UNITED STATES OF AMERICA

FINANCIAL CRISIS INQUIRY COMMISSION

Interview with Lawrence H, Summers, Phd

The commission met, pursuant to notice, at 2:07 p.m., Friday, May 28, 2010, in the Office of the Financial Crisis Inquiry Commission, when were present:

PHIL ANGELIDES, Chairman
CHRISTOPHER P. SEEFER, Esquire
BROOKSLEY BORN, Commissioner
WENDY EDELBERG,
DOUG HOLTZ-EAKIN, Commissioner
LAWRENCE H. SUMMERS, Phd
Director for the National Economic Counsel, and Assistant to the President, for Economic Policy
DONALD VERRILLI, Esquire,
White House General Counsel.
ALSO ATTENDING,
Marne Levine
Roberto Gonzalez
George Mariso
Michael Gordon
Gary Cohen
Greg Feldberg
Ron Borzekowski
Randall Dodd
Scott Ganz
MR. SEEFER: Dr. Summers, thank you very much for coming in today. My name is Chris Seefer, of the Financial Crisis Inquiry Commission. We were established by a statute called the Fraud Enforcement and Recovery Act of 2009 last May, and it tasks us with figuring out the various causes of the financial crisis by the end of this year.

In that regard, we are talking to many people that we hope can help us understand various causes, and of course we have identified you as 1 person to talk to. Thank you very much for coming in.

As you can see, we do have a court reporter, so you've probably been through this drill before, I'll try not to speak over you and vice versa, so we can get a clear record. If you need a break, just say so and we'll take a break. I know you wanted to make a statement before you got started.

MR. VERRILLI: Yes, thank you Chris. I'm Don Verrilli, of the White House Counsel's Office, and I'm here today representing the interests of the White House. As you know, Dr. Summers is a senior white house official, and one of the President's closest advisers.
The White House has agreed to make Doctor Summers available for the purpose of this interview today in recognition of the commission's important mission. But we all need to recognize that even agreeing to a step like this interview is an extraordinary accommodation for this or any White House to make.

We have had what I think are very productive discussions with commission staff, regarding the interview, and based on those discussions we are confident and we hope to share a sense with you that the interview can go forward in a way that helps you accomplish your important work, and that respects the interest of the Presidency.

Specifically, it is our understanding, based on those discussions, that the interview today will focus on the historical record and not on current administration policy or current events that the administration is confronting or may have to confront. We have an agreement about that?

MR. SEEFER: Yes.

MR. VERRILLI: All right then, thank you.

MR. SEEFER: So Doctor Summers, our statute tells us to look at 22 different areas. I'm going to frankly ask you about several of those
areas. But before I do, I really just wanted to broadly get your opinions to start on what you feel were the primary causes of the financial crisis. And then I'll ask more specific questions after we hear that.

DR. SUMMERS: The beginning for me, the right way to think about this financial crisis or for that matter any major accident, to think in terms of a number of factors which came together to cause the crisis. In all likelihood, in the absence of most of them, history would have plaid out quite differently.

So I like to think of the factors in 4 broad clusters. The first is the macroeconomic environment. A combination of overconfidence caused by a period of low volatility. Low interest rates, very low interest rates, very substantial capital inflows into the United States, relating to both external economic conditions in the countries, and to U.S. budget policy. The relatively easy availability of credit contributed to a macroeconomic environment that was prone to speculative excess, broken asset and debt markets.

Second, obviously these are related, you had quite a pervasive pattern of excessive leveraging
and risk taking. At one level that's a reflection of what's surely a factor in most human failure, greed, irresponsibility, and cupidity. At another level it's a reflection of the incentive arrangements that were poorly aligned, with respect to the compensation of individuals, with respect to awards, open to institutions. At another level, it was reflects failures of regulation both gaps that allowed leveraged decisions to be made without serious review or allowed commitments to be made, where such an equivalent to leverage, guarantees and the like, without serious regulatory review. And failures by regulators to fully assess risk in situations where they were engaged in review. So a situation speculative excess, combined with a situation of excessive leverage created an environment that was very easy for crisis to develop. If you would like, a very, very dry forest. The third factor was a set of evolutions in our system that had made it more brittle, made it brittle, and without the resilience that it had earlier. It could be argued for some significant interval, perhaps through the 1990s, that our systems, the argument that Al Greenspan had made at that time, had a resilience that came from credit
being provided on the 1 hand by banks, and on the
other hand through the capital markets. And that
there was some tendency when the banking system got
in trouble as it did in the early '90's, for capital
markets to take up the slack. And when capital
markets got in trouble, for the banking system to
take up the slack.

The ways in which securitization evolved, the
ways in which the shadow banking system evolved,
particularly as regards mortgages, ways in which the
derivatives markets evolve, created a system that
was very brittle, in the sense that there were a
large number of no's. Failure at any 1 of which
called the broad stability of the system into
question. And so the jump from crisis to systemic
collapse came to be a much shorter one.

A fourth factor was the lack of satisfactory
tools for crisis resolution that placed public
authorities in a situation where it was challenging
to act rapidly, decisively and legally. And that
faced them with, even if they were able to get the
legal authorities that they might wish, with
agonizing dilemmas's between on the 1 hand chaos,
confusion and potential collapse. And on the other
hand the indiscriminate infusion of large quantities
of taxpayer money, with associated risks for taxpayers and associated moral hazard consequences down the road.

So while there are many, many aspects and contributors, for me the broad list of the macro, without a problematic macroeconomic environment, we likely would have survived many of the other problems that we would've had with the problematic macroeconomic environment, but without excessive leverage and failures of regulation consequences. Quite likely it would have been less serious, even with a flawed macroeconomic environment and excessive leverage, without the degree of brittleness and non-resilience that had emerged, we would've had a better outcome. And even with all 3 of those, we might well have been in a much stronger position if we had more satisfactory mechanisms for containing failure.

I might just finally emphasize, because I realize that I didn't say it again. When I spoke of excessive leverage, the examples I used in my tone, emphasized in financial institutions. Of course excessive leverage by households, by businesses and the decisions to extend excessive leverage to households and to businesses are also part of the
leverage story.

MS. EDELBERG: Can I just ask a follow-up question? So what I keep coming back to is comments like Chairman Bernanke's. Where he said early on when we said our housing market turned, the subprime crisis was contained. And what did we know at that time, and what did we not know at that time? And the reason I keep coming back to that is that I can't help but think, given how many smart people were, would have had every incentive to avoid a financial crisis, that what led to the financial crisis was things they didn't see, or connections that they didn't see.

So with that in mind, I look at your list and there are a number of these things that we knew in 2005. We knew what was happening in the macroenvironment, we arguably knew a huge amount about leverage. It could be that there were parts of leverage that we didn't understand, but we could have understood them if we had looked in financial institutions. We certainly saw what was happening with undervalued ratios, and we understood what was happening in the regulatory environment. I would argue.

The part that I see on your list that I don't
know that we appreciated in 2005, I'm trying to roll
back some time before the crisis, is the brittleness
of the system. Is that fair?

DR. SUMMERS: Well I think it's, I made 2
or 3 points. First, the brittleness would have
mattered less if the other factors that led the
resilience of the system to be tested, had not been
present. So even if your point was completely
right, it wouldn't follow that I should ascribe the
crisis only to the brittleness.

Second, I think it's in some ways simpler to
think about the problem activities of investors
who's motivation wasn't to fix the situation, but
only to evaluate it. And who were therefore operate
with fewer constraints. Obviously very large amount
of money were lost by people who had considerable
experience and considerable successful experience.

Hindsight is 20/20, and I think in retrospect
it's clear that the macroeconomic environment was
highly suspect in the ways that I described. I
actually was I who fairly early in this 2006/2007
gave some warning about various aspects of the
macroenvironment, it corresponded to my judgment.
But it wasn't that it was an obvious judgment, a
completely obvious judgement. While it seems
obvious today, is I gave those warnings at that
time, I was aware that it was a quite common, and
really very widely held view that when the Dow
reached the 6000 range in 1996 that it had a bubble
element as well. And ex post, that judgement
appears not to have been the right one.

So I think the judgment of when you have a
bubble, all these looks much easier ex post than it
does ex ante. Any moments in markets there are
bears and the ones who were bears at the moment the
ex posts were peaks, tend to look like they were
very wise. So I don't think that the fact that
somethings were out there is quite as definitive.

