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Wendy Edelberg
Executive Director

August 9, 2010

<u>Via Email & Mail</u>
Chairman Christopher Cox
Bingham McCutchen LLP
600 Anton Boulevard
Floor 18
Costa Mesa, CA 92626-7221

Re: Financial Crisis Inquiry Commission Hearing on May 5, 2010

Dear Chairman Cox:

Thank you for testifying on May 5, 2010 in front of the Financial Crisis Inquiry Commission and agreeing to provide additional assistance. Toward that end, please provide written responses to the following additional questions and any additional information by August 23, 2010.[1]

1. Do you think the current Dodd-Frank Wall Street Reform and Consumer Protection Act is adequate in reforming the financial services system? If not, please describe your recommendations or priorities for what Congress should do in reforming the financial system.

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

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

[1] The answers you provide to the questions in this letter are a continuation of your testimony and under the same oath you took before testifying on May 5, 2010. Further, please be advised that according to section 1001 of Title 18 of the United States Code, "Whoever, in any matter within the jurisdiction of any department or agency often United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both."

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

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

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

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

Sincerely,

Wendy Edelberg
Executive Director, Financial Crisis Inquiry Commission

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

Responses of Former SEC Chairman Christopher Cox
to Additional Questions of August 9, 2010
from the Financial Crisis Inquiry Commission

1. *Do you think the current Dodd-Frank Wall Street Reform and Consumer Protection Act is adequate in reforming the financial services system? If not, please describe your recommendations or priorities for what Congress should do in reforming the financial system.*

No.

The most significant actors in the "shadow banking" system that contributed to the mortgage meltdown were Fannie Mae and Freddie Mac. Their current status in federal conservatorship, with multi-billion dollar losses continuing after taxpayers have already paid over $140 billion into them to keep them afloat, is unsustainable. The government's ongoing ownership and use of these GSEs as instruments of policy to stimulate the housing market is inconsistent with the ostensible aim of the legal conservatorships into which they have been placed, which is to restore them to financial health. This is particularly important as the conservatorships: (1) have not seriously addressed the underlying concerns raised by FHFA to justify the conservatorships; (2) have not required the GSEs to charge guarantee fees that fully reflect the cost of Treasury's Senior Preferred Stock or that build the capital base necessary for the GSEs to be considered adequately capitalized, either under the old regime, or under the "bank-like" capital standards that OFHEO and FHFA had previously suggested was appropriate for the GSEs; and (3) have required the GSEs to engage in practices that support housing at the expense of their financial well-being. Likewise, the government's completely unjustifiable practice of keeping these two GSEs off of the federal balance sheet even as they are under government ownership makes a mockery of financial reporting norms and honest accounting. Addressing this glaring omission in the Dodd-Frank Act must be the top priority of financial reform in the next Congress.

Next in importance is the inadequacy of bank capital and liquidity standards. Dodd-Frank does not adequately address the obvious failure of the Basel standards in the financial crisis, their powerful incentives for asset concentration in mortgages, their reliance on credit ratings per se, and their role in generating the mortgage bubble that led to the financial crisis. The inadequacy of the Basel standards currently in use became manifest with the bailouts of Wachovia, Citigroup, Bank of America, and hundreds of other banks whose regulators, such as the Federal Reserve, relied upon the Basel standards then and continue to do so. The failure of over 200 traditional banks since the crisis began is further evidence of the need for more, and higher quality, bank capital and liquidity. Yet the Basel process for reforming the current inadequate standards has been tediously slow, and planned implementation of the results of that process has now been delayed until 2018. This makes a U.S. legislative solution a matter of the utmost urgency, in particular for commercial bank holding companies, whose ranks now include not only such large and systemically important entities as Citigroup and Bank of America, but also the nation's largest investment banks.

The emergency actions taken from late fiscal 2008 through the middle of fiscal 2009 had the effect of transferring significant investment risk from the private sector to the government, greatly increasing the need for improved government accounting. The lack of high-quality standards for the federal government's financial statements has been an embarrassment for many years, but it has become a critical obstacle to sound financial decision making by Washington policy makers since the onset of the financial crisis. Dodd-Frank does nothing to deal with this problem.

