, focused on the retail business. It's akin frankly to running a retail store or being in the packaged-goods industry. We brought a lot of people in from the package-goods industry. I used to work for the bank, and they found that transition to the consumer side easy to make.

And then you have the corporate-banking side

which has its own culture. It's very customer-focused. It's obviously more sophisticated in a financial sense of the world. If you have a large global business like we did, the ability to operate globally this culture unto itself as well. It is difficult for people who have had all of their working experience in America to all of a sudden have responsibilities for global activities. It helps a lot if you've worked overseas, you understand the difference both on the customer side as well as the staff side.

You know, the U.S. is very much a culture of rules. Most societies around the world are cultures of relationships, and the rules are less important than the relationships. And you have to understand that that's true both with regard to your staff as well as with regard to the governor, government, and your regulators and also with regard to your customers.

And then you get the sort of trading culture, the capital markets culture, which exists in the money centers. You see it very much in New York. You see it very much in London, in Hong Kong, Singapore to a somewhat lesser degree.

These trading cultures are quite different than all of these others. And when we merged, of course, with Travelers, we had the Travelers Insurance

Company which was totally different. You know, if you go to Hartford and you visited the insurance company, it had a very different culture, one that was very interested in investment returns on their reserves. Because an insurance company that can get a better return on its investment of its reserves can afford to take more risks than one that does not; and they really become very focused on investment management as well as assessing insurance-type risks. A very different dynamic than the banking business.

And then Smith Barney, which is a brokerage firm and a very good brokerage firm, totally different. Smith Barney, you know, intermediate in capital markets. But on behalf of retail customers with basically salesmen who get to know the customers extremely well are less knowledgeable about the capital markets than the people in the capital markets business.

So you had a multiplicity of cultures all put together.

MR. BONDI: And how does a CEO manage so many different cultures and so many different business lines? And along those lines, was Citigroup too big to manage?

MR. REED: Well, history certainly suggests that it might have been. If you look at the results, you would have to say it didn't work. And, you know,

it’s got to be laid to the management. You can’t blame anybody else. So then there’s an issue there.

You know, when we did the merger, we did so because we thought it made sense -- and I can walk you through why, if you wanted -- but it clearly was a big company to manage. It required somebody who had a fairly decent knowledge of the various businesses, but also somebody who had an ability to practice, to make sure that you could both have differentiation of the different businesses and integration across the totality.

You may or may not know that the reason I left Citi was because Sandy and I, who was my co-executive -- we were co-CEOs, I guess, at the time -- he and I both agreed that you couldn’t run the company with two people. We were driving everybody nuts because no one knew who to come to. Should they come to me? Should they go to Sandy, et cetera, et cetera.

He and I had a deal where either one could veto the activities of the other. That worked quite well. We did things that we agreed on; we didn’t do things we didn’t agree on. But we agreed that we needed a single person.

I suggested that the two of us step down and that we bring somebody in who was from neither Citi nor

Travelers; and he disagreed. He wanted to stay.

I didn't think he was capable of running the company. Not that he isn't capable of doing other things or that he wasn't a capable manager or investor, et cetera, et cetera. But this was a big, complex, global organization with lots of pieces that, you know, he had no experience with. And he is not a practiced manager. And he doesn't have much respect for process, budget disciplines, risk disciplines, et cetera, et cetera. He very much managed things through the personal relationships, which I didn't think was appropriate for that particular situation.

We argued to the board. The board decided he was the right person. I disagreed with that; but, you know, boards make those decisions. And I argued as best I could for what I thought was right. And he stayed on. History would say that someplace there was a managerial failure and the place got out of control.

By the way, had Citi not failed, Salomon Brothers sure would have. In other words, the merger, while it created a company that the government had to come in and save, had we not had the merger, Salomon Brothers would have been on your list with Bear Sterns and AIG and so forth and so on, because it was the trading activities at Salomon Brothers that would have

been right in the middle of it, just as Lehman was and Bear Sterns was and AIG and everybody else.

So you could say that this merger created a problem that the government had to deal with. I would argue that there would have been an equal problem had there not been a merger; it just would have been called "Salomon Brothers" or "Travelers," had it not been called "Citigroup."