I think an element, I think a very, very
important element in understanding the crisis, and
it's somewhere between like the second and third
factors on my list, was that people who buy low
investment grade credit or junk credit, believe it's
going to be credit worthy and believe it's going to
work out, or they wouldn't buy it. But they do so
with the understanding that failure is a
possibility, and based on a consideration of the
possibility of failure and the risks associated with
it. The investment in top grade securities, AAA
securities, AAA tranches, in various kinds of
collateralized instruments, comes with relatively little consideration of risk, because it's just assumed to be safe.

And so when the failure of what has previously been assumed to be safe comes into doubt, you can get a very substantial panic reaction. It's as if somebody has said, somebody has used the analogy, it would take a very little bit of botulism, the smallest risks to change life quite profoundly if people wondered about the integrity of the water supply which they had previously completely relied on as being safe. So that was in part a source of the brittleness, and that brittleness has elements in the structure of the financial system.

But it also has elements in what the size of the bubble turned out to be. It also has elements in how much leverage there was, because if there had been less leverage, even with the bursting of a bubble, the previously safe securities wouldn't have. So I understand why you are going to the question of brittleness, but at least in my view, to really trace it through, and to capture this aspect of the previously safe not being the gestalt changing, with respect to the previously safe. You'd have to look to all 4 of the factors that I
MR. SEEGER: Understanding your point about folks that invest in AAA's and perhaps don't consider losing anything to panic, one of the factors in our statute is looking at the credit rating agencies, and in fact our next hearing is going to be on credit agencies. What are your opinions about the role they plaid in the crisis?

DR. SUMMERS: There are aspects that I know more about, there are aspects that I know less about. There are probably no aspects that I know enough about. Credit ratings would be an aspect that I know less about.

There is no question that the credit rating agencies made huge errors, and that uncritical reliance on the credit rating agencies, while credit rating agencies were making huge errors, was an important aspect of the problem. And obviously the credit rating agencies and those who in regulation make use of their product, I'm talking about this, phrases like investment grade, have a lot of soul-searching to do.

I would make 2 other remarks. The first is that I think they sort of go in opposite directions. The first is that, and again, I think you will find
people who can speak to this, speak to what I am
about to say much in much more nuance than I can.
You'll find that there was some activity of the
credit rating agencies which is like what most
people's image of what a credit rating agency does.
I issued a bond, you rate the bond, and after I've
issued the bond you evaluate the bond.

There came to be at least a substantial amount
of activity, particularly in the synthetics area,
where it is at least frequently alleged that the
rating agency was a partner or at a minimum a close
advisor, or was more actively involved and rather
more extensively compensated in the design and the
rating process. And that obviously raises more
serious kinds of questions.

At a level, you know the distinction can't be
drawn with precision. If I evaluate and you rate,
If I issue and then you rate. Suppose I issue it
this way, how would you rate it? Suppose I issue it
that way, how would you rate it? How does iterative
question asking differ from cooperating in the
design? There are clearly some difficult
distinctions in that area. But I think one has to
think that where there is more extensive
involvement, that's an area that requires I think
particular scrutiny, I think it receives particular scrutiny at least in some versions of the financial legislation now under consideration.

The other point I would make though, goes in a somewhat different direction, just in assessing credit rating agencies. Is that you have a number of specialized entities concerning credit risk and is the credit rating agencies. Another who's difficulties also have contributed in a non-trivial way to the crisis is the bond insurance agencies. And the bond insurance agencies did dismally in many cases. And the 1 thing that you can say about the bond insurance agency is that their failure was not due to the incentive problem that the credit agencies had. They were in a position where they were on the hook if a bond they insured failed. So they had massive incentives to avoid it, and made many of the errors that the credit agencies made.

So my instincts would be that it may slightly oversimplify what I think is a very deep problem to attribute it in a dominant way to incentive problems, rather than to intellectual problems, given the pervasiveness of the problem, even where there were very strong incentives to avoid.

Now again, particularly in the synthetics
cooperative area, I think there were real questions that can be asked about the arrangement. The issues are a place where I have had a little bit of an occasion to think about these issues. Similarly, there are some similarities with the set of issues involved in the work of accountants auditing, designing tax policies, doing consulting business, how one draws lines. There is a place where these things have been fairly substantially considered.

MR. SEEFER: So am I understanding you correctly that when it comes to the Ambacs and the MBIA5 and I guess we can throw AIG in there when we talk about the bond insurers, that there was more a function of I guess a lack of intellectual firepower, so to speak?

DR. SUMMERS: Intellectual firepower, I think I would rather make the slightly more narrow statement that corresponds to what I have some chance of knowing. Which is it wasn't an incentive problem, in the sense that they have very strong incentives to do right. It was a judgment error, whether the judgment has to do with the unsatisfactory quality of information they received, or the intellectual judgments they made about that information, I don't have a basis for making any
judgment at all about that question.

MR. SEEFER: I understand that, another area that we're looking at, another area that the statute tells us to look at, is the role of executive compensation and compensation packages in general. And whether it's Ambac, MBIA or AIG or any other company, there are still compensation incentive structures where the managers incentives may not necessarily be aligned with the company. I mean have you thought about it at all, for the Ambac's and the MBIA's and the AIG's?

Let me go back to your 4 factors, and ask you about what you wrote, what you said in a speech before the Brookings Institution on March 13th of 2009. And in there you were talking about how there's 2 kinds of economic downturns. One, you know, monetary policy and rising inflation, and then of course the financial crisis, the spontaneous correction of financial excess, as you said. You talked about how we get 2 or 3 of these a century, and I'm wondering if you just think, given these 4 factors, that if you had the fourth factor, if you did have satisfactory tools for regulation by government, could we avoid these financial crises 2 or 3 times a century?
DR. SUMMERS: In my tone, as I spoke to the 4 factors, was to suggest that I thought that with any one of them fixed you would make the situation substantially better, and that would be my belief. If you're going to have fires, it is vastly, vastly, vastly better to have an effective fire department than not to have an effective fire department. But it doesn't quite follow, if you just have an effective fire department it's okay to have fires.

So I don't want to be heard as suggesting that with satisfactory resolution authority everything else can be allowed to rip, and that you won't have serious problems. I do think that with the right kinds of resolution authority the risk of a crisis becoming systemic and coming to the brink of bringing the system to the brink of breakdown could be quite significantly attenuated.

MR. SEEFER: Let me ask you some follow ups on your 4 factors. Several of them are in our statute, not surprisingly are within your 4 factors so far. In the article that you and Mr. Geithner wrote in the Washington Post on June 15th of last year, "A New Financial Foundation" it was called. And 1 of the first things you talked about in terms
of the macroenvironment was the global imbalance of savings, which is 1 of the first things we are supposed to look at in the statue.

Any further comment on how that contributed to the financial crisis, other than the way you explained and described in the first factor?

DR. SUMMERS: I think you have 2 or 3 aspects. There is an aspect which is that when money is cheap it's more attractive to borrowers. And the very substantial availability of funds from countries that for a variety of reasons were seeking to accumulate liquid reserves, and the posture of monetary policy reflecting concerns about deflation led to money being cheap, which in turn encouraged borrowing to buy, which in turn encouraged higher asset prices. I think that's 1 aspect.

A second, and I think logically not completely independent, but somewhat separate aspect is that a very large demand for safe assets called forth a desire to supply them, which in turn drove the creation of the apparently safe assets, which were subject to the gestalt changes that I described, and also drove the rather large and substantial activities around tranching, and the creation of synthetic securities, which may, given the absence
of transparency and with problems in regulation, contributed to the brittleness of the system.

CHAIRMAN ANGELIDES: Can I just ask a question?

MR. SEEFER: Of course.

CHAIRMAN ANGELIDES: Can I probe this for a minute? Which is obviously you've identified that there is a demand for the safe assets, perhaps 1 and that's spurred the creation of a whole set of products to satisfy that demand. But I keep thinking about the other end of the chain. Which is at the other end of the chain, at least the first set of products, before you got into the synthetics and mezzanine CEO's. What is it that drove American consumers to borrow so substantially? What were the driving factors there? Now, not to give the answer, but obviously if someone is offering you cheap money for the option, money, I can see that. But was it that people were over their skis, in terms of being able to meet their needs, wages were flat, money was cheap. People saw the ability to borrow to buy assets that they thought had appreciation? What were the driving factors at the other end?

DR. SUMMERS: I'm not sure that I can articulate them neatly into categories, but I guess
I could suggest several. First, there was optimism founded on recent experience. House prices, for that matter car prices, had been robust for a substantial period of time. The set of phenomena the economists were calling, "The great moderation" had led households to a sense that their incomes would be relatively robust. By and large those who had borrowed had... it had turned out reasonably well for a quite long period of time. And in general, this is a sort of nonscientific generalization, but financial messes, both for individuals and firms and for countries tend to made when there's a ton of behavior that takes the form of doing today what you wish you had done yesterday. When people buy things that have just gone up, because they've just went up, that's what causes bubbles. When people borrow, because people who borrowed a decade ago and it ended up working out well for them, that tends to be when you get over-leveraging. So I think there was an element in the household system.

