



**SIGTARP**

OFFICE OF THE SPECIAL INSPECTOR GENERAL  
FOR THE TROUBLED ASSET RELIEF PROGRAM

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

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HOUSE COMMITTEE ON FINANCIAL SERVICES  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
AND CONSUMER CREDIT

**STATEMENT OF CHRISTY ROMERO**  
**ACTING SPECIAL INSPECTOR GENERAL**  
**TROUBLED ASSET RELIEF PROGRAM**

BEFORE THE  
HOUSE COMMITTEE ON FINANCIAL SERVICES  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
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Chairman Capito, Ranking Member Maloney, and Members of the Committee, I am honored to appear before you today to discuss the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”) and whether it ended the concept of “Too Big To Fail.”

The Office of the Special Inspector General for the Troubled Asset Relief Program (“SIGTARP”) is charged with conducting, supervising and coordinating audits and investigations of the purchase, management, and sale of assets under the Troubled Asset Relief Program (“TARP”). SIGTARP’s mission is to promote economic stability through transparency, robust enforcement, and coordinated oversight. In fulfilling its mission, SIGTARP protects the interests of those who funded TARP programs—the American taxpayers.

This Committee is committed to examining whether the moral hazards created by Government interventions in the market in 2008 (which includes TARP) have been resolved. As part of its mission of transparency, SIGTARP has examined the Government’s response to the financial crisis through TARP and the increased moral hazard that was an inevitable byproduct of TARP. In order to determine whether this increased moral hazard has been resolved, it is necessary to examine past actions by market participants that made them “too big to fail” and the Government’s decisions to stand behind these companies. These decisions made in the wake of the financial crisis have implications for the future. Only by examining the past can we take advantage of lessons learned to better protect taxpayers in the future.

Treasury and Federal banking regulators made decisions related to TARP in order to bolster investor and consumer confidence in the nation’s financial system. SIGTARP has shed light on the details of critical decision-making in this area. For example, we released an audit report detailing the decision by the Government to step in and provide an unprecedented bailout

to banks under TARP's Capital Purchase Program ("CPP") in October 2008. At that point in time, a number of events including the failure of Lehman Brothers, Inc., the extension of an \$85 billion line of credit from the Federal Reserve Bank of New York to American International Group, and the failure of Washington Mutual, Inc. (the largest depository institution failure) devastated investor confidence in the nation's financial system and set the stage for the unprecedented \$700 billion TARP. In October 2008, then-Treasury Secretary Henry Paulson announced the creation of CPP and its intent to increase confidence in the banks and increase the bank's confidence so that they would deploy, rather than hoard capital, which in turn was supposed to lead to increased lending. Treasury immediately pledged \$125 billion in TARP funds to nine large financial institutions. According to Treasury, these first nine institutions were chosen for their perceived importance to the greater financial system. In a matter of weeks, two of the original nine institutions (Bank of America Corp. and Citigroup, Inc.) needed additional support.

In January 2011, SIGTARP released an audit report entitled "Extraordinary Financial Assistance Provided to Citigroup, Inc." The audit examined the basis for the Government's decision to deem Citigroup to be too systemically significant to be allowed to fail and to provide it with not just \$25 billion through CPP, but also with additional Government assistance in the amount of a \$20 billion capital injection through the Targeted Investment Program ("TIP") and Government guarantees against losses on certain assets under the Asset Guarantee Program ("AGP"). As detailed in the report, after a frantic weekend dubbed "Citi Weekend," the consensus of Government parties held that it was necessary to save Citigroup at all costs in order to stabilize the nation's financial system. The report describes discussions on November 20, 2008, among the Federal banking regulators and Treasury. Federal Reserve Chairman Ben

Bernanke characterized one call as a discussion of Citigroup's condition and the "too big to fail" issue. During the call, then-Federal Reserve Bank of New York President Timothy Geithner told the other principals, "We've told the world we're not going to let any of our major institutions fail. We are going to have to make it really clear we're standing behind Citigroup."

Although the concept of "too big to fail" existed prior to TARP, public statements and the actions taken by Government officials during late 2008 and early 2009 made it explicit that the Government would stand behind the major financial institutions and not let any of them fail. The Government was focused on sending a message to skittish markets during the height of the financial crisis. After the additional bailout of Citigroup was announced, the impact was immediate and Citigroup stabilized. There are several lessons to be learned from the Citigroup bailout for the future, particularly in light of the enactment of the Dodd-Frank Act. As Federal Deposit Insurance Corporation ("FDIC") Chairman Sheila Bair stated before this very committee on May 26, 2011, "the outcome of the next financial crisis is already being determined by decisions regulators are making today in the Dodd-Frank implementation process."