MR. BONDI: Speaking of Salomon Brothers, the public filings of Citigroup have suggested, certainly, that the -- that Citigroup suffered significant losses from its CDOs, collateralized debt obligations. And Citi's investment bank, Citi Markets and Banking, was run by former Salomon Brother traders. Some of them had started in the junk-bond trading arena.

Do you believe that that Salomon culture led to or contributed to Citigroup's financial problems and perhaps taking on too much risk?

MR. REED: Yes. Let me qualify. I retired April 2000, and we're now talking about events that were subsequent to that. And I did not have any contact with the company after I retired. You know, I'd occasionally run into somebody in the street or something; but, you know, no one ever called me and asked my advice -- and you're not surprised, given the basis on which I left.

So I don't have any insider knowledge. But my understanding, if you will, is that the Salomon culture, and particularly the leverage that they brought in -- you know, they were able to leverage themselves substantially because of their situation within Citigroup. And the culture of Salomon did dominate the -- you know, even before I left, some of the people from Salomon were being given broader responsibilities involving the entire capital markets activity.

And my own belief is, it was that risk-taking culture and so forth that is at the core of the problems that Citi has suffered.

MR. BONDI: How does a CEO go about reining in excessive risk-taking at an investment bank like Citi Markets and Banking?

MR. REED: You have limits.

You know, we had -- you know, when I was running Citi, we had trading activities primarily in the foreign-exchange area. We had some trading activities involving bonds. Not -- nothing compared to Salomon.

But as with regard to all risk, you have limits, you have loss limits by individual trading position and by the aggregation of sets of trading positions and by trading activities.

You know, we had trading floors around the

world. We probably had 30 or 40 significant trading floors around the world; and we had a whole array of limits that applied to, you know, what kind of positions we could take and what kind of losses we could experience.

My general rule of thumb was that when you experienced *[inaudible]*, it was about twice the limit, which showed you more or less the guys always overran the limit by the time you found out about the loss. But we were aware of that. And so we had limits that, you know, were designed to create potential losses, and we felt we could manage.

But you manage trading floors by people. You don't put people in charge of trading activities that you don't feel you can trust and who don't share your values, if you will, with you. And I have had occasions where we've removed people from trading positions simply because we didn't particularly feel comfortable with them being in those positions.

And you manage it by having a set of limits, and you have a set of auditors who you make sure -- because, obviously, you've got to make sure that people book things properly -- in fact, you've got to make sure that they book them at all.

And so you have to have an independent audit

function. We had a very strong audit and accounting function, where we often got into battles with people on how to book things. And, you know, you've got to make damn sure you book things properly.

But it's a set of processes to have human beings but they have checks and they have approvals. And, you know, just go and talk to Goldman. They do it, and they do it pretty well.

MR. BONDI: You know, Citi has publicly said in its filings that they maintained the very highest-level tranches of CDOs. These were rated above AAA. There's some that may argue that taking a position at AAA should have no limits.

Do you believe that limits still should come into play with respect to positions that are rated AAA and above?

MR. REED: Yes, because as I told you right from the beginning, I have -- and this was true when I was working -- I never thought that risk rating made any sense.

The first time when I was at Citi that we took a big loss, it was on U.S. government bonds. That was because Mr. Volcker came into the Fed and raised interest rates, and the value of our bonds dropped. In those days, banks kept bond portfolios for liquidity

purposes, and we took a big write-off on U.S. government bonds.

I was the young kid in the bank. I didn't have a big responsibility. And I said, "My, my. It turns out you can take losses on something that, you know, turns out" -- I mean, no one doubted the government bonds were going to be paid, but you had interest rate risk.

You know, I spent my life trying to collect loans from Latin American countries that we had lent money to. We were successful in getting it back, but it took ten years. And, you know, when I was in the banks, sovereign lending was thought to be relatively riskless. I think my predecessor was quoted as saying, "Countries don't go broke." And I think he's correct, countries don't go broke, but the people who lend to them do.

And so I, early on, decided that this idea of being able to anticipate risks before the fact was simply intellectually flawed. And so as we got into the debates, which sort of started in the early nineties about maybe our capital should be allocated based on risk, I rejected this. I said that as far as I'm concerned, all assets have the same amount of risk, and we *[inaudible]* associate with them, I don't care if they're AAA, AA, A, E, or what they are.