Second, we had the innovativeness and to some extent the greed and irresponsibility of lending institutions combined with inadequate regulation. In the spring of the year 2000, Andrew Cuomo and I
issued a report on predatory and subprime lending practices, that talked about no doc loans, talked about loans with adjustable rates with inadequate disclosure of the adjustment. It talked about a variety of the other practices that became famous. So it had to do with household decisions, but you know there is a saying about life insurance, that it's sold, not bought. And something similar can be said about a fair amount of lending activity. So the absence of satisfactory consumer financial regulation, coupled with a plausible story as to why consumers were better off borrowing created strong incentives for the excess borrowing on the consumer side.

MS. EDELBERG: I want to ask a quick question on global imbalances.

CHAIRMAN ANGELIDES: Just 1 small point. So how much of any of it was driven by flat wages, need to borrow versus the optimism, the wishing you had done yesterday what you're about to do now, the availability of product?

DR. SUMMERS: You know it's-

CHAIRMAN ANGELIDES: And I don't know if there is any, I have asked the staff whether that can really be quantified.
DR. SUMMERS: Here is why I am having trouble answering. It's a terrific question, but I'm having a little trouble answering. On the hand if wages had risen, if you had a period when real wages were rising significantly, I'm sure there would've been less need for borrowing and there would have been more wherewithal to repay. And by the way, if the environment with rising wages and higher incomes, there would have been more upwards pressure on housing prices, which would have also averted some of the problems.

So at level I agree with you, and I should say-

CHAIRMAN ANGELIDES: I don't know-

DR. SUMMERS: The reason why I didn't put more emphasis on it, is because it related to the argument that was made a little bit earlier. The type of argument that was made a little bit earlier. Wages were, wages have been relatively stagnant for middle-class families for a long time. And so I'm not sure that wages that were stagnant and had been stagnant are so much a cause of the problem. On the other hand you can argue that in a period when investment was particularly strong, federal budget position was better in the 1990s, You did see some
significant wage growth. Perhaps if that whole pattern had continued, that too would have contributed to reducing these problems.

MS. EDELBERG: So on global imbalances, global imbalance confuses me for a couple of different reasons. And you seem like a good person to get clarity from. So I can understand why monetary policy would've made it cheap to borrow in the U.S. Short-term, and Vince Rinehart has this argument, that it's actually the steepness of the yield curve that matters, and that makes some sense to me. But I don't understand why monetary policy or really even certain parts of the world economy saving a lot of money means that they have to bring that money into the U.S, and invest it in assets that are part of an asset bubble. And part of what I'm looking at there, is I'm looking at the gross flows, which is the net flows. And money has gone a lot this way, money has gone a lot that way. This doesn't seem like it's an inevitability. That the global imbalances create an asset bubble within the U.S. And that it's monetary policy to blame, partly.

DR. SUMMERS: Well again, I think it was the nature of the way I laid out the factors to
suggest that it was the 4 of them coming together that caused the crisis. Which is to say that no 1 of them made the crisis inevitable.

MS. EDELBERG: Right.

DR. SUMMERS: So in that sense-

MS. EDELBERG: I'm sorry, I meant the asset bubble.

DR. SUMMERS: -I relate to what you are saying, if you, and I don't doubt that with nothing different in the rest of the world, if there had been more responsibility and better risk management systems, stronger regulation, that led to less leverage and better judgments by financial intermediaries, that it would've had a significant effect on the pattern that emerged in asset prices. So that's certainly right as well.

If the question is though why is large accumulation of reserves by China for example, relevant to this whole phenomenon, I'd come back to 2 factors, to the 2 things that I tried to get at before. That ceteris parabus, other things equal, there's higher, it's a higher level of savings in the world, and there is a tendency for real interest rates to be equalized around the world, you'll have lower real interest rates, which contribute to more
mortgages, and that many of the savers, to use, I don't know who's phrase it was, first Keynes I think and then Frank Amagiani's phrase. Preferred habitat. If you had a substantial increase in saving on the part of those who had a preferred habitat, in safe liquid securities, then that's going to affect the relative pricing of safe liquid securities, which in turn is going to influence the incentive to create them, which in turn is going to influence the EPG, Treasury Bills, AAA tranches. Which in turn is going to influence the demand for the assets with which they can be attached, mortgages and ultimately housing.

MR. SEEFER: You mentioned the paper that you and Mr. Cuomo came out with in the spring of 2000, when you were talking about irresponsible lending practices and predatory lending, and you and Mr. Geitner mentioned the same thing, in the June 15th, 2009 Post article, and surprise, surprise, our statute tells us to look at the role of fraud and abuse in the financial crisis.

CHAIRMAN ANGELIDES: Is there a statute that they tell us not to look at?

MR. SEEFER: And I believe that you are also on record as saying, "If we would've had a Consumer
Protection Agency it would've been able to protect against these subprime abuses."

So I guess I have a two-part question. One, generally do you have opinions on the role of fraud and abuse, in particular predatory lending in the crisis, and why do you think having a Consumer Protection Agency will help, since I think we've had some failures in regulation which contributed to the crisis too?

CHAIRMAN ANGELIDES: Or maybe the question is why it might have helped—

MR. VERRILLI: I prefer the Chairman's formulation of the question.

CHAIRMAN ANGELIDES: That's fine, that's fine. It was inadvertently effective.

DR. SUMMERS: If you look at certain areas where you see the greatest problems emerge in the housing market, you also see the highest fraction of mortgage activity that would fall within the kinds of categories that Secretary Cuomo and I had identified in our predatory loans document, you would have no down payment loans without documented income, substantial adjustability in rates, that was poorly disclosed, inadequate appraisal practices, questionable compensation arrangements, involving
all participants, the realtors and so forth.

So I think the nexus between some of the most problematic elements of the housing market in the lending practices suggested by the pervasiveness of the lending practices, and their particular pervasiveness in the places where the housing market was most serious.

With respect to the question consumer financial regulators, I think there are probably 3 arguments. First, when you have consumer responsibility in the agencies, whose primary mission and criteria for success is safety and soundness, inevitably there will be some tendency to prefer things that contribute to profitability to things that might interfere with profitability. Even with the best motives and judgment.

Second, you have a substantial amount of consumer lending activity, an activity that placed substantial pressure also on activity in banks took place outside the banking system. And it is to be expected that activities placed in banking agencies can place consumer lending and banking agencies, however you define those agencies, more attention would be paid to banks then will be paid to non-banks, as in fact proved to be the case.
Third, there is just a cultural if you like, feature around those who are appointed to the positions and those who are at political level decisions, and those who choose to spend their career in the civil service positions, that when the primary mission is around monetary policy, or when the primary mission is around safety and soundness, those who will end up with the responsibility will be people who have more experience in and more passion for what is the primary mission.

That's why over time we as a country have come to have large numbers of independent regulatory agencies, rather than place all the responsibility with some focus in the mission. So those seem to me to be the reasons why one would expect that established in December, the Occupational Health and Safety Administration will lead to more focus on occupational health and safety than placing the responsibility of the Commerce Department whose mission is to promote America and economic growth, one can give a large number of similar examples.

So those are the judgements that have lead me for quite some time to favor a Consumer Protection Agency.

MS. EDELBERG: I'm sorry, I just want to
make sure I understand. And I'm not talking about any of the legislation that's being proposed, just thinking backwards. Would you include, so when you said monetary policy, my ears perked up. Are you saying, does that even include the Federal Reserve? Right? That the Federal Reserve with its primary goal of monetary policy, then the people who are rising up through those ranks were most focused on that primary mission, and not on regulation, and perhaps that was true at Treasury, perhaps that was true at other?

DR. SUMMERS: Well I think that was, I mean my comments really went, the Federal Reserve, and there are people in this room that probably know more about the structure from year 1. Probably know more about the details of the structure of the Federal Reserve than I do. But I think it would be fair to say that the Federal Reserve employs a substantial number of people whose mission is around helping to calibrate and set monetary policy, including monetary policy with a view towards financial stability. It employs a substantial number of people whose work is focused on various aspects of financial market conditions and financial suitability, including in particular the supervision
of financial institutions. And it employs a significant, but I suspect quite a bit smaller number of people whose mission is around consumer protection or the enforcement of anti-discrimination statutes and the like.