### **SIGTARP's Findings and Conclusions in the Citigroup Audit**

In November 2008, worried that Citigroup would fail absent a strong statement of support from the U.S. Government, and that such failure could cause catastrophic damage to the economy, then-Treasury Secretary Henry Paulson and then- FRBNY President Timothy Geithner held a series of discussions with FRB Chairman Ben Bernanke, FDIC Chairman Sheila Bair, and then-Comptroller of the Currency John Dugan to discuss bailing out Citigroup. The underlying premise of these discussions was that Citigroup was too systemically significant to be permitted to collapse. According to Chairman Bernanke, it was "not even a close call to assist them."

By late on November 23, 2008, Citigroup had agreed to a Government proposal that would provide Citigroup a package that included asset guarantees and a \$20 billion capital infusion in exchange for preferred shares of Citigroup stock. The essential purpose of the deal, as Secretary Paulson and FRBNY President Geithner later confirmed to SIGTARP, was to assure the world that the Government would not let Citigroup fail. After the deal was announced, the impact on the market's perception of Citigroup was immediate: its stock price stabilized, its access to credit improved, and the cost of insuring its debt declined. Citigroup had been saved, at least for the time being.<sup>1</sup>

SIGTARP found that the Government constructed a plan that not only achieved the primary goal of restoring market confidence in Citigroup, but also carefully controlled the overall risk of Government loss on the asset guarantee. As one FRBNY official explained to SIGTARP, the deal was structured to “convinc[e] the skittish market that the Federal Government was taking the risk, even though the risk really remained with Citigroup,” because the Citigroup loss position ultimately exceeded anticipated losses. The Government also insisted on a \$20 billion capital injection in return for preferred stock, even though Citigroup did not request such an injection. Here, too, the focus was on sending a message to reassure the markets – the Government would not let Citigroup fail.

From the perspective of minimizing taxpayer risk on the asset guarantee transaction itself, the deal with Citigroup looks even better with hindsight. Citigroup did not fail, and the global economy avoided the catastrophic financial collapse that many feared would flow from a Citigroup failure. And while the transactions hardly solved all of Citigroup's problems, the

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<sup>1</sup> Just over a year later, Citigroup terminated the guarantee program and repaid the \$20 billion of Government-supplied capital.

Government incurred no losses, and even profited on its overall investment in Citigroup by more than \$12 billion. Nevertheless, two aspects of the Citigroup rescue bear noting.

First, the conclusion of the various Government actors that Citigroup had to be saved was strikingly ad hoc. While there was consensus that Citigroup was too systemically significant to be allowed to fail, that consensus appeared to be based as much on gut instinct and fear of the unknown as on objective criteria. As Secretary Paulson stated on one of the Citi Weekend conference calls, “If Citi isn’t systemic, I don’t know what is.” FDIC Chairman Bair told SIGTARP that “we were told by the New York Fed that problems would occur in the global markets if Citi were to fail. We didn’t have our own information to verify this statement, so I didn’t want to dispute that with them.” Another FDIC official told SIGTARP that in terms of Citigroup’s systemic significance, FDIC directors and other Government entities “made a judgment call.” Citigroup CEO Vikram Pandit summed up the feeling at the time when he told SIGTARP that no one knew what the systemic effects of a Citigroup failure would be, and that no one wanted to find out.

Given the urgent nature of the crisis surrounding Citigroup, the ad hoc character of the systemic risk determination is not surprising, and SIGTARP found no evidence that the determination was incorrect. Nevertheless, the absence of objective criteria for reaching such a conclusion raised concerns. Then-Director of the Office of Thrift Supervision John Reich, at FDIC’s Board meeting on November 23, 2008, in which FDIC made its determination to proceed with the Citigroup transactions, observed that there had been “some selective creativity exercised in the determination of what is systemic and what’s not,” and that there “has been a high degree of pressure exerted in certain situations, and not in others, and I’m concerned about parity.”