And I do not believe that bankers have a good track record at anticipating risk before the fact. And, therefore, all this risk adjustment and so forth and so on, I just think is wishful thinking.

And I would have paid no attention whatsoever to the rating on the various instruments -- AAA, AA, what have you. You would have had to have had limits on whatever instrument you were talking about

MR. BONDI: How much does compensation and compensation structures play in risk-taking? And do you have a view as to the appropriate way to incentivize employees, that they take the appropriate risk but they don't go too far?

MR. REED: Well, in the culture of a trading organization or the people who intermediate capital markets, you've got to be careful. When I joined the industry people, you know, I used to have a feeling for some of our customers who have been in the investment banking business, and particularly Morgan Stanley, which we were close to at the time.

In the beginning, they were very customer-oriented. And my guess -- and I don't know this for a fact -- but my guess is the compensation didn't particularly affect the sort of risk profile of the firm.

But as trading became more important and as profits from proprietary positions became more important, then customer business less important, then I think compensation begins to play an important role. I don't think compensation and traditional consumer lending or compensation and, you know, traditional corporate banking makes much difference.

I do think compensation for customers who originate -- you know, if you're going to have a mortgage bank -- we owned a mortgage bank when I was running Citi -- you have to be very careful as to how you pay people who originate mortgages because, obviously, if you pay them just for the volume of originations, they're going to originate garbage and you're going to be stuck with it. And so you've got to be very careful at the customer center if you're talking about origination.

You also have to be very careful in trading floors where they can take positions. And, of course, they're trading on your name. You know, we you'd to have traders who say, "Well, I made $10 million this month," or whatever, and you'd say, "Yes, you made $10 million because your name is Citibank, and you have customers that are willing to deal with you. Now, how much was it because they dealt with Citibank, and how

much was it because you're this great genius?"

And so you always have this argument about why people are able to make money.

You clearly need claw-back capability. If you're going to build a business with big bonuses, which is the current characteristic of the industry, you have to have some claw-back kind of situation. You either have to say, "Hey, you're not going to be paid until we actually book the profits." Not that we just have a bookkeeping -- you know, if you're marking your mark, your books to market every day, you could have apparent profits that disappear very quickly.

And you could have a system -- I don't know anybody who does it -- you could have a system that says, "Hey, until we realize those profits, you don't get any bonuses." Or you could have a claw-back, where you have an ability to claw-back bonuses that were paid.

I much more prefer long-term compensation. I much prefer to pay people enough so that they could eat based on their salary, and then have any -- you know, anything that basically goes to their net worth accumulate over extended periods of time, either by having deferrals of your ability to get your hands on bonuses that are earned or by doing it by doing something that's related to the price of the stock.

This idea of paying people less money than they need to live but then making up for it with big bonuses, in my mind, is a flawed system.

MR. BONDI: And how do you empower a chief risk officer and risk officers in an organization like Citigroup to be more proactive? How do you empower them to be on the same footing as the business level personnel and business management?

MR. REED: Well, first of all, you just put them above them. You know, when I was at Citi, the two most senior people on my team was the head of risk and the head of HR. And I made very clear to everybody that, you know, I looked to the HR person because, you know, the quality of the people in the organization is more important, almost, than anything else.

Then secondly, our ability to take risk. And everybody knew that if there was the slightest disagreement, I was going to back the person in charge at risk.

We had a process, which Sandy stopped, whereby we had a monthly meeting which we called, "Windows at risk." And we went over -- we spent the morning trying to assess what risks were out there in the world, and then we looked at what our positions were; and then based upon the morning discussion plus our positions, we

would make decisions about changes.

I did not allow the people with line-business authority to be in that last conversation. And the reason is because the people in the business obviously fall in love with it. They are going to be seen as the people who are most expert. And so there's a natural reason to defer to them. And they're going to be the last person to have a reasonable assessment of the risks.

So if we were talking about, say, commercial real-estate lending, the head of commercial real-estate lending was not in the room when we made decisions about how big an exposure we were willing to have in commercial real estate. Because he inevitably wanted more, and he inevitably had lots of facts so that he could tell us all why we were wrong. And he inevitably was wrong.