My comment was to suggest that the orientation of the institution was heavily enough to the first 2, to make you wonder about the third. But I think you may have been seeking to see whether I was expressing a view about the second, relative to the first. And I was quite consciously not saying anything about that.

MR. SEEFER: Obviously 1 area we're looking at was the growth in subprime loans and broader non-traditional mortgage loans over time, and the reasons for that growth. And areas that we've been looking at include the originate to distribute models, securitization, whether that was creating demand for all the GSEs, and other things that escape my mind right now. But do you have any opinions on the causes of the growth of the non traditional mortgage product in the decade of the 2000s?

DR. SUMMERS: As you noted, a great deal of the growth took place in the 2000s, took place in
particular over a period when I wasn't in
government, wasn't in the financial markets and
wasn't especially watching. So you'll have access
to the people with a keener sense than I.

My impression is that in a period of quite
robust housing price performance, default rates on
almost every kind of loan had been very low for a
long time. And therefore it appeared profitable if
the experience of the previous period continued to
hold. To make loans, even loans underwritten to
less rigid criteria than had been the case
previously.

Entrepreneurs sought to do that. The
additional public policy, subsidy to the activity
that was provided by the fact that the GSE's were at
a certain point significantly encouraged by being
given low income credit, or credit towards their
affordability goals, to hold these loans was
obviously a reinforcement, both in a direct
financial sense, and probably a broader moral sense
to this kind of activity.

What fraction of the... to what extent they
bear responsibility, that the GSE extension in, to
what extent that's responsible for a large part of
the growth in subprime predatory, or small part of
the growth in subprime predatory is a question in your place. I would think was an important one, but not 1 where I know enough to presume to venture a view.

I think it is legitimate to explore the extent to which we may, there are other aspects that are appropriate to explore here. I have raised questions during the time I was at the Treasury about the magnitude of the implicit subsidy through the aura of government credit support, and how large a subsidy that was to the GSEs. Some of which flow to their shareholders, but some of which flowed to the nation's housing market, and flowed therefore into housing. And the magnitude of that all increased, both as their activities expanded quite substantially, and as their leverage increased. There were efforts I made some, Chairman Greenspan made some in the very late '90's and the early 2000s to address the questions that were raised by the GSE.

There is a broader question to be asked which goes to the very substantial benefits that our society generates from being a society in which families are enabled in many circumstances encouraged to own their own homes on the 1 hand.
But on the other hand homes are large, permanent rather illiquid assets, and home ownership may not be appropriate as an objective for people in all circumstances. Certainly, the suggestion has been made, in so far as it caused gazes to be averted from some of the more egregious subprime practices, so far as to cause some lack of scrutiny of the GSEs at a certain point I think it was problematic around the approach we as a country take, in terms of the degree of encouragement of home ownership.

But the other hand we have derived enormous benefit as a country from home ownership. There's all kinds of evidence on the benefits for children, and families that own their own homes and so forth. So I think it is an area that needs very considerable thought and there obviously were some excesses in the kinds of ways credit was provided, but I wouldn't presume to judge where the right balances were.

MS. EDELBERG: Should we be thinking of putting the subsidy to the GSEs in the same category as all of the subsidies to home ownership in the tax code? Whether it's the relative tax rates for homeowners, versus renters, the fact that you can write off mortgage interest?
DR. SUMMERS: Just so we're all clear

MR. VERRILLI: That would be great.

MS. EDELBERG: My question was totally theoretical.

DR. SUMMERS: Just so I'm not being misunderstood. The GSEs currently are in conservatorship, so you are in a rather different framework than we were previously.

With respect to the previous question, there are sort of 2 questions, to analyze the GSEs, and I don't know whether I was written while you were the CBN director or not, Commissioner Holtz-Eakin, but CEO has periodically written reports that say in careful ways what I am about to say.

To reach the question you first have to decide how large the subsidy was to the GSEs, which depends on the judgment of what their creditworthiness is, and how to think about their creditworthiness in the absence.

Second, in so far as you have formed views on how large the subsidy is, you need to decide to what extent it's being passed on to homeowners, and to what extent its sticking to their shareowners. My suspicion is that analysts would tend to judge that the GSE subsidy, while important in a number of
respects, was probably not huge, relative to the tax subsidy. Or to take another issue that is vexed, the aspects associated with the deductibility of property taxes.

MR. SEEFEER: You found stickiness though?

CHAIRMAN ANGELIDES: Yet the bulk of the subsidy went to the shareholders, a de minimis base point reduction, in Morgan Chase.

MR. SEEFEER: Turning back to causes for the increase in non-traditional mortgage products. Another thing we've looked at since we first asked you this question. In 2003, you saw the big refi boom, and then after that the feds started to tighten. I think you saw, I think relatively more home purchase loans that you did refis. In your opinion did monetary policy and other factors in that part of the decade contribute to the increase in non-traditional mortgage loans? Do you think it had any role?

DR. SUMMERS: Monetary policy was itself responsible to a whole range of macroeconomic conditions, including a set of issues associated with the pressure of capital inflows, in intervals when short-term interest rates rose for some time. But there was less impact on long-term rates than
many expected. But I was not watching markets closely enough for me to have an opinion that would be particularly helpful for you.

MR. SEEFER: According to a transcript that I saw at least of an April 22nd 2010 PBS news hour, it was about you. You know that you said that there was no question, you know, that things had happened on Wall Street, where the reason we had this financial crisis and you mentioned a couple of things. Mistakes on Wall Street, the mortgage area, the subprime bubble, house price appreciation, loans that borrowers could not afford, and you said that credit errors on Wall Street brought financial institutions to the brink of insolvency.

Can you maybe give us a little more color on the mistakes that were made in the mortgage area, and then in credit errors that were made on Wall Street? Or was the transcript wrong?

(Laughter.)

DR. SUMMERS: No, the transcript was I assume right. That always makes me nervous when people read back things I've said. But that one actually felt fine.

(Laughter.)

As you were reading it back, no, I'm just not
sure that I've got a lot to add to what I've been saying. There were obviously very substantial misjudgments of the risks associated with mortgage-backed securities that were made by many financial institutions to purchase those securities, and as a consequence lost very large amounts of money. And those errors, as a matter of logic could have been averted by, if the houses on which mortgage were written had not collapsed in value, then there couldn't have been those errors.

If there had been limits on the leverage, and the initial equity in those houses, then even if the houses had collapsed, there would have been much less money lost, if the guys who held mortgage-backed securities or contemplated holding mortgage-backed securities, had foreseen the risks associated with them, and paid appropriate prices, they wouldn't have lost large volumes of money that would've been a major source of risk associated with the system. And if they have been prudent in their diversification and in the extent of their risk-taking, the magnitude of the consequences of their errors on the first 3 points would have been less serious for the health of the financial system.

MR. SEEFEER: Obviously it's always hard to
call a peak, and you know very few people are successfully calling peaks and troughs, but I really want to ask though, why were there such serious errors in judgement given the underlying quality of the collateral, I mean you had . . . and there were a lot of, it seems to me, yellow and red lights going off. Home prices rising at 10, 11, 15 percent a year. I think certainly a level of knowledge about the type of instruments in the market, no doc loans, very high debt to income ratios, extraordinary, no proven ability, no respective ability to pay. So loans really made on rapidly escalating collateral prices, without ability to service the loans.

Knowledge which I guess to many people wasn't available, that we really did have a . . . you now hear no one could have anticipated a 30% decline in national house prices. Of course many of these securities become impaired by mid 2007, when house prices have dropped off 1 or 2%, and we had a 2% drop in the '90 to '93 area. Of course mostly driven by regional drops.

I guess just fundamentally, if you step back, why was there such, do you think, a lack of understanding, a lack of due diligence, the magnitude of error about the underlying
collateral?

Dr. SUMMERS: I think you would be much better advised to ask those who made these errors. To ask those who made these errors what they're thinking and their judgments on that question would be much, much more valuable than my judgment. I think it seems incredible in retrospect, but much always seems incredible in retrospect. The fact that something that was very commonly said in those days on a national basis, house prices had never come down. It had never happened over a 50 year period, and people thought therefore that meant that it wouldn't happen. It is a substantial contributor. I'm not able, I don't think I ever knew, and certainly don't know now the precise dynamics of the pricing of these securities. I suspect that when they failed in 2007, even if house prices had not fallen much yet, the decline in mortgage-backed securities reflected what was at that point a reasonable expectation that there would be significant declines in housing prices. So it's not that they were so leveraged that they were vulnerable, that they were that incredibly vulnerable to a period of stagnant house prices.

