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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U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

WRITTEN TESTIMONY SUBMITTED BY

THE HONORABLE CHRISTY L. ROMERO

SPECIAL INSPECTOR GENERAL

FOR THE TROUBLED ASSET RELIEF PROGRAM

BEFORE THE
U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

July 16, 2014

Chairman Brown and Ranking Member Toomey, I want to thank you for holding today's hearing which holds great importance for hardworking Americans. The Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") serves as the watchdog over the Federal bailout known as the Troubled Asset Relief Program ("TARP") passed by Congress in 2008 in response to the financial crisis. TARP is a program that will continue to last for many more years, as Treasury has scheduled financial obligations under TARP until at least December 31, 2021. Congress created SIGTARP to protect the interests of those who funded TARP programs – American taxpayers. An important part of SIGTARP's mission is to bring transparency to decisions that were made in the wake of the financial crisis, because there are important implications for the future.

<u>Lessons Learned from TARP on Identifying Systemically Important Institutions</u>

Today's hearing asks a very relevant, critical and timely question: "What Makes a Bank Systemically Important?" Another way to pose that question is what made a bank so important in the past that taxpayers had to bail it out to prevent systemic harm? SIGTARP conducted two deep dive audits into how the Government determined that certain TARP recipients were systemically important, and we are including our findings from these reports to assist the Committee's examination of this issue. Only by examining the past can we take advantage of lessons learned to protect taxpayers in the future.

Interconnections of banks to each other and to hardworking Americans

In 2008, Treasury and Federal banking regulators were forced to address the question of systemic importance when they came to a surprising realization that our nation's largest financial institutions were tied as counterparties to each other so that if one went down, it pulled the others and our economy down with it. Some companies did not understand their true exposures to their counterparties or other large financial institutions which were hidden in complicated derivatives like securities backed by subprime mortgages sold by Bear Stearns, Lehman Brothers or others, and hedging products like credit default swaps sold by AIG. With exposures to these financial institutions hidden, regulators were caught unaware. According to then-Treasury Secretary Timothy Geithner's June 18, 2009 testimony to Congress, the rise of new financial instruments "that were almost entirely outside of the Government's supervisory framework left regulators largely blind to emerging dangers." Companies also did not understand their exposures to short-term funding counterparties. Then-Secretary Geithner testified on September 23, 2009, that firms were "reliant on very short-term funding that can flee in a heartbeat. And that is what brought the system crashing down." The interconnections and exposures of these new instruments and short-term funding had grown more intricate, complex and dangerous as banks had grown to become megabanks.

Even more surprising was the realization that the finances of hardworking Americans were dependent on these too big to fail players and the market they created – and that was why Treasury and the Federal Reserve Board requested Congressional authority for the TARP bailout. When then-Federal Reserve Board Chairman Ben Bernanke asked Congress to authorize TARP on September 23, 2008, he testified, "the taxpayer is on the hook" if the system does not work the way it needs to work. The following day, he testified before Congress, "People are saying, 'Wall Street, what does it have to do with me?' That is the way they are thinking about it. Unfortunately, it has a lot to do with them. It will affect their company, it will affect their job, it will affect their economy. That affects their own lives, affects their ability to borrow and to save and to save for retirement." His testimony proved true, as trillions of dollars in household wealth were lost in the crisis, even with TARP. One lesson learned from TARP is that too big to fail is not just about size – it is about the interconnections the largest financial firms have to each other and to American households. The interconnections that pose grave risk to the financial system and ultimately to American households in the event of the institutions' failure or near failure make banks and other financial institutions systemically important.

Investor Confidence & the Threat of Bank Runs as a Measure of Systemic Importance

In addition to these interconnections, an institution's ability to impact investor confidence plays a material role in answering the question of "What Makes a Bank Systemically Significant?"