The last person in the world who would recognize the risk coming up in commercial real-estate the was the guy who had line responsibility for running it, because he fell in love with the business, and he should. I mean, you want somebody who loves the business and loves his *[inaudible]*.

But the point in time is, you've got to be damned sure that the decisions associated with what your

risk appetite and so forth are made by people who are looking at the company's overall position and not the people running the businesses.

You can imagine, I was not very popular in Citi for running things this way; but I did it because I learned the hard way that the guys running the business are the last guys in the world who are going to have a reasonable assessment of the risk.

MR. BONDI: Mr. Reed, in retrospect, do you believe that there were seeds planted while you were CEO at Citi or prior to that, that ultimately grew into problems that ultimately led to the financial difficulties of Citigroup in recent years? Were there seeds that were planted way back during your tenure -- or that you observed others, rather, being planted that you believe ultimately led to the problems that Citigroup suffered in recent years?

MR. REED: Yes, I mean, the seeds were there was the dominance of the Salomon Brothers sort of culture; our unwillingness to sort of come to grips with it.

Remember, Salomon had been absorbed into Travelers only about five or six months before the merger with Citi. So it was, by no means, you know, fully absorbed when we had our merger.

And if you look at the facts, you'll find that there were three people responsible for running Salomon which, by definition, I mean, is not a great idea.

And the seeds were planted by, you know, our unwillingness to come to grips with Salomon, and then by our unwillingness to have sort of a process-oriented management structure for the combined companies. And these, of course, were the problems that led to conflicts between Sandy and myself, and which ultimately ended up with the board and ended up with them deciding that Sandy should stay on.

And those were seeds. I don't think that, you know, the balance sheet of the company at that time was particularly a risky one. I don't think the capital was leveraged. We didn't have the off-balance sheet entities that later turned out to be the source of the problem.

I think the source of the problem came later, when this mortgage-backed securities -- I mean, there was no such thing as subprime, low-doc, no-doc mortgages at that point. But it was this cultural thing and this managerial thing that were precursors, if you will, of what later on became problems.

MR. BONDI: And, sir, if you wouldn't mind, would you elaborate on that Salomon culture during your

tenure?

MR. REED: Salomon, they were extremely able, intelligent, capable people; but they were used to taking big risks, and they were used to leveraging their balance sheet to the extent that they could.

And mind you, if you look at Salomon, I believe it had gone bankrupt three times. In other words, I think Salomon had some serious troubles at one point, and they merged -- I can't remember the name of the company, but they merged with somebody that was in the commodity business, and that basically was to keep them from going down.

And then Salomon got into trouble when, with goods and they tried to sort of corner the U.S. government market. And they had gotten into trouble. And they sold themselves, of course, to Travelers because they had been in trouble. And Warren Buffett had come in and tried to discipline them unsuccessfully. So we're talking about a set of folks who had a history here of making an awful lot of money for a short period of time, but then getting into trouble, and then making a lot of money and getting into trouble.

And that pattern continued within Citi. They were nice people, the people were -- you know, I enjoyed them, they were good folks, et cetera, et cetera,

et cetera. But these guys were serious traders. And, of course, my own view was, we were trying to have Salomon play a role that would help us serve our customers; but I never put much value on the money you could make from trading because I didn't think it meant much to the stockholders. It was so unpredictable.

And so, you know, my interest in Salomon was much more, what could we do with that kind of capability to serve our customers?

But, anyway, Salomon had a history of taking fairly big risks, making a lot of money, occasionally getting caught out. And as I say, you'd have to go back and look at the record, but I think they had gone on -- they had been in the position where they were forced into mergers at least twice and maybe three times prior to becoming part of Citigroup.

And so it was -- it was a -- and it's a big organization, and it was housed in its own facility down in southern, you know, Manhattan. And so it was a tough organization to get control of.

And, you know, when Sandy and I first went off-campus to decide how to put a management structure in place, we had agreed to have a single manager run Salomon, Jamie Diamond, who is now over at J.P. Morgan Chase.

And then when we came back, Sandy changed his mind and said, "Oh, we can't leave Jamie there alone. We've got to make it a triumvirate," which turned out to be crazy. And so Salomon had a culture of its own.

MR. BONDI: And did you ever come across Tom Mahairis?

MR. REED: Oh, sure. A nice guy from Chicago. He was head of it.