Legislation is needed to ensure that the most significant financial obligations of the federal government are not chiefly hidden off-balance sheet, as is the case today, and that they are fairly presented in accordance with the highest standards of accounting in the private sector. Likewise, with the $2.5 trillion state and local bond market under stress because of the insolvency of state and local governments, both the protection of investors and the health of the economy require that honest accounting standards are applied in the municipal market. Federal law should mandate the maintenance of high quality, transparent accounting standards – and a standard setter with teeth – for all state and local government securities that are traded in public markets.

Additionally, Dodd-Frank has inadequately dealt with the problem of concentration in commercial and investment banking, and the correlative risk that financial failure in these concentrated industries will permeate the financial system. Indeed, the crisis itself resulted in greater concentration, as major banks were acquired or liquidated; arguably the Dodd-Frank legislation serves to validate that status quo through its distinct regime for systemically important institutions. In addition to giving the Financial Stability Oversight Council a strong incentive to protect specific competitors, rather than to protect competition which might take market share from the dominant firms, the "systemically important" designation implies government readiness to support the firms in a crisis, perversely encouraging more risky behavior despite the more stringent capital and other requirements, and thus deepening moral hazard. As former Federal Reserve chairman Paul Volcker testified about the "systemically important" designation before the House Financial Services Committee, "Whether they say it or not, that carries the connotation in the market that they're too big to fail."

Finally, the Dodd-Frank Act failed to include provisions mandating greater transparency in many important areas of the financial markets. The recent financial crisis demonstrated how disclosure that was adequate in a legal sense, but grossly inadequate in a practical sense, resulted in even sophisticated investors relying on credit ratings in structured finance offerings. This lack of transparency will become an even more serious problem as new rulemakings under the Dodd-Frank Act continue to multiply the number of forms, and their length, that are used for disclosure by regulated entities. Congress should restore the concept of disclosure to its original purpose of providing investors with clear and comprehensible information, in place of the highly legalistic, often incomprehensible, and difficult to locate disclosure that is currently the norm. Instead of disclosures that serve only to protect issuers in the event of litigation, legislation should mandate an electronic system for use by government and issuers alike that permits each piece of information to be individually searchable and that permits easy electronic collation and analysis of that information on a broad scale. In addition to permitting markets to better price risk, such a system would also greatly enhance the search for errors and fraud. Congress should also mandate a new disclosure system based on a single, integrated platform for the administration of the Securities Act and the Exchange Act, which uses interactive data for not only financial but non-financial information as well. Legislation to achieve these objectives is already under consideration in the Congress.

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

Credit default swaps, which by law were unregulated by any agency of the federal government, lacked transparency. Over-the-counter CDS contracts created financial exposures to the mortgage market that were in many cases invisible to other market participants. Absent the statutory authority to regulate CDS, no regulatory authority had a complete picture of how they affected the regulated securities markets. Moreover, what was true for the government was also true for the market. The available information about CDS and most other OTC derivatives products, as well as about market participants and trading, was seriously limited in comparison to what was available for other financial products and markets subject to the federal securities laws. Lacking such information, the market relied heavily on the credit rating agencies for analysis of the reference securities and counterparties. Both the rating agencies and CDS sellers relied upon flawed pricing models that failed adequately to consider issues such as seller-related downgrades. The failure of market participants and regulators to assess the risks of CDS exposures and the opaque disclosure of information that might have permitted its discovery became critical factors in the financial crisis as the use of CDS grew enormously over the space of just a few years. When an entire asset class – mortgages – began rapidly to lose value, the market began to question the creditworthiness of the CDS counterparties themselves. The lack of transparency meant that investors fled from exposure to both good and bad firms, in order to escape altogether from risks that were known to be sizeable but the locus of which could not be precisely determined. Since many of the affected firms were themselves mortgage lenders, the downward pressure on their equity constricted their ability to lend and in many cases threatened their viability. This in turn deepened both the mortgage crisis and the crisis for financial firms.