There are a set of questions about mortgages.
There are then a set of questions that I don't feel at all authoritative on. But I think they are perhaps relevant to your broader inquiry, having to do with how these judgments were made. Judgments about risk made by the people who were doing the trading? Were the judgments made independently? How is the process of coming to judgment supervised? These are all questions in terms of, there is an element of understanding the cognitive aspect of why an error was made, and then one has an explanation of what the cognitive pattern is. There's still the question of what kinds of scrutiny were applied to the judgments when they were made. And there is the question of what kind of conviction, how much was put at risk around this.

And then I think there's also an aspect which I touched on earlier, which goes to the question of resilience. Which is the consequences for the system of 1 financial institution making mistakes alone is very different than the consequences for the system of multiple financial institutions making the same mistakes. Because then when it comes time to unwind, everybody is unwinding in the same direction. That goes to various incentive problems. Keynes wrote famously about it being better to be
wrong conventionally, than right unconventionally. I'm not sure whether that's right or not, but I'm sure if you are going to be wrong, it's better to be wrong conventionally, then to be wrong unconventionally. That leads to a fair amount of band-wagoning.

MS. EDELBERG: So now is the perfect time for this question. We have been struggling with common shock versus liquidity shock? Well no, there's 2 different shocks. So there is the question of-

MR. VERRILLI: I'm sorry, I'm just asking Dr. Summers whether he wants a break.

DR. SUMMERS: No, I'm okay. I can go for the whole session.

MR. VERRILLI: Just let us know.

MS. EDELBERG: Okay. So 1 of the things that we're struggling with is that a lot of financial institutions get in trouble all at once, and there's a question as to whether that's in trouble all at once. I guess that's part of the hypothesis, that they got in trouble all at once. And part of this hypothesis is, they got in trouble all at once because they were all basically exposed to either the same asset, which was the mortgage
shock, or actually they were all exposed to the same utter dependence on liquidity and they were basically just all exposed to a liquidity shock. Or there was some shock, there was little bit of E coli in the system, and we actually had contagion and it spread through, due to interconnectedness. Does that seem like a fair, yes? So we are trying to differentiate between those 3 stories.

DR. SUMMERS: I know this sounds like a wiseguy answer, I don't mean to give a wiseguy answer. I can't really walk across the street without both my right shoe and my left shoe, and so I don't quite know how to answer. Is it my right shoe that causes me to walk across the street, well yes. Does my left shoe cause me to walk across the street? Yes. Is it both my shoes? So I think the answer is that all of those were present. I think it is certainly the case that many of the same judgments were reached in many financial institutions. And so when those judgments proved to be problematic, the problems were common to many institutions.

Second, when the errors were propagated, the fact that the institute judgments were common to
many institutions meant that it was difficult to unwind the securities. In the speech that you referred to earlier, I spoke about a variety of different vicious cycles that kicked in 2 or 3 times a century. The first of those was de-leveraging, leading to Sally, leading to more de-leveraging. And so you have a kind of contagion that comes from that, reinforced by losses make lending more difficult, make losses on other capital assets.

And then you have the elements of illiquidity that clearly were coming from rising credit spreads coming from changing macroeconomic conditions. So I don't know that you can ... if all 3 were important and all 3 were importantly, at least to my mind, interconnected and I don't know that you can precisely say what their relative importance was.

CHAIRMAN. ANGELIDES: Can I?

MS. EDELBERG: Yes.

CHAIRMAN ALGELIDES: Another question that is related in a way is this. The dot com bubble was about a 5 or 6 trillion dollar shock, the housing bubble was about a 5 to 6 trillion dollar real shock, the latter appears to have cruised to financial crisis, the former did not, why?
DR. SUMMERS: The largest simple
explanation of it-

CHAIRMAN ANGELIDES: We're doing our dirty
laundry, these are the debates we've been having.
We're letting you adjudicate all of them.

MR. SEEFER: Or suck you in, 1 of the 2.

DR. SUMMERS: In many ways it's an
incomplete answer, but I think the first sentence
is that if Larry Summers loses a dollar then he's a
dollar poorer. As a consequence, he will spend
less, maybe he'll spend a nickel less, that way
he'll lose the dollar over his life. Maybe he'll
just feel he's got to get it back this year, and
he'll spend a dollar less.

If a bank that has a tier 1 capital ratio of 5%
feels a need to maintain that 5% tier 1 capital
ratio loses a dollar, then they have to rein in $20
of balance sheet activity, and so it's the
difference between the nickel when the assets sit
proximately within an individual who is going to
spread it over time, and the $20 when the assets are
sitting heavily at a levered financial institution
that I think is the beginning of understanding why
it's so much more serious.

COMMISSIONER HOLTZ-EAKIN: So that was my
first answer too, I was leveraged, I wasn't. So my next question is, why? Why didn't we see this sort of derivatives and financial innovation against the dot com stock bubble that we saw against the housing bubble?

DR. SUMMERS: Can I ask for clarification here?

COMMISSIONER HOLTZ-EAKIN: Sure thing.

DR. SUMMERS: I guess the leverage was inherent in the nature of, of course some of that stock would have been leveraged, correct? Not nearly to the same extent.

COMMISSIONER HOLTZ-EAKIN: That's where I'm going next.

DR. SUMMERS: Okay. I think that would be. It's been a while since I was a more pure academic, and thought about-

COMMISSIONER HOLTZ-EAKIN: Welcome to my club.

DR. SUMMERS: Thought about these kinds of questions Doug, but I think 2 aspects that I might want to think about are the volatility, at least as it was judged as of that time, associated with stocks, was very substantially greater than the volatility associated, I mean any theory of leverage
would emphasize that you lever more that which is less volatile. And the volatility of stocks was quite different.

Second, the leverage associated with commercial real estate. I think that's probably the most important thing. Second thing is people like to live in their homes. People like to begin living in their homes that they are going to own at a relatively young age, before they have accumulated sufficient assets to buy it. And therefore the substantial leverage derives from the desire to live in a house before one is in a position to buy the house for cash. In contrast, the dominant, sort of the dominant role of housing is to be lived in. A dominant role ultimately is of stocks, is to prepare for one's retirement or to save. So if you look at the leverage of stocks in the United States, the feasible amount of leverage is much less than it would be on houses. Nobody can borrow 80 percent on their stocks, because of the different volatility, but for the most part, stocks are not levered to the extent that they could. To the extent that they could be levered, reflecting judgements about risk and return and savings for retirement, and the degree of volatility that would be associated with a
levered portfolio isn't something that most people would be likely to want. You do see substantial leverage in the small business area, and you've seen some of the kinds of adverse developments, vicious cycles in community banks and the like.

MS. EDELBERG: But that gets us into foreclosure crisis, some part of our foreclosure crisis. At least the 1 before you get the feedback effect from the economy tanking. But that doesn't necessarily get us ... so I can understand households leveraging, typically leveraging their home gets us maybe more foreclosures. But it doesn't get us why the financial system didn't figure out how to leverage the dot com bubble. And certainly at the time there was lots of rhetoric about how we're in a new economy, stock prices are never going to come down, it's a brave new world. So why didn't the financial system figure out how to do this? Why did they only do this with housing? Is that it?

Dr. SUMMERS: Well I think part of the answer to that, partly volatility-

MS. EDELBERG: You said volatility-

DR. SUMMERS: Volatility. You know I think relative to what's actual volatility. It's
often said that people have a tendency to confuse price discovery with price volatility. And so you see in the stock market a price every day, it goes up 100 points or it goes down. You don't see the price of your house everyday. If there was a mark to market price for your house everyday, it would appear quite volatile. Not seeing that price, you probably think of the differences in volatility as being rather less than... think of the difference in volatility as being even greater than it in fact is.

CHAIRMAN ANGELIDES: Can I ask one last question, and then I will leave all of you to finish this up, and then I will eagerly await reading the whole transcript. But I would like to ask you 1 question. So looking back, as we all know, hindsight is 20/20. Very few of us are perfect at calling things, right time, right place. If you were to look back at your service during the Clinton Administration and you were to look at frankly mistakes or errors or things you would have done differently that may have been foundational. Not to causing the crisis, but may have been contributors to. What do you think are the biggest markers you look back on? And I say that not just personally, it's not a gee, would I Larry, if you
look back in terms of policies undertaken in the late 90's, were there policies undertaken that may have accelerated, exacerbated, sewn the seeds in some way of this that, on reflection, part of this process is to reflect back at what we did and should have done differently. Hopefully with the mind of making different judgements in the future.