MR. BONDI: And what was --

MR. REED: A trader. Very smart, but he certainly was at the base of some of the *[inaudible]*.

MR. BONDI: Did you -- were there instances that you observed Mr. Mahairis taking risk, even back then, that you thought were inappropriate?

MR. REED: No, sir. You know, I wasn't watching his positions. I did feel that attitudinally, he was more aggressive than I am. And we tried to get him embedded within a capital markets group, which he would not have been running; and we were unsuccessful in getting that done.

There was a guy from Citi who I would have liked to have put on top of all of our -- you know, our foreign exchange, our bond trading, and our equity trading; but we did not do that.

But Mahairis is a smart guy. I don't know if

you've met him, but he's a very smart, able person. He comes originally from Chicago. An attractive personality. I like him. His wife had a first child while he was working for us. And a perfectly nice guy but aggressive. And, you know, he had a sense of what he wanted to do.

And my guess is that -- and I'm guessing -- that he outran any sort of controls that might have been put on top of him.

MR. BONDI: Now, there are some, Mr. Reed, of the philosophy that traders shouldn't control their own risks; that there should be other persons that control that risk. That traders should take the most risk possible, and that there shouldn't be any sort of self-governing of risk.

I take it from your statements that you probably wouldn't agree with that?

MR. REED: No, that's what limits are. Limits say to -- you know, the question is, why does a car have brakes?

MR. BONDI: Uh-huh.

MR. REED: A car has brakes so that you go fast. If you got into a car and you knew there were no brakes, you'd creep around very slowly. But if you have brakes, you feel quite comfortable going 65 miles an

hour down the street.

The same is true of limits. You want trading rooms and trading desks and individual trading positions to have limits. Within those limits, you say to the trader, "Hey, do whatever you think is proper, as long as you stay within these limits. You have a sense of the market, and you should feel free to take positions as long as they don't exceed these various limits."

Those limits should not be set by the traders.

MR. BONDI: Uh-huh.

MR. REED: I mean, by definition, you don't ask your kids, "Well, what time would you like to come home tonight?"

"Oh, midnight."

"Fine. Well, then let's agree midnight."

I think you say, "Mom and dad have decided that we'd like you to be home at eleven o'clock, and so would you please get home by eleven o'clock?"

And so the point is, limits should be set by people who are in the risk business. You know, at least in Citibank, our credit people and risk people set limits. We had people who had counterparty limits and so on and so forth.

Obviously, traders could say, "Gee, I think my limit is too small." But they should not be able to set

the limits. You don't -- I mean, that would be crazy.

MR. BONDI: And did you have many encounters with Chuck Prince during your tenure at Citi?

MR. REED: Yes, Chuck Prince and I used to talk every morning. He and I used to come in early, much earlier than most, and we swapped books and used to talk. He sat right down the hall from me, and I saw a lot of Chuck.

MR. BONDI: And what is your view of Mr. Prince as the CEO of Citigroup? Or do you have a view?

MR. REED: He wasn't qualified for the job.

You know, if you got a job description for a CEO of a company such as Citigroup and then matched it with Chuck's background, there wouldn't be much of an overlap.

I presume, but I don't know, that the board chose him because they felt that some of the problems that the company was dealing with were legal. If you recall, they had some run-ins with Mr. Spitzer. So they must have felt that, you know, he had some skills that were relevant to what was going on.

I don't know, I wasn't there and no one asked me.

Chuck's a very good person. He is very

definitely a "Sandy person," in the sense that he worked for Sandy for his whole life.

And I once asked him, I said, "Hey, Chuck" -- because I was working with him -- I said, "If you had a situation where you had to choose between being loyal to Sandy and loyal to the company, which would you do?"

And he said, "I wouldn't find any such situation," which was a way of ducking the question, which as far as I was concerned, meant that he'd be loyal to Sandy.

I asked him that after the merger because, obviously, it was important for me to understand, you know, just what was going on.

And so he was very loyal to Sandy for good reason. I mean, they had worked together for 40 years. And -- but he's a perfectly decent person, and I'm sure he tried very hard to run the company well. But he had none of the background that would have allowed him to have some independent judgment on how to run the company.

He did know all the people, and he knew them well; but this was sort of a continuation of Sandy's idea that he could run a big company by knowing a set of folks, which I don't believe you can.

