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"Three Years Later: Reflections on the Financial Crisis and the OCC"

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Thank you very much for the opportunity to speak at this excellent symposium. I confess I am partial to great Washington DC law schools, being the son of a lifetime law professor and one-time dean of that other law school across town. Among other things, George Washington University provides an extraordinary environment to become a lawyer, and events like this one are a perfect example of how to tap the Washington community for a thoughtful examination of important policy issues of our day.

As many of you know, I am a recovering bank regulator. Today, roughly three years after the financial crisis of 2007-2009, I would like to use that distance in time to provide some reflections on both the crisis and the role played by my former agency, the Office of the Comptroller of the Currency ("OCC"). There have, of course, been a number of reports, books, and articles written about this period, each with its own distinct perspective. It won't shock you to learn that I have found some of these reviews more accurate than others, and I appreciate this opportunity to add my direct observations on this critical period in our nation's banking and financial history.

Let me begin with some general remarks about the financial crisis, which I think began in March of 2007 with the Bear Stearns transaction; reached its zenith of fear and panic in the fall of 2008 with the implosion of Lehman Brothers and the government take-over of AIG; and subsided only after the massive infusion of private capital into the banking system in the wake of the remarkable, almost magically successful stress tests of 2009.

People often say that this period was the worst financial crisis since the Great Depression of the 1930s – but they are wrong. That depression was certainly the worst economic collapse the country ever suffered, with a quarter of our people out of work, and one of its fundamental causes was indeed the collapse of thousands of banks across the nation. But as a *financial* crisis – a period of fear, panic, loss of confidence, and impending failures of major financial institutions both here and around the world – the panic of 2008 was worse. That is certainly the view of the person who has perhaps the best informed perspective on both: Federal Reserve Chairman Ben Bernanke, one of the foremost scholars of the Great Depression and someone who was at the epicenter of the more recent crisis, describes September and October of 2008 as "the worst financial crisis in global history, including the Great Depression" – where 12 of the 13 most important financial institutions in the United States "were at risk of failure within a week or two"[1]– something that had no analog in the 1930s.

Now, I emphasize this point because it is the predicate for all the extraordinary measures that the Treasury Department, the central bank, the OCC, the FDIC, and other regulators took during this period in an effort to stop the panic, restore confidence in the banking and financial system, and most important, prevent this epic financial crisis from translating into

[1] Ben S. Bernanke, Chairman of the Federal Reserve, Testimony before the Financial Crisis Inquiry Commission, November 17, 2000, at 24.

another Great Depression. In retrospect, some of these measures were misguided; some addressed particular problems quite well; some didn't work at all; some proved to be only temporary fixes; and some were necessarily unfair and politically radioactive. It was a remarkable period where the senior policymakers across two very different Administrations of the most powerful country in the world were not at all sure what would work – I know this, because I witnessed it – but they nevertheless pulled together with a series of creative and aggressive measures to achieve a common goal. And taken as a whole, these measures worked: they did stop the panic; they did restore the basic soundness of and confidence in our financial system; and they did avert another Great Depression. And they did so with a surprisingly low direct cost to the taxpayer, without rampant nationalization of the financial system, and with a much faster government exit from most financial institutions than ever seemed possible.

In saying this, I do not mean to minimize at all the severe problems the financial crisis and its causes have left in their wake, including stubbornly high levels of unemployment, a massive number of home foreclosures, systemic mortgage servicing breakdowns, a government-run system of mortgage finance, and deep popular distrust of our largest financial institutions. But as serious as these problems are, they simply do not approach the severity of a deep and prolonged economic contraction that, in the case of the Great Depression, inflicted so much misery on people here and around the world, rending the social fabric and helping to sow the seeds for the second World War. If we had allowed the financial system to collapse in 2008 and 2009, we would have experienced a depression of at least that magnitude. We can never, ever forget this fundamental fact.

Now, with this context, let me talk about some of the most important principles at work in key decisions made by the bank regulators during the crisis. Given what I have just said, by far the most important was the need to prevent runs and financial panic and restore confidence in the financial system. This is the fundamental, core principle of banking regulation. It is why we have federal deposit insurance; discount window lending by central banks; restrictions on bank risk-taking; intrusive examination and supervision; capital and liquidity requirements; and a specialized regime for bank failures. And it is also why we take extraordinary government measures to prevent financial instability and panic when these more traditional regulatory measures prove inadequate.

Unfortunately, during a financial crisis, and this one was no exception, this preeminent principle of financial stability often trumped other important principles – a painful but necessary reality. For example, in order to prevent panic during 2008 and 2009, it was necessary to –

- Save some institutions from marketplace failure, and even worse, save only big institutions but not smaller ones;
- Expose the taxpayer to massive potential losses through direct equity investments and guarantees; and
- Nationalize the GSEs and AIG, and seriously consider nationalizing some large banks.

These extraordinary measures were unfair, expensive, and extremely unpopular. But at least in my experience, they were <u>only</u> driven by the policy imperative of preventing panic and keeping the financial system operating; they were never driven by any desire to protect management or shareholders, "coddle" an institution, cave into "lobbying" efforts, or by any of the other ill motives that have sometimes been ascribed to these decisions.