<u>What made the first nine TARP recipients systemically important:</u> In SIGTARP's report "Emergency Capital Injections Provided to Support the Viability of Bank of America, Other Major Banks, and the U.S. Financial System," we examined the Government's selection of the first nine financial institutions as systemically important, resulting in them receiving TARP capital injections under TARP's Capital Purchase Program in October 2008. SIGTARP found that these nine institutions were chosen for their "perceived" importance to the market and greater financial system. Government officials strongly urged the nine institutions to accept these monies as a group, irrespective of whether individual institutions felt that they required assistance, in the belief that it was crucial to restore public confidence in the banking system.

To demonstrate Federal government support to the financial system and promote consumer and investor confidence, Bank of America, Citigroup, Wells Fargo, JPMorgan Chase, Goldman Sachs, Morgan Stanley, Merrill Lynch, State Street Corporation, and the Bank of New York Mellon were selected to receive the first TARP capital injections based on the types of services they provide to the consumers and businesses and their collective importance to the financial system, according to Treasury officials and Federal regulators. Federal regulators agreed that the institutional selections were logical and viewed them as systemically important because of the types of services they provide, their size, and their interdependence with each other and the broader economy. As such, their participation in TARP's CPP was considered central to the government's solution to stabilize the financial markets.

According to Treasury officials and Federal regulators, the nine institutions represented the nation's leaders in the commercial and investment banking sector, as well as the U.S. custodial and securities processing system. These institutions include four large commercial banks, three investment banks, and two custodial and processing institutions:

- The four large commercial banks—Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo—are "traditional" banks. They accept deposits, make commercial and industrial loans, and perform other banking services for the public.
- The three investment banks—Goldman Sachs, Morgan Stanley, and Merrill Lynch—are largely financial intermediaries. They perform a variety of services, including underwriting (purchasing and distributing securities), acting as the intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and acting as brokers for institutional clients.
- State Street and the Bank of New York Mellon are also central to the financial system because they provide custodial services, such as securities processing and settlement services for financial transactions.

Together, these nine institutions provide broad financial services and engage in key activities of the U.S. financial system. Another criterion considered in the selection was the size of the institutions. The nine selected institutions together held more than $11 trillion dollars in banking assets—approximately 75 percent of all assets held by U.S-owned banks as of June 30, 2008.

Various Federal officials and bank executives noted that these nine systemically important institutions are also highly interdependent and interconnected with each other. Some of the institutions are counterparties to each other, such that a risk of one institution failing to live up to its contractual obligations would cause financial problems, if not failure, for another. Bank of America and Merrill Lynch had counterparty exposures with many financial institutions, including several of the nine banks in the initial group that received CPP funds. In addition, two bank executives SIGTARP interviewed explained that State Street and the Bank of New York Mellon were included in the initial group of nine institutions because they were 'infrastructure' institutions that provided securities processing and settlement services for other financial transactions. According to the executive, when the operations of then-Bank of New York were temporarily disrupted as a result of the terrorist attacks on September 11, 2001, it had significant effects on the functioning of other financial institutions.

<u>What made Citigroup systemically important:</u> In SIGTARP's report "Extraordinary Assistance Provided to Citigroup, Inc.", SIGTARP examined the decision by the Government to provide additional TARP assistance to one of the initial nine TARP recipients, Citigroup, through a TARP program known as the Targeted Investment Program. The stated goal of TARP's TIP program was to invest funds, on a case-by-case basis, "to strengthen the economy and protect American jobs, savings, and retirement security" where "the loss of confidence in a financial institution could result in significant market disruptions that threaten the financial

strength of similarly situated financial institutions." Treasury provided an additional $20 billion each in TARP assistance to Bank of America and Citigroup under this program.

SIGTARP reported that in November 2008, Citigroup teetered on the brink of failure. Even though it had received $25 billion from TARP's Capital Purchase Program just weeks earlier, it was the subject of a global run on its deposits, its stock was in a nosedive as short sellers sought to profit on the market's perception of its deteriorating condition, and the cost of insuring its debt in the credit default swap market was increasing at an alarming pace compared to its peers. 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.