MR. BONDI: And, I take it that Salomon

culture that you described, that wouldn't have been the type of culture that Mr. Prince was part of; is that --

MR. REED: No.

MR. BONDI: -- fair to say?

MR. REED: No. First of all, remember that they had only been bought in Travelers, you know, five, six months before, so they were just as new to Mr. Prince as they were anybody else.

And secondly -- you know, he's a good, quiet lawyer. He's -- you know, he sits and he thinks and he's smart, he's well-read and *[inaudible]*. And I think he has a sense of people, and I think he's capable of being tough with people on occasion. But he would have had no understanding of trading or risk or leverage or capital or any of the above.

MR. BONDI: A couple of follow-up questions, and that is, in your opinion, did government policies -- and by that, I'm namely meaning the affordable housing goals of Fannie Mae and Freddie Mac or the Community Reinvestment Act -- did government policies play any role in the financial crisis?

MR. REED: It's hard for me to answer that.

If the reason that the regulators didn't jump up and down and yell at the low-doc, no-doc subprime mortgage is because they felt that the Congress had sort

of pushed in that direction, then I would say yes.

If the reason that the regulators didn't jump up and down and so forth and so on on that was because they just didn't see the risks, then I would say no.

I don't think that any private-sector institution would originate a bad mortgage because they thought the government policy allowed it, unless they could lay it off to Freddie Mac or Fannie Mae or something, and sort of say, "Gee, the government wanted me to do this, and I'm doing it on their behalf."

There was probably some of that because Freddie Mac and Fannie Mae were clearly buying some of this paper. And so to that extent, it probably was a policy or…

MR. BONDI: And you've alluded to it before, and that is the originate-to-distribute model for mortgage origination.

Do you believe that the model itself of originating mortgages to distribute on to the secondary market and to Wall Street for securitization, that that model had inherent flaws, versus a model of originating mortgages to hold on portfolio?

MR. REED: And don't limit it to mortgages. In other words, once you do have a way of passing off risk, it clearly has an impact. In other words, if you

could take credit risk, if you lend money to, say, General Electric but then hedged the risk by going into the market and buying one of these credit-derivative swaps on GE, so that you'd say, "Gee, I just lent GE a million dollars, but I hedged risk by taking the swap position," that's going to affect your judgment. It will affect your risk-taking because you believe you don't have any risk. In other words, you think you've laid off the risk.

And so whether it's a mortgage-backed security or something that you could hedge in the market, the ability to quote, "hedge it," clearly has an impact on the care and your willingness to take risk.

You know, as soon as you have these instruments -- I don't want to say the model is flawed, I just want to say it's very different.

MR. BONDI: And you've touched on, certainly, the Glass-Steagall, and I know you've spoken on that.

Is it fair to say then that the repeal of Glass-Steagall, in retrospect, was a mistake?

MR. REED: It certainly, in retrospect, which is 20/20, is questionable.

You know, at the time there was an awful lot of pressure from the customers to have their banks be in a position to help them with capital markets activities

and hedging activities and so forth and so on.

And so from the point of view of the customer, the CFOs of your customer, they were sort of coming to you, saying, "Look, we'd like you to help us hedge our foreign-exchange risk or our interest-rate risk or to raise some money in the bond markets." And so there was a lot of pressure from customers, for legitimate reason, who get their additional financial suppliers banks to begin to perform some of these functions.

And some of the capital-market players were beginning to put together bank loans. So you were beginning to get a breakdown of these barriers. And so gradually, over time, you know, Glass-Steagall fell apart so at the time it made a lot of sense.

We now have experienced this meltdown. I don't think you could blame it on Glass-Steagall.

The only institution that benefitted from Glass-Steagall that was involved in this crisis was Citi.

During the crisis, the government sort of sold Bear Stearns to J.P. Morgan Chase, which up until then had not had an investment banking function much developed within it. And they sold Merrill Lynch to Bank of America, which similarly at that time had not had such activities as part of it.

So the only institution that really was in the center of the crisis, that was sort of a Glass-Steagall product, was Citi. And, as I pointed out before, I think it's fair to say that had Citi not been in the middle of it, Salomon would have. So the problem for the government would have been the same, it would have just been a different name on the door.