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

Yes, each of these factors contributed to the creation of systemic risk.

The largest derivatives dealers were units of the largest commercial and investment banks. The Federal Reserve and the Treasury effectively determined these financial institutions were "too big to fail" at the height of the financial crisis.

In almost every case, the exposure of these banks to the collapse of the mortgage market was deepened by their exposure to the CDS market and its counterparties. In some cases, the market judged a bank's exposure to the CDS market to be a negative factor simply because of uncertainty about the extent of the exposure, a lack of transparency, and a lack of contrary evidence. But even these factors alone, given the overpowering market movement to avoid hidden exposures to the mortgage market collapse, were sufficient to contribute significantly to the weakening of the largest banks.

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

The rescue of the largest commercial banks, and the largest investment banks, through the TARP and through Federal Reserve and Treasury-assisted ad hoc financing, was undertaken, according to the Fed and Treasury at the time, because they believed that these institutions were too interconnected with others in the financial system to be allowed to suffer losses or fail in the normal way according to established rules and legal precedents. The same was true for AIG, which was rescued at the very moment that Lehman was allowed to fail. Interconnectedness was never defined with precision, but I believe that the Treasury and the Fed used it in significant part as a shorthand for the exposure of a firm's counterparties to risk from credit default swaps and other derivative obligations that, the Treasury and Fed believed, would have caused large losses to those counterparties. The Treasury and Fed further maintained that such losses would then contribute to financial instability beyond the particular institutions involved. Other factors besides CDS and OTC derivatives, of course, also contributed to the Treasury and Fed decisions, most notably the firms' exposures to subprime mortgages and other toxic assets. Moreover, these other factors were not independent of the impact of derivatives. When counterparties reduced their exposures to a particular bank or financial institution over fears of its exposure to toxic assets, this included moving their derivatives positions to other dealers, quickly withdrawing the cash collateral they had posted. This intensified liquidity pressure on the already-struggling institution, deepening its difficulties.

5. *Were credit derivatives a factor in fueling the securitization of mortgages and other loans? If so, did this in turn contribute to the housing and credit bubbles?*

Yes. The use of credit derivatives fueled the securitization of mortgages by allowing banks and other financial firms to take larger and more complex risks than they otherwise would have. The seemingly inexpensive insurance provided by derivatives permitted the structuring of hedges that ostensibly managed the risk — thus enabling the issuance of more mortgages and more corporate debt within existing risk management parameters.

Since the derivatives contracts were tradable, this not only increased the number of parties that were exposed when the mortgage market collapsed, but also made it harder for the market to determine which banks and other firms wound up with unacceptable risks. Neither regulators nor market participants could assess the size of particular firms' derivatives positions and exposures, which would have allowed both the monitoring of risk concentrations at individual firms and the collation of data to determine systemic implications. Lacking this critical information, investors fled from banks and financial firms as a class, deepening the crisis.

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

The decision by the Treasury and the Federal Reserve to inject what is thus far over $180 billion in taxpayer funds into the attempted rescue of AIG was prompted, according to the Treasury and the Fed at the time, by the interconnectedness of AIG within the financial system. By this was meant the exposure of other firms to the risk of AIG's inability to meet its obligations, including in particular its contract obligations on CDS. Just as important was the lack of transparency in the derivatives market, which has also been cited to justify the decision by the Federal Reserve and the Treasury to commit to an attempted government rescue. From their perspective at the time, the Fed and the Treasury could not determine whether those who held AIG's $440 billion in credit default swaps might suffer crushing losses if those instruments weren't honored. It was thus not just the actual exposure of AIG to the credit derivatives market, but also the fact that regulators and market participants lacked the necessary information to understand the risks that these exposures posed, that contributed to the Treasury and Fed decision to mount a government bailout. The cost of this uncertainty, and the government's acting on the fear of what might ensue, was enormous in terms of taxpayer dollars.