DR. SUMMERS: Well I think the financial reform bill, without getting into its details, that is under discussion today reflects something that is fairly close to my thinking, and I suspect the thinking of many of us who served in the Clinton administration.

As to what type of structure best reduces the risk of financial crisis, if we had been more successful in calling, in recognizing the need for, foreseeing the need for, applying political pressure for and in legislating the kinds of measures that we have now judged and we now see as essential, I think that would have put the country in a better position than it was, coming into this crisis.

I say that with the recognition of on 1 hand this bill proved to be not perfect, that's always the case, and with the recognition that markets changed very, very dramatically during the 2000 and
after period. So it would in some areas probably have required great foresight. And with the knowledge that the political constellation, in terms of the appetite of Congress for regulation in various areas was quite different in the 1990's. But I guess when I asked myself what I would have wished, it goes back to the kinds of proposals that we are now putting forward.

MR. ANGELIDES: Well sir, just to probe that, just a little. So the "Shadow Banking System", a system of relatively unregulated or lightly regulated institution, many depend on short term money. Did people see that there would be risks inherent in that system or just not identify with that point? The calculation on derivatives was that there wouldn't be the kind of growth in the marketplace? And again, it's very hard to be prescient. Was it mostly that they were unseen risks, or that the political calculus just isn't there to move on risks unless they become wholly evident?

DR. SUMMERS: I think others would have to sort of go back and try to... I think it may be useful to do this kind of thing to think of risks that were present but not recognized. Risks that
could clearly have been foreseen and risks that really substantially emerged after 2000.

And I think, I don't doubt that there were elements of all 3. I'm not sure that I could distinguish in a careful way what the proportions of those 3 categories of risk were.

CHAIRMAN ANGELIDES: Okay, 1 last one on this. In terms of, for example, risks recognized and not acted upon, can you identify any of those from the '90s and 1 other, looking back, the most substantial risk present, but not fully recognized?

DR. SUMMERS: Well I think the risks that were probably recognized, I'm not sure that I understand the 2 parts. Well the first was recognized and not fully acted on. What was the second?

CHAIRMAN ANGELIDES: And that was present, but at the time not recognized, but looking back and saying, okay, that's the 1 where winding this clock back, that was a ticking time bomb?

DR. SUMMERS: You know, I think that with respect to risks that were recognized but not fully acted on, I think the sets of risks associated with the mortgage market and housing finance were recognized by many, and not... the system didn't act
as fully on them as we would have liked, or than
many would have wished.

I'm not sure that I can give an answer, in
terms of risks that were recognized that were there
at the time, but not recognized. There are clearly
a set of issues around derivatives, where it's very
clear that by 2008 our regulatory frame work with
respect to derivatives was manifestly inadequate.

It's clear that there were derivatives extant
in the 1990s. It's clear that the derivatives that
proved to be by far the most serious, those
associated with credit default swaps increased 100
fold between 2000 and 2008, and it's clear that
some, including Commissioner Born warned about
derivatives very strongly in the 1990s. And so
whether derivatives constituted an area where the
situation evolved very substantially, the warnings
that we gave this area needed to be continually
watched, weren't heeded as credit default swaps
rose, or whether an alternative way to think about
it would be that there was a risk there that was
foreseen at the time, that was not adequately
perceived at the time.

A question of interpretation on which different
people will take different views.
CHAIRMAN ANGELIDES: I appreciate it very much. Thank you, and I'm sorry for having to exit, but as I said, I know that my colleagues here will ask better questions than me, and I look forward to seeing the transcript. Thank you very much.

DR. SUMMERS: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you.

MS. EDELBERG: Do you have any questions on derivatives? This seems like a good time.

MR. SEEFER: That's actually, I was going to say a perfect segway.

CHAIRMAN ANGELIDES: I wandered it in for you.

MR. SEEFER: One of the things that we're asking everybody on derivatives is just their general opinion of what role do you think, if any, derivatives played in the financial crisis? Whether there as a cause, whether as a problem or anything? And then not just predatory derivatives, but any kind of derivatives.

DR. SUMMERS: You know I think the overwhelmingly, clearly the events at AIG and AIG's use of credit default swaps to take on a set of risks that then proved to threaten its viability, which, given it's interconnection, threatened major
systemic risk, was obviously a critical aspect of understanding the crisis.

There are issues it seems to me a variety of issues to explore there, where I'm just not into - what my duties have been for the last 18 months - into the details enough to make judgments.

Clearly if their unregulated derivatives affiliate had been extensively regulated in the way proposed in 1999, but was never something Congress was prepared to act on, that might have offered the prospect of reducing the risks.

There are many who argue that the real source of the problem was AIG's desire to take risk and the lack of comprehensive risk regulation of AIG. And so even if somehow there hadn't been derivatives, they would've taken the risk, and if their overall risk taking had been regulated, it would have worked their way into the problem.

There are others who argue that if their derivatives activities had been non-bilateral, had been through appropriate clearing arrangements, that involved the appropriate posting of margin, it would not have been possible to build up the risk positions that were built up. And I think all those positions have a certain logic to them, and the
approach that we've taken with respect to
derivatives in the legislation, that many people
have taken, since they are a matter of public
record, is really to address all the possibilities.

To insist on comprehensive regulation of AIG,
and others systemically important financial
institutions, which should independent of any
regulation of particular instruments have offered
the prospect of eliminating or attenuating that
problem. And also to require any major financial
participants, the use of substantially enhanced
transparency, and the use of appropriate clearing
arrangements. So that however I judges that
historical question, there is an element of belt and
suspenders in the regulatory approach of this
proceeding.

There is an important set of issues which I
don't have a clear set of views on. Having to do
with, aside from the situation at AIG, what were the
roles of derivatives activity, both in leading to
runs of various kinds on major financial
institutions at difficult moments in complicating
the process of workout in leading to market
breakdowns. My impression is that many people at
least feel that in terms of the continued operating
and functioning of derivatives, markets, that was less of a major problem that many people would've expected, given the magnitude of all of the other problems.

But no doubt, derivatives issues played an important role in the thinking with respect to many different aspects of the work out of the crisis. And as I say, the judgment we've come to is that a sort of belt and suspenders approach, that gets at derivatives is part of risk regulation of institutions, and gets at derivatives markets per se, offers the best prospect of success, and clearly for some variety of reasons, I think there is a sense that the, that credit default swaps in particular raised questions.

There are questions that I think are very important for financial regulation that are not just systemic risks questions. Issues going into transparency, in their execution, issues with respect to manipulation and market integrity. And there are a set of issues that have arisen for some time, with respect to, in the equity area that with the rise of credit default swaps, now exist in the credit default swap area of control rights divorced from economic or their non-coincident with economic
interests.

All of those require, and I believe are receiving regulatory attention. As a consequence, all of this has arisen really over quite a remarkable developments, in terms of these markets where some of these instruments, particularly credit default swaps just about doubled every single year from 2000 on.

MR. SEEFER: Let me ask you, in terms of what you said about if AIGFP would have been regulated as proposed in '99. Well the CFMA passed and that wasn't the case.

DR. SUMMERS: Excuse me.

MR. SEEFER: Sure.

DR. SUMMERS: You didn't mishear me, but I think you may have misunderstood CFMA. The proposal that I referred to is a proposal that would have regulated the risk taking capital adequacy and the like, with respect to derivatives affiliates.

CFMA went in various ways to the ability to regulate the market, the market and the process of trading on derivatives, as distinct from the financial position of affiliates or the entities that traded derivatives.

MR. SEEFER: Thank you. What I wanted to
ask you, in terms of the regulation not of the market but of the entity. AIG was regulated, the OTS was its consolidated regulator. So there was regulation and I believe they had jurisdiction, since they were a consolidated operator, to look at FP. Any opinion on the role of regulation in AIG?

DR. SUMMERS: Well I think it's, again there are various aspects of macro and the financial markets have been professional preoccupations of mine. Structure of financial regulation has not historically been so. You'll be able to find people with much greater expertise than I have. But I think it's fair to say that it is very widely felt that the regulation of AIG on a consolidated basis by its consolidated supervisor, DOTC, was manifestly inadequate. In addition to the results on evidence of form, the extent of scrutiny, extent of analysis and reporting. One could buttress that conclusion, although I'm not the one that's informed enough to do it.

My impression is that the view is quite widely held that the regulation was inadequate, if you believed that systemic regulation of such institutions was appropriate. That the regulation was inadequate, even without reaching the judgment
about the results of the regulation.

COMMISSIONER BORN: May I ask a couple of follow-up questions on things that Larry has already talked about a little bit. On the credit default swap funds, some of the issues we're looking at, and I wondered if you had thought about these things and had an opinion on them.