Now, with this context, let me provide some thoughts from my vantage point as Comptroller about key causes of the crisis, some specific actions taken during the crisis, and the role of the OCC in each.

First, this crisis did not begin with the activities of insured commercial banks, including national banks regulated by the OCC, although it eventually spread to them. The worst mortgages with the shoddiest underwriting – which really were the core trigger of the crisis – were overwhelmingly originated by other types of institutions. The biggest early problems were incurred by the major nonbank mortgage lenders, such as New Century; by the major trading houses that were heavily involved in mortgage-related products, such as Bear Stearns, Lehman Brothers, and AIG; by the biggest thrift institutions, such as Countrywide, WAMU, and IndyMac; and by the housing GSE securitizers, Fannie Mae and Freddie Mac. In cases where bank holding companies were involved, the biggest problems tended to be generated by their nonbanking affiliates, *e.g.*, Citigroup's broker-dealer affiliate and Wachovia's thrift affiliate, Golden West. Indeed, before the end of 2008, organizations with strong commercial banks were viewed as part of the *solutions* to the worst problems the system faced, with JP Morgan Chase acquiring the troubled Bear Stearns and the failed WAMU; PNC acquiring the troubled National City (which was the largest national bank that did get into trouble entirely on its own); Wells Fargo acquiring the Golden West-infected Wachovia; and Bank of America acquiring Countrywide and Merrill Lynch – although in this last case, the acquisitions proved to be enormous problems for BofA that ultimately precipitated its need for extraordinary government assistance.

That commercial banks were the last to feel the effects of the crisis was no coincidence. By design, these institutions, with their express ties to the federal safety net of deposit insurance, the discount window, and the federally guaranteed payments system, had always been subject to the most intense regulatory scrutiny – far more so than the unregulated nonbank mortgage lenders; the investment bank holding companies; thrifts and their holding companies; and even the nonbank affiliates of banks. In fact, I would argue that this was a fundamental part of the problem: while our antiquated regulatory system focused most heavily on insured banks, which were clearly the potential sources of financial panic in times past, it failed to focus adequately on other types of financial institutions that increasingly performed functions that made them equally susceptible to runs and panic – and once that panic appeared outside the banking system, it eventually spread to banks as well, including large national banks.

Once the crisis began, the OCC's initial challenge, working with other regulators, was to take all possible actions to ensure that these large national banks took no excessive risks, and were as strong and liquid as they could possibly be so they would not succumb to the panic, lose market confidence, and fail – which would only make the crisis worse. In those instances where that loss of confidence could not be avoided, the agency's even more daunting challenge was to help manage the sale, emergency government assistance, or recapitalization of the organization of which the bank was a part in a way that restored confidence and certainly did not contribute to the panic or cause a new one. On both counts, I strongly believe the OCC performed its core mission exceptionally well.

First, in terms of fortifying institutions to fend off the panic, of the 20 national banks in the agency's Large Bank division in 2007, 16 survived the crisis without severe distress and without extraordinary government assistance (other than the TARP capital that the government initially urged nearly all banks to accept in an effort to shore up confidence in the system generally). Some of these 16 institutions were strong and well managed, requiring less supervisory attention, but a number of them were not. In these latter cases the OCC aggressively pursued supervisory actions – many of which were not visible to the public – that forced institutions to squarely confront problem assets. A number of these actions proved critical to these institutions' viability as the crisis intensified.

In this context I want to particularly emphasize the role played by the OCC in forcefully requiring banks to build high levels of loan loss reserves, both before and during the crisis, in anticipation of expected losses. Critics argued at the time that such substantial provisioning was fundamentally pro-cyclical. I disagree. When times are difficult and banks stop paying dividends to husband capital, aggressive reserve building has one of two consequences. Either it correctly anticipates and absorbs large future losses that come to be, or, if times get better, it results in substantial reserve releases that get transferred to the capital account through additions to retained earnings. Both results are positive, and both position banks to be stronger to absorb losses and maintain a strong position to lend. Of course, we have been fortunate in the US to have the situation where the expected losses didn't fully materialize and the unused reserve builds really turned out to be pre-funded capital contributions. This has helped make US banks strong enough to resist the temptation to shrink their portfolios to increase capital ratios. Instead, because of the migration of reserves to capital in the wake of the crisis, newly recapitalized banks are fully positioned -- ready, willing, and able -- to make loans to fund growth in a weak economy. In short, the OCC has always been the leading federal banking agency in supporting high levels of reserves, both as a supervisory and a policy matter, and I believe this leadership paid particular dividends both during and in the wake of the financial crisis.

Now let me turn to a necessarily brief discussion of the OCC's actions in handling the four large national banks that required the most supervisory attention during the crisis – the ones where declining confidence and the threat of failure and panic was most pronounced. I need to qualify this discussion, however, by the fact that I am constrained by federal law from revealing confidential supervisory information about any institution we supervised – a restriction that I take very seriously. As you will see, I strongly believe that OCC supervisors performed exceptionally well in the very trying circumstances the agency confronted with respect to each of these banks. These situations also illustrate the multi-faceted challenges the bank regulators faced, where finding the best solution was never a simple black or white matter.