Concerns about “selective creativity” and “parity” could be addressed at least in part by the development, in advance of the next crisis, of clear, objective criteria and a detailed road map as to how those criteria should be applied. Secretary Geithner told SIGTARP that he believed creating effective, purely objective criteria for evaluating systemic risk is not possible: “What size and mix of business do you classify as systemic?...It depends too much on the state of the world at the time. You won’t be able to make a judgment about what’s systemic and what’s not until you know the nature of the shock” the economy is undergoing. Secretary Geithner also suggested that whatever objective criteria were developed in advance, markets and institutions would adjust and “migrate around them.” If the Secretary is correct, then systemic risk judgments in future crises will again be subject to concerns about consistency and fairness, not to mention accuracy. The Dodd-Frank Act created the Financial Stability Oversight Council (“FSOC”) and charged it with responsibility for developing the specific criteria and analytical framework for assessing systemic significance. That process is under way, with FSOC having invited public comment on those issues. SIGTARP remains convinced that even if some aspects of systemic significance are necessarily subjective and dependent on the nature of the crisis at the time, an emphasis on the development of clear, objective criteria in advance of the next crisis would significantly aid decision makers likely to be burdened by enormous responsibility, extreme time pressure, and uncertain information. Moreover, FSOC must be transparent about how it will apply both objective and subjective criteria to a failing institution, and must seek to gauge the market and adjust the criteria in the event that firms do indeed seek to “migrate around them.” Without minimizing the legitimate concerns raised by Secretary Geithner, it is imperative that FSOC not simply accept the adaptability of Wall Street firms to work around regulation, but instead maintain the flexibility to respond in kind.

Second, the Government's actions with respect to Citigroup undoubtedly contributed to the increased moral hazard that has been a direct byproduct of TARP. While the year-plus of Government dependence left Citigroup a stronger institution than it had been, it remained, and arguably still remains, an institution that is too big, too interconnected, and too essential to the global financial system to be allowed to fail. Indeed, a senior FRBNY official told SIGTARP in January 2010 (before the passage of the Dodd-Frank Act), that Citigroup was then still "too big to fail," and that if history repeated itself there is "no question we would do it again...[with] a similar or different program." Citigroup's creditors and counterparties were left largely unscathed by its need for repeated assistance from taxpayers, and the concern voiced by Chairman Bair on February 22, 2009, for the need for management changes "at the top of the house" at Citigroup arguably was not fully addressed. While there have been notable changes at the board level and some changes in management, some of those in Citigroup's senior management who came to the Government seeking assistance in 2008 remain in place.

When the Government assured the world in 2008 that it would use TARP to prevent the failure of any major financial institution, and then demonstrated its resolve by standing behind Citigroup, it did more than reassure troubled markets – it encouraged high-risk behavior by insulating the risk takers from the consequences of failure. Unless and until institutions like Citigroup are either broken up so that they are no longer a threat to the financial system, or a structure is put in place to assure that they will be left to suffer the full consequences of their own folly, the prospect of more bailouts will potentially fuel more bad behavior with potentially disastrous results.

Notwithstanding the passage of the Dodd-Frank Act, which does give FDIC new resolution authority for financial companies deemed systemically significant, the market still

gives the largest financial institutions an advantage over their smaller counterparts. They are able to raise funds more cheaply, and enjoy enhanced credit ratings based on the assumption that the Government remains as a backstop. Specifically, creditors who believe that the Government will not allow such institutions to fail may under price their extensions of credit, giving those institutions access to capital at a price that does not fully account for the risk created by their behavior.

Cheaper credit is effectively a subsidy, which translates into greater profits, giving the largest financial institutions an unearned advantage over their smaller competitors. And because of the prospect of another Government bailout, executives at such institutions might be motivated to take greater risks than they otherwise would, shooting for a big payoff but with reason to hope that if things went wrong they might still be able to keep their jobs.

The moral hazard effects of TARP in general and the bailouts of Citigroup in particular may eventually be ameliorated by full implementation of the provisions of the Dodd-Frank Act, which was intended in part to address the problem of institutions that are “too big to fail.” Whether it will do so successfully remains to be seen, with important work by FDIC, FSOC, and a host of other regulators far from complete. Even after those bodies develop and implement new rules and regulations authorized by the Dodd-Frank Act, which would prohibit some of the benefits received by Citigroup under TARP, taxpayers likely won’t know about the extent of their continuing exposure until the next crisis. As Secretary Geithner told SIGTARP in December 2010, with the Dodd-Frank Act, the “probability of failure is reduced because the banks hold more capital. The size of the shock that hit our financial system was larger than what caused the Great Depression. In the future we may have to do exceptional things again if we face a shock that large. You just don’t know what’s systemic and what’s not until you know the

nature of the shock. It depends on the state of the world – how deep the recession is. We have better tools now, thanks to Dodd-Frank. But you have to know the nature of the shock.”

Secretary Geithner’s candor about the difficulty of determining “what’s systemic and what’s not until you know the nature of the shock,” and the prospect of having to “do exceptional things again” in such an unknowable future crisis is commendable. At the same time, it underscores a TARP legacy, the moral hazard associated with the continued existence of institutions that remain “too big to fail.” It also serves as a reminder that the ultimate cost of bailing out Citigroup and the other “too big to fail” institutions will remain unknown until the next financial crisis occurs.