So, you know, I'd hate to -- I wouldn't want to go around saying, "Hey, had it not been for Glass-Steagall, there would not have been a crisis," because that's not true. There would have been a crisis, period. And the only institution that might not have been in it would have been Citi. But Salomon would have been. And so the dollars are at risk, and the dollars of the government would have had to put in and so forth would have been approximately the same.

On the other hand, if you believe, as I said before, that going forward it would be better to have some compartmentalism in the industry, then you get back into something, maybe in retrospect, the compartmentalization that was created by Glass-Steagall would be a positive factor.

MR. BONDI: I have in my notes to go back and look into that instance that you described earlier, Mr. Reed, about the Treasury -- the Treasury bills and

Paul Volcker.

Do you recall what year that was?

MR. REED: Yes, that was '79.

MR. BONDI: '79?

MR. REED: Yes. It was an interest-rate thing. In other words, Volcker who was -- President Carter appointed Mr. Volcker to head up the Fed. We had raging inflation at the time. Paul came in, in a really deft political move, said, "I'm going to control money supply, not interest rates," and proceeded to drive interest rates up into the teens. And, of course, anybody who was holding government bonds took a big loss on them because, you know, in that interest-rate environment, they were worth less than they had been when issued.

And most banks in those days, the portfolio of government bonds for liquidity purposes. As I recall, ours was about $3 billion which, in those days, was big money. You know, the company probably made profits of maybe $100 million or something.

And we took a very substantial loss on that portfolio. And so I realized right away, you know, that it had nothing to do with the creditworthiness of the paper. It was an interest-rate question. We took a big loss.

And so I have learned in the banking business that, you know, you cannot anticipate where losses are going to come from; and you certainly can't say, "Oh, this asset is fine, and that asset isn't."

But it was 1979 and Volcker drove up interest rates when he became chairman of the Fed.

MR. BONDI: Uh-huh. And we're coming off of a long trek of historically low-interest rates. Some, as you know, have blamed that historically low-interest rate environment on the financial crisis.

Again, what sort of impact would you say the low-interest rate environment of the early part of the last decade -- this past decade -- played in the financial crisis?

MR. REED: Well, I think that it was part of the background; and, obviously, there was a lot of mortgage refinancing and things of that sort because of the interest-rate environment. And it undoubtedly was, you know, part of the background.

But you would never design a banking system that couldn't operate in low-interest rates. In other words, you wouldn't say, "Gee, if interest rates are low, you're going to have a banking crisis."

MR. BONDI: Uh-huh.

MR. REED: The banking system ought to be able

to operate in low rates, medium rates, and high rates. And it's like designing a sailboat: You've got to design the sailboat for whatever wind conditions might exist. So this idea of blaming the problems on low-interest rates is simply, I think, not correct.

I think the fact that they were low contributed to -- our friend Greenspan would have called the "irrational exuberance."

In the current circumstances, where they are also low, I think the Fed has gone to great length to tell the industry, "Hey, guys, the interest rates are low and we're keeping them low for a while here, but they are going to go up one of these days, so please don't get yourself with a bunch of assets that are going to produce losses as soon as interest rates go up, because they are going to go up and you guys should be aware of that."

And, I mean, the Fed has made very clear that while this environment exists now and is going to be sustained for a while, no one should think it's going to go on forever.

And so, you know, interest rates are part of the world in which bankers have to live.

MR. BONDI: And, Mr. Reed, we've talked about certainly a lot of subjects in the time that we've had

here.

Is there anything that you think that the Financial Crisis Inquiry Commission ought to know or ought to be focused on that we might not have talked about today?

MR. REED: No, I think you've covered the key things. And I think the conversation that is ongoing, I think it's healthy for the country. No, I think it touched on everything, and you certainly have touched on everything.

MR. COHEN: Mr. Reed, this is Gary Cohen.

MR. REED: Yes.

MR. COHEN: I think this has been very, very thoughtful.

I just have an overall question for you, which days been bothering me, and it's really more of a philosophical question.

How do you think it came to be this way, where the changes that have been in the last 20, 30 years evolved in the direction to, you know, increase risk, including leverage increase? Essentially, you know, high-stakes financial gambling that I think you may have alluded to earlier, and from what seemed to be a fairly dull financial environment back in the sixties or seventies and earlier. Do you have any sort of

overall -- if you could, with your position as the elder statesman in the industry, do you have any sort of overall philosophical thoughts about how this happened?