One, whether credit default swaps tended to fuel or accelerate the securitization process, because AIG was insuring through CDS the top AAA tranches, and thereby allowing them to be AAA rated and to seem like very secure investments?

DR. SUMMERS: I don't have expertise to make that judgment, either in terms of detailed knowledge of what it was that AIG was insuring. I suppose the question would arise, would there have been other ways. Without insuring them, they could have written a letter of guarantee on them. Which would have been tantamount to insuring them.

So whether one should think of that in terms of a credit default instrument or not, I think it is at least something one would want to study. But I don't know enough about it to have a view. I think that's part of it.

COMMISSIONER BORN: Well the second
hypothesis we're looking at is, there were instruments called synthetic CDO's, which were composed either entirely or partly of credit default swaps, rather than mortgage-backed securities. They were in essence credit default swaps on existing mortgages or existing mortgage-backed securities or existing CDOs. And we are looking at whether that amplified the market for securitization and thereby made it a larger market, and continued it for a longer period of time, after the mortgage market was really shutting down, so there weren't mortgage-backed securities available to fund these things?

DR. SUMMERS: I don't have enough granular knowledge of the quarter by quarter evolution of the market to be helpful. I think in general, I think I needs to always ask the question, if a financial market participant has for whatever reason, bad judgment in grade, misaligned incentives and intellectual misunderstanding of how the world is working, has decided to take on a certain risk, whether by regulating instruments rather than by regulating that financial institution, one is going to succeed in getting them not to take on that risk and how that's going to happen, is a question that I
think one always has to keep in mind in designing regulatory regimes.

The orientation that runs through the financial regulation bill is towards a belt and suspenders approach, as you force a lot, you regulate capital if you're systemically important, you regulate transparency in general so that people can see what's going on and see instruments where there are particular problems, you also regulate there.

But I would worry a little bit about the hope that by regulating instruments in a world where people can innovate, you will succeed in controlling overall risk taking.

COMMISSIONER BORN: Another thing that we're looking at is the need to rescue AIG. And it's potential interconnectedness with other counterparties through the credit default swaps, through other kinds of mechanisms. I wonder what your views are on that?

DR. SUMMERS: There are certainly 2 sets of questions that are implicit in that, in the issues that you raise, and I can distinguish between them, but I can't say a great deal about either. As a general matter, my view having been in government, having been out of government, is that when you're
out of government is very difficult to know all of the information, all the pressures, all the constraints, and all the opportunities on those that are making the decisions. So it's very, very difficult to second guess or ask questions. I wasn't in government at the time.

I would find it very surprising if a compelling argument could be made that simply allowing AIG to file for bankruptcy and letting the chips fall where they would, in a way that was done at Lehman would have been an availing strategy at that moment. With respect, that would have seemed quite hard to believe to me that, that would have been a viable option.

With respect to the way in which transactions were handled, and then respective decisions that were made, I have enormous respect for the people who were in authority at that time, and the sense of the fog of war that would've surrounded the decision-making at points like that. But I don't have nuanced opinions on the ways in which decisions were made or the particular structures that were adopted, or the ways in which dealings were made.

COMMISSIONER BORN: One last question. In terms of the runs on investment banks, other
institutions, do you think that there was any role
played by with respect to derivatives in those runs?
Do you have any views on that?

DR. SUMMERS: I alluded to that
possibility, to say that I didn't know enough to say
to be confident either yes or no. My impression is
that there were probably issues involving the
posting of margin bilaterally, and concern about
margin being lost in the event of failure that led
to runs, and contributed to the pressure on
institutions, which in turn contributed to their
desire to hoard cash, which contributed to the
freezing of the system. And that there was, again,
my impression, not my firm knowledge, is that there
were behaviors that served to strike for the case
for more multilateral, joint and severally liable
kinds of clearing arrangements, so the kind that are
contemplated in this legislation, that I might say
is the kind that in the 90's, mid 90's were
essentially prohibited by law. And where we worked,
including in the CFMA to establish permissive
frameworks that enabled the clearing houses to
engage in a certain amount of suasion. Which is of
course, is a step significantly short of the step
that's contemplated in the current legislation.
Which is essentially to mandate for a wide swaths of these transactions, the use of clearinghouse house clearing arrangements.

MS. EDELBERG: So going to an earlier government intervention when the market was in trouble, long term capital management. So can you talk about your role in that? And then whether or not you think that any of the government response to long-term capital management created any moral hazard that had an affect?

MR. VERRILLI: Just in terms of the answer. Of course Doctor Summers will answer the question. There is a parallel constraint on his ability to answer during that period of time, to the extent that you're asking about his communications with President Clinton, or deliberations. That would be... I think we would have to have President Clinton's lawyer here. That would be off limits, for the same reasons as the current situation. But with that constraint-

MS. EDELBERG: I'll happily defer to whatever you think is,

MR. VERRILLI: We'll carve that part out.

MS. EDELBERG: Yes.

DR. SUMMERS: My personal role as things
happened was not large, because my preoccupation was on the international area, where there was plenty going on at that time. I would say that I am probably pretty familiar with . . . I think it's very important to distinguish between what went on in the LTCM context and in a variety of other contexts. Other than sandwich money at the New York Fed, no taxpayer money was involved in the LTCM case.

The role that was played by the official sector was a coordination role in brokering what was a mutually advantageous set of arrangements for the various participants. So if I were to think about various events that were generating of moral hazard, I wouldn't be inclined to put great weight on LTCM. A degree of financial cost, subsequent litigation and such on those at LTCM was perhaps not as large as it could imaginably have been, but was large enough that I think any operator would be at very substantial pains to avoid the fate that befell LTCM. I think LTCM did point out a variety of issues around transparency, around regulation of prime brokers. Some of which we pursued at that time, some of which are addressed in this legislation.
I also think I has to be slightly careful in thinking about moral hazard. Moral hazard is a bad thing, confidence is a good thing. And in a sense anything that is successful in reducing run risks, is that the provision of confidence, or is that the establishment of moral hazard? That's part of why these are such complex subjects.

MS. EDELBerg: Well that's fair enough. But certainly market participants, and certainly in retrospect, market participants viewed what the government did with LTCM as extraordinary government involvement. That the government took an unusual step over and above what they typically do, and did it because they thought that LTCM had some sort of systemic role in the economy, or in the financial system? Whether or not there was taxpayer money at stake. I mean there is an opportunity cost associated with government actions. They may do 1 thing and not another. They chose to go in and-

DR. SUMMERS: No, I don't... we may have different readings of the views about the participants.

It was an extraordinary circumstance, and in that extraordinary circumstance government did something that was extraordinary. Perhaps not
surprisingly in an extraordinary circumstance
government would do something that was
extraordinary.

We were busy, we had a lot to do, I suppose.
But I'm not sure the opportunity cost of a week of
the Federal Reserve President and New York's time is
a factor, that would loom enormously.

MS. EDELBERG: No, I meant the government
could actually be going around brokering deals that
it thought were to the good of the economy.
Elsewhere, the government chooses not to get
involved in that activity, because it chooses to do
other things, with it's political capital.

DR. SUMMERS: I suppose, I think that's
fair, and I think that 1 of the reasons for the
effort, rather substantial efforts involving both
the private and the public sector in the wake of
LTCM, was to contemplate rather more satisfactory
legal frameworks for the self executing failure of
hedge funds, which were a test. Amaranth, there
were a number of failures of reasonable sized
financial institutions that didn't have the same,
the systemic consequences, in part because of a
variety of things that were put in trade after LTCM
changed settlement procedures, changed margin
procedures and the like.

There were a variety of special factors that mostly went to urgency, immediacy and externality that lead to the judgements that were made during LTCM. And while there's much that one can question in financial markets, I think it's, at least I have not heard the case convincingly made that some aspect of what happened at LTCM either set a precedent that led to a variety of misguided government interventions, or lead to a set of expectations that somehow contributed to problems down the road. But you know, perhaps there are other arguments with respect to the LTCM experience.

MR. VERRILLI: Just, if you could hang on for 1 second. It's about 3:15, so I just want to make sure that we know that we are coming up on our 2 1/2 hour limit here. So we have a report that needs to get done, and I know you've got another that has to get done.

MS. EDELBERG: Sorry, I'll ask you a question on a different front. Though I do really want to know what you think about what those factors were, but I will put that aside, in leading to one of the extraordinary involvements of LTCM.