### **The Process for Designating Systemically Significant Financial Institutions**

As Chairman Bernanke has stated, “A clear lesson of the past few years is that the government must not be forced between bailing out a systemically important firm and having it fail in a disorderly and disruptive manner.” The Dodd-Frank Act charged FSOC with identifying and designating certain non-bank financial companies as systemically important financial institutions (“SIFI”) for heightened prudential supervision by the FRB. In addition, FSOC may make recommendations to the FRB regarding the establishment and refinement of heightened prudential standards for nonbank financial companies designated as SIFIs and certain large, interconnected bank holding companies. The Dodd-Frank Act grants FDIC new resolution authority designed to assist in the orderly liquidation of financial companies deemed systemically significant. The Dodd-Frank Act also requires that these institutions prepare resolution plans (sometimes referred to as “living wills”) for a rapid and orderly resolution in the event of material financial distress or failure, and allows for the FDIC and FRB to shape these living wills. The Dodd-Frank Act also grants regulatory authority to set more stringent capital,

liquidity and leverage requirements and to limit certain activities that might increase systemic risk.

FSOC's notice of proposed rulemaking for designating nonbank financial companies as SIFIs sets forth a framework of criteria that would be rooted in 11 statutory considerations set forth in the Dodd-Frank Act for such designations, and would generally fall into two categories. The criteria in the first group (size, lack of substitutes, and interconnectedness) address the spillover effect from the firm's distress on the broader financial system. The criteria in the second group (leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) address a company's vulnerability. If designated as a SIFI under the proposed rule, the largest, most interconnected and highly-leveraged companies would face stricter prudential regulation, including higher capital requirements and more robust consolidated supervision. Public comments reveal two common concerns: (1) the proposed rule is insufficient to provide any guidance as to what the criteria will be for determining which entities are SIFIs and (2) the framework presented, although helpful, needs to be clarified and included in the rule.

### **Effect of Systemically Significant Designation and the Existence of Too Big To Fail**

Whether or not the systemically significant designation will provide a competitive advantage for those institutions ultimately may be dependent on the market's perception of whether the Government will step in again to tell the markets that they stand behind these companies. As Chairman Bernanke stated in a speech to community bankers in March 2010, "if a firm is publicly perceived as too big, or too interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm's business model, its management, and its risk-taking behavior."

The mere enactment of the Dodd-Frank Act did not end the concept of “too big to fail” in the market’s eyes. In January, after the Dodd-Frank Act’s enactment, Standard & Poor’s (“S&P”) and Moody’s Investor Service (“Moody’s”), announced its intention to make permanent the prospect of Government support as a factor in determining a bank’s credit rating. According to S&P, “We believe that banking crises will happen again. We expect this pattern of banking sector boom and bust and government support to repeat itself in some fashion, regardless of governments’ recent and emerging policy response.” In its ratings, Moody’s has assumed Government support for the eight largest banking organizations. As long as the financial institutions, counterparties, and ratings agencies believe there will be future bailouts, competitive advantages associated with “too big to fail” designated institutions will almost certainly persist. As long as the market perceives future bailouts, market discipline will be reduced as creditors, investors and counterparties have less incentive to monitor those institutions they believe the Government will save in the future. Restoring market discipline may be necessarily tied to ending “too big to fail.”

It is too early to tell whether Dodd-Frank will ultimately be successful in ending “too big to fail,” and that success will be dependent on the market’s perception of the effectiveness of the actions taken by regulators and Treasury. As we observed with Citigroup stabilizing after the announcement of additional Government assistance, the market will react to the words and actions taken by regulators. In order to end “too big to fail”, the regulators must take effective action now using the tools given to them under Dodd Frank for the markets to be convinced that the Government will not intervene again.

Regulators have a benefit that was missing during the financial crisis—the benefit of time. It is vital that regulators use the time when the nation is not in a financial crisis to

promulgate rules to make effective use of the authorities granted to them under Dodd-Frank. To be effective, regulators should develop objective criteria and a solid framework for applying those criteria, so that should the nation face another potential financial crisis, the roadmap is in place along with all of the needed signposts.

Rules, however, are only as effective as their application. In order to convince markets, promises of the regulators to end “too big to fail” must be matched with actions that signal with certainty that the Government will not make future bailouts. The markets will watch to see the level and type of enhanced prudential supervision that comes from a SIFI designation. The markets will watch to see whether institutions designated as SIFI are restructured and simplified. Regulators have authority to shape the living wills of systemically significant institutions, and to compel substantial changes to the structure and activities of these companies. These actions rely on the courage of the regulators to protect our nation’s broader financial system against any institution whose demise could potentially trigger another financial crisis.

Chairman Capito, Ranking Member Maloney, and Members of the Committee, thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

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