Secretary Paulson, FRB, and OCC expressed concern at that time that depositors might start a run on Citigroup, and that as a result, the bank would suffer a severe liquidity crisis (not have enough cash on hand) and not be able to meet its obligations as they became due. During the November 23, 2008, meeting in which the FDIC Board unanimously voted to recommend that Treasury invoke the systemic risk exception for Citigroup, one FDIC official said "The risk profile of Citibank is increasing rapidly due to the market's lack of confidence in the company and the substantially weakened liquidity position. Without substantial Government intervention that results in a positive market perception on Monday morning, OCC and Citigroup project that Citibank will be unable to pay obligations or meet expected deposit outflows next week."

Another participant in the meeting said, "The issue now is the potential for a large worldwide bank run, and that's what has got to be brought under control." SIGTARP reported that the Government gave the $20 billion in additional TARP assistance with the focus on sending a message to reassure the markets – the Government would not let Citigroup fail.

SIGTARP reported that 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. The absence of objective criteria for that conclusion raised concerns as to whether there was selective creativity being exercised in who was systemic and who was not. At the FDIC meeting, Office of Thrift Supervision Director John Reich said, "It's obviously a systemic risk situation. I don't have any question about that." According to Chairman Bernanke, it was "not even a close call to assist them." Secretary Paulson said, "If Citi isn't systemic, I don't know what is." An undated action memorandum for the Secretary discussed Treasury's reasons for supporting the Systemic Risk Determination. According to the memorandum, Citigroup's failure would threaten the viability of creditors and counterparties exposed to the institution, impair the liquidity of even well-capitalized institutions, dislocate the credit markets, and undermine business and household confidence in the broader economy.

As SIGTARP reported, 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." SIGTARP reported that 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 roadmap as to how those criteria should be applied.

SIGTARP reported that Citigroup was perceived as being interdependent and interconnected with a broad array of different financial institutions both in the U.S. and internationally, and in FRB's view, Citigroup's failure would have implications that reached beyond the bank itself. FRB regulators believed that a Citigroup failure would have destabilized the global financial system by seriously impairing already disrupted credit markets, including short-term interbank lending, counterparty relationships in qualified financial contract markets, bank and senior subordinated debt markets, and derivatives. Citigroup's Global Transaction Servicing unit offered integrated cash management, trade, and securities and fund services to multinational corporations, financial institutions, and public sector organizations spanning more than 100 countries and 65,000 clients. Given the significance of Citigroup's GTS unit, the collapse of Citigroup would have had devastating effects on the broader economy. Chairman Bernanke told SIGTARP that he believed that a Citigroup failure had the potential to block access to ATMs and halt the issuing of paychecks by many companies and governments. An FDIC official separately said that adverse effects on money market liquidity could be expected on a global basis.

As reported by SIGTARP, according to FRB's memorandum assessing the company's systemic risk, Citigroup also was a major player in a wide range of derivatives markets, both as a counterparty to over-the-counter trades, and as a broker and clearing firm for trades on exchanges. At the end of the third quarter, the notional principal value of its derivatives positions was more than $35 trillion, the bulk of which was held by its Citibank, N.A., subsidiary. A failure of Citigroup would have left many of its derivatives counterparties scrambling to replace contracts that they had with Citigroup. Citigroup's derivatives positions were fairly well balanced, so in more normal conditions counterparties might be able to replace Citigroup's derivatives contracts relatively easily, according to the FRB memo. However, given concerns about counterparty credit risk and strains in some derivatives markets at the time, those contracts might have proven difficult to replace.

SIGTARP's concluded its January 2011 report Extraordinary Financial Assistance Provided to Citigroup Inc., reporting that then-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 Wall Street Reform and Consumer Protection Act ("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. 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.