MR. REED: Yes, I would *[inaudible]* things, I've obviously thought about it. I've actually written about it.

But, first, let's focus on shareholder value. That was new. That came into being *[inaudible]* during the eighties and early nineties. And it came into being for good reason. In other words, we had a fairly long period of time where the stock market didn't do very much, and investors were not earning much of a return, and there was a lot of pressure, particularly from the pension-fund managers on the investment managers saying, "Hey, guys, we're trying to provide for people who are going to retire, and we're not earning much in the way of returns and we're unhappy. And all of a sudden, some investors came to understand that they could take positions in a company, and then scare the management into better performance and do very well.

And there was a clear shift where power moved from management to investors. For a lot of time, managers sort of ran their companies, and if it did well, they did, and if they didn't, they didn't. But there wasn't a lot of pressure from investors.

And then all of a sudden you got into this situation where investors became very demanding, they would get rid of managements, force mergers, force divestitures, so forth and so on. And the industry shifted into -- CEOs would start out every annual report saying, you know, the sun comes up and goes down with shareholder value.

And so this was a big philosophic change, and it had a tremendous impact on management looking at short-term sort of things. And this still exists to a significant degree.

The second thing is, clearly, we fell in love with markets, particularly the financial sector but even more broadly. There was a feeling that market values -- which, of course, change every day -- reflected reality, and we should mark our books to market and that, you know, marking things to market would keep you on your toes, and so forth and so on.

And I think it was the combination of this focus on shareholder value which, of course, is the form of marketing to market as well, and the idea that, you know, markets really communicated an awful lot of information, and when they jumped and so forth that one should pay attention to them.

And I think, like everything else in life, it

got carried away. I mean, the financial sector particularly got interested in making money. When I was young, we were interested in serving customers. The money we made was that which was left over after you did your job with the customer. I never heard anybody sort of say, we should just make as much money as we can. It was always, try to serve the customer. And that shifted.

And so I think it came from those two sort of philosophical things in the sense that stockholder value was everything and, secondly, that somehow the market accurately reflects all values. And if your stock goes up, you must be doing good things; and if it goes down, you must be doing bad things, and et cetera, et cetera.

And it did change attitudes. It was inconceivable to me as an old-time person, that you could have the entire banking community basically go bankrupt. And that's what they did. Had the government not stepped in, I believe every major player would have gone down. And maybe Goldman would argue that they wouldn't have, but it would have been awfully tough for them.

And so I'm astounded that we became so blindsided that we could get ourselves into that position.

MR. COHEN: Okay, well, thank you.

MR. REED: Okay.

I hope it is useful, because *[inaudible]* report would be beneficial to call me up, you should feel free to do so.

MR. COHEN: Okay, and if you have any articles or, you know, presentations in the past which by some small chance we actually missed, you should feel free to send them off to Brad.

MR. REED: Okay, I'll take a look.

I wrote something for the American Academy of Arts and Sciences once, before this crisis on the shareholder-value thing. And I may just e-mail you a copy of it.

MR. BONDI: That would be wonderful, Mr. Reed.

I'll give you my e-mail. It's BBONDI, B-B-O-N-D-I --

MR. REED: Okay.

MR. BONDI: -- at FCIC.GOV.

MR. REED: Okay, got it.

MR. BONDI: And if, by chance, we do need to reach out to you, what's the best way to reach you?

MR. REED: I have a secretary. Her name is Terri, and it's at 36CFR1256.56: Privacy And you could just call her up.

MR. BONDI: Wonderful, sir.

Well, thank you very much for your time today. I really appreciate it, and I've enjoyed this conversation.

Thank you.

MR. REED: Okay, well, I appreciate it. And hopefully it was helpful.

MR. BONDI: Yes, sir.

MR. REED: Have a good one.

MR. BONDI: Thank you, sir.

MR. REED: Yes.

MR. BONDI: Bye.

MR. COHEN: Okay, bye-bye.

MR. BONDI: Going off-record. It is -- the time is 3:45 p.m.

(End of interview with John Reed)

--o0o--