Shadow banking system versus traditional
banking system. There is a question, 1 of the things we're wrestling with is, did different things happen to 2 different financial sectors, or did the same thing happen to both of these financial sectors? And you know, to the extent that something different happened to these 2 different sectors, was it because of the different regulatory environments that these 2 different sectors were in, or is that actually a red herring, and in fact you know, you had talked a little bit earlier about the interplay between the banking sector and capital sector, and 1 used to save the other, etc. How do we think about the interplay?

DR. SUMMERS: You had a set of problems in the mortgage company sector for example that were not heavily caused by or causal to the banking system. So far as those were important issues, one could probably think of the 2 systems with some degree of separateness.

You had a set of issues arising out of securitization, where the 2 systems proved to be auction rate securities, where the 2 systems proved to be rather more closely linked than many had supposed. So I think there were elements in this of both aspects of your question.
MR. SEEFER: So as we wind down; too big to fail. What are your opinions on what makes an institution too big to fail, and how did it contribute to the financial crisis? In looking forward, not looking forward, and do you avoid it? Is the answer simply more capital, more liquidity, or is the answer something else?

DR. SUMMERS: Too big to fail refers to a situation where an institution, at least for me, refers to a situation where an institution derives a significant benefit from what the market sees as a government provided put, caused by the fact that its failure would have catastrophic consequences. And if you accept that definition, there are several ways, there's 3 broad categories of approach and to constraining too big to fail.

The first is by making failure less likely. So even if there is a perception that the government will come in and will support it if it fails, that's kind of not a relevant factor, because an assumption even ex governments support is that it won't fail. And the agenda for doing that is sort of broadly the regulatory agenda towards the institution, with at least 3 specific elements. Capital leverage standards, liquidity standards, and restrictions
which go to riskiness, which goes into everything from compensation arrangements to limitations on proprietary trade or the like.

Second category measures systemic measures that make failure more acceptable, clearing for derivatives, multilateral clearing for depravities is one such example. Measures which enable the system to survive the failure of the institution.

And the third is managers, is what I call or think of as local measures, can make failure a viable option. And that is resolution frameworks which provide for a framework for going through a bankruptcy type of procedure rapidly and with a minimum of uncertainty. Plan your own funeral type arrangements, is a kinder vision in this build.

I don't think there's any single silver bullet with respect to, too big to fail. But I think that it can be quite substantially curtailed in the ways that I just described.

MR. SEEFER: We are almost out of time, so 1 of the things I definitely want to ask you is what haven't you told us, that you think is important for us to know? I know we've asked you a lot.

DR. SUMMERS: You gave me a pretty open first question, where I had a chance to touch on
every aspect. The only thing I would say in conclusion I guess, is something that I've said in a number of my speeches on this, if you'll permit me on that. If you'll permit the somewhat overdrawn and oversimplified analogy.

If you look at the history of automobile safety in the United States, it was dismal, it was terrible. And the first major contribution that the young Daniel Patrick Moynihan made to public policy was an essay he wrote on automobile safety. What it basically said in that essay was that the then prevalent approach, which was based on lots of drivers had, and lots of criminality for reckless driving. Because if we could only get people to drive safely, then we would have fewer automobile accidents. It was basically a terrible failure.

And he basically felt that we should move from an approach that was based on human betterment, making people better, to an approach that was directed at making the system better for people who were as they were.

I think with respect to the financial system, people are going to be avaricious, people are going to extrapolate from the recent past, people are going take advantage of gambles that are favorable
to them. People, whether in the private sector or the public sector, are going to have highly imperfect foresight. So the lesson is that the system needs to be safe for ignorance, and safe for human fallibility. And the system that has those characteristics, that's why some of the themes that I kept coming back to were capital and leverage. Why in a number of different contexts I used the phrase belt and suspenders, why I wanted to allow some overlap in regulatory functions with some separateness of the consumer.

And I guess as you think about causes, I would resist the temptation to take a list of causes and make judgments about their relative importance, in favor of thinking about the multiple stages at which an accident might have been avoided.

Was World War I caused by the assassination of the Archduke, or was World War I caused by the ascension of Germany and the difficulty of the international system to accommodate the ascension of Germany? I kind of think it's a somewhat sterile agenda to try to distinguish the respective roles of those 2 factors, rather than recognizing that a strategy for maintaining peace can usefully address the events pointed out by both of those things.
And I guess my thought would be that if I have not been entirely definitive in answering some of your questions, part of the reflection of the vast amounts that I don't know, and it's in part a reflection of a judgment that there are these multiple levels of causation associated with different levels of solution, that you have to think about with respect to a crisis like this.

MR. SEEGER: I certainly don't think it's the plan to look at the 22 sections and assign percentages at the end of the year.

DR. SUMMERS: Right.

MR. SEEGER: So thank you very much – MS. EDELBERG: But on the flip side, the perfect storm is something I think worth resisting. It suggests that it just happened. That there were so many factors, who could ... you know. I think we need to find something in between.

DR. SUMMERS: I'm sure I've been unclear, but I didn't think that I had been that unclear. Nothing in what I've tried to say this afternoon, and certainly nothing in my last thought should have been interpreted as any excuse for fatalism. Indeed, the notion of causation at multiple levels actually has as it's implication that there are
multiple independent strategies, the success of only
1 of which would have been sufficient. And so it
seems to me to suggest that this was a perfect storm
is in some ways, it's sometimes invoked. I
recognize that the notions of a perfect storm are
invoked to suggest a DSX Mac and so that there can
be avoidance of responsibility on anyone's part.
I've got a rather different view, which is that it
requires many contributing elements.

And if the navigation system had been better on
the ship, if the systems for keeping the ship stable
in waves had been better. There are multiple ways
in which the accident could have been averted. And
I think the more one sees it in that way, the more
different avenues one is lead to pursue and the
greater the prospect of doing it.

In contrast, I think if you take more, and no
one here is doing it, the morality play view of a
crisis, you are then left with the aspect, can you
change the aspects of human nature that Aristophanes
and Shakespeare wrote about. And that's probably a
more daunting challenge than establishing
multilateral clearing mechanisms. That's why I put
it in the way that I did.

COMMISSIONER BORN: May I just ask 1 final
thing? I'm taking from everything that you are saying that you would not attribute the financial crisis to the sole factor of a housing problem? That it may have been 1 of the issues, but obviously it came in the context of all the rest of the activities?

DR. SUMMERS: I like to use the metaphor when thinking about the financial crisis of a very, very, very dry forest, into which someone throws a cigarette butt. And then the question is did the cigarette butt cause the fire?

Well there is a sense in which the answer to that question is clearly, yes. But there is also a sense in which, I think this is your point, Commissioner. If that cigarette butt hadn't arisen, if it was a very, very, dry forest, there likely would have been a fire in any event. Look, I think a question that, and again I'm just quoting myself from things I've said in the past. That the last generation, we've seen the 1987 crisis, the stock market crash, the S & L debacle, Mexico, LTCM, Asia, Russia, the NASDAQ bubble, Enron, now this. And so what you probably think of this, this financial crisis is much more profound in some ways, but comes off a background of a financial system that has been
too often a source of too much instability, and I think that perspective has to inform how we think about its regulation.

MR. BARKER: Thank you very much Dr. Summers, for your time.

DR. SUMMERS: Thank you.

MR. VARRILLI: Thank you. And before we go off the record, I just want to say for the larger group, about 2 things first. That we appreciate very much that you were able to structure this interview in a way that worked for you and for us as well.

Second that Chris and I discussed the rules of confidentiality applying to your Treasury Department interviews that we all agree apply here. And what that means as far as we're concerned, is that we are going to review the transcript, decide whether anything is confidential from our point of view. Don't know whether we'll conclude that anything is. But our understanding is, until we have had the opportunity to do that, the contents of this interview and transcript, both will remain confidential.

MR. SEEFER: Does the record reflect that everybody is copying? Very good.
MR. VARRILLI: That's on the record.

MR. SEEFER: Okay, I guess that's correct.

MR. VARRILLI: That's correct.

MR. SEEFER: Thank you very much.

(WHEREUPON, the proceedings were concluded at 4:30 p.m.)
I, Charles Hoffman, do hereby certify:

That the foregoing proceedings were taken before me at the time and place herein set forth; that any witnesses in the foregoing proceedings, prior to testifying, were placed under oath; that a verbatim record of the proceedings was made by me using machine shorthand which was thereafter transcribed under my direction; further, that the foregoing is an accurate transcription thereof.

I further certify that I am neither financially interested in the action nor a relative or employee of any attorney of any of the parties.

IN WITNESS WHEREOF, I have this date subscribed my name.

Dated: June 8, 2010

CHARLES HOFFMAN