The designation of systemic importance is critical because as SIGTARP reported, 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.

Addressing Systemic Risk Posed by Systemically Important Institutions

For those institutions already identified as systemically important, more hard work is required. The institutions themselves, and their regulators, have the benefit of what was missing in the crisis – time – time to understand the interconnections and the risk they pose, and limit any dangerous risk so they are not caught unaware again.

Too big to fail continues to be a threat. Our nation's top financial regulators must take the necessary steps to end too big to fail by uncovering, understanding, and breaking off dangerous interconnections that could sow the seeds for a future crisis. It is the threat of these interconnections to the greater financial system that if not resolved, will determine whether there are future crises, and future bailouts. To let one of the largest financial firms fail requires regulators to have confidence that they can close down the firm without damaging the greater economy, and as a nation we have made progress, but there is more to be done.

Dodd-Frank reforms seek to end future taxpayer bailouts of systemically important institutions by using a dual approach: front line measures aimed at keeping the largest financial institutions safe and sound, and a last line defense aimed at letting a company fail without damaging the economy. Then Federal Reserve Chairman Bernanke testified before Congress in July 2012 that the blueprint for attacking too big to fail lies in Dodd-Frank's fail-safes that a company will be allowed to fail in bankruptcy or a new FDIC process called orderly liquidation authority.

The existence of bankruptcy planned by living wills and the FDIC's orderly liquidation authority, however, have not fully convinced the market to change its perception that select financial firms will get another bailout, and have not convinced megafirms to simplify their organizations or disentangle dangerous interconnections. There may be no time for bankruptcy particularly for certain players who dominate the market in providing a critical service to the economy as was the case in 2008. In addition, because the nation's largest financial firms remain highly interconnected, impairments will spread to others, decreasing the number of healthy firms available to buy assets from the failing ones. Additionally, the FDIC's orderly liquidation authority requires that debt holders hold sufficient debt to absorb the losses (not the case in the last crisis), otherwise, the FDIC borrows funds from Treasury.

Regulators should use information contained in living wills proactively, to root out and address dangerous interconnections institution by institution through off-balance sheet exposures, collateral pledges, hedging strategies, and other areas that caught regulators unaware in the last crisis. Additionally, regulators have an opportunity to use information in living wills to build a comprehensive roadmap of interconnections to capture the common risks, linkages, and interdependencies between the megabanks and non-banks across the financial system, assessing threats that institutions may pose to financial stability of other megafirms and American households.

If regulators expand their use of living wills from a deathbed document to a roadmap of interconnections in our financial system, they can take preemptory, supervisory action to force firms to break off dangerous interconnections that pose a threat to our system. Dodd-Frank provides regulators with significant authority over megafirms that pose a grave threat to financial stability, including requiring the company to terminate certain activities, stop offering certain products, or sell certain assets. Former Federal Reserve Chairman Ben Bernanke testified before Congress in July 2012 that living wills "provide a blueprint if you wanted to break up banks or hive off parts of banks. The living wills provide some information about how you could do that in a sensible way."

Ending too big to fail can be done; it must be done. It will not be easy. Ending too big to fail will require hard choices by companies to break up certain products or business lines and break off dangerous interconnections. Ideally, companies should do that on their own, which might even unlock additional shareholder value, but some have gotten bigger with complicated operations. Ending too big to fail requires banking regulators to shift their primary approach from the safety and soundness of each individual institution, to the safety and soundness of the financial system by focusing on the complex interconnected web these companies have formed. Regulators must protect taxpayers by ensuring that megafirms break off interconnections that pose a grave threat to our financial system. This requires steely courage of financial regulators to protect the nation's financial system from any one institution that can pose grave risk to hardworking Americans. However, if done right, our nation will take a major step toward preventing another crisis, or at least limiting its impact to those who made risky choices. Our nation's history of the crisis and resulting TARP bailout must not be allowed to repeat itself.