The first institution, National City, is one that almost no one refers to now in retrospectives about the crisis. Let me assure you, however, that the situation was very different in the fall of 2008, when we were deeply worried about depositor and counterparty confidence in the bank. In the wake of the disastrous failure of the California thrift IndyMac that summer, where very visible runs occurred and the FDIC was forced to take it over and incur billions of dollars of losses, banks that had had well publicized problems began to suffer elevated levels of deposit withdrawal and creditor pullback. National City was at the top of that list, despite the fact that it had received a healthy injection of private equity capital in the spring of that year. We worked very hard, with management, to find a buyer for the institution. While there was a tremendous amount of tire-kicking by healthy banks, no one would initially commit, and our concerns intensified. Then Congress made TARP funding available, which we creatively used as an incentive to entice healthy banks back to the bidding table. That eventually resulted in the purchase of the institution by PNC in a transaction that protected all of National City's depositors and creditors – preventing any runs – and provided economic value to its shareholders – all without any assistance by or cost to the FDIC. While there was criticism by local press and congressmen at our facilitating an out-of-state acquisition of the bank, I consider this transaction one of the agency’s finest successes in the crisis. Nobody talks about it now because it worked so well, but let me assure you that the outcome could have been starkly different.

The second institution was Bank of America. Here it was clear that the organization’s problems during the crisis were not caused by its national bank, though that institution certainly had its issues. Instead, its fundamental problems resulted from its acquisitions of Countrywide and Merrill Lynch, both of which the federal government encouraged (although make no mistake, Bank of America was a very willing buyer). The national bank had an exceptionally strong deposit franchise, and if it were not for these two purchases, I strongly believe that the organization would never have had to resort to extraordinary government assistance to survive. Then again, if Bank of America had not made these two acquisitions, the failure of the other two firms could have fueled real systemwide instability, especially the failure of Merrill Lynch. Bank of America truly helped move the system away from financial panic by absorbing the two distressed institutions when no other firm would. But because it did so, the firm was forced to seek extraordinary government assistance in the near term and has sustained extraordinary levels of problems and losses in its mortgage business over the long term – not an ideal outcome for the firm, certainly, but better for financial stability.

The third institution was Wachovia. This institution also had a strong deposit franchise and a number of strong businesses, but in the fall of 2006, at just the wrong moment, it made the mistake of purchasing Golden West. This large California thrift was loaded to the gills with so-called “payment option” or negative amortization residential mortgage loans. During my very first months as Comptroller in 2005, the OCC – first among the federal banking agencies – began moving aggressively against these very risky mortgages, and over the next two years national banks substantially reduced their origination of such loans. Ironically, despite these outspoken and aggressive efforts, the OCC was not the agency with jusisdiction over Wachovia's application to purchase Golden West. As a holding company acquisition, the only agency that needed to approve the application was the Federal Reserve, which it did.

The acquisition proved to be an albatross, generating significant losses as the mortgage crisis intensified. That along with very visible unsuccessful efforts to merge the firm with other financial institutions during the summer of 2008 began to create confidence problems for Wachovia. Rumors began to spread about the depth of the company's weakened condition, and creditors and counterparties began to pull back. The OCC was aware of all of these issues, but we believed that the core franchise of Wachovia remained fundamentally strong; that the mortgages acquired in the Golden West transaction, while problematic, constituted a relatively small part of much stronger overall assets of the company; and that the company maintained strong levels of liquidity to deal with immediate counterparty concerns. Moreover, we shared this information and supervisory assessments with the other federal banking regulators.

But problems at this time were intensifying. The largest depository institution failure in the FDIC's history, WAMU, occurred not over a weekend, as is usually the case with bank failures, but on a Thursday. While all depositors in that transaction, including uninsured depositors, were fully protected in the acquisition by JP Morgan Chase, subordinated creditors were not. As a result, the credit markets on Friday were chaotic, spreads blew out, potential investors in Wachovia turned away, and management reached the conclusion that the only real option was to sell the firm quickly. It also became unclear whether the institution would be able to meet their obligations the following week as confidence problems worsened, despite their having over $100 billion of liquidity on hand. Both regulators and management became convinced that Wachovia needed to be sold over the weekend to avoid a run-induced failure, and regulators swung into gear with the two potential acquirers, Citigroup and Wells Fargo.

I confess that I was surprised by this assessment, as we believed that the company was considerably stronger at that moment than others seemed to. To this day, there are key supervisors at the OCC who believe that the firm could have made it at least through the following week as a liquidity matter, and that its basic franchise and asset quality were strong enough to weather the storm, at least for an extended period. But given the climate at the time, and the intensifying sense of panic in the wake of the WAMU failure, regulators agreed that we could not take a chance by allowing the firm to open on its own on Monday.

You may recall what happened next: after first believing it could acquire the bank on an unassisted basis, Wells decided late Saturday that it could not, at least not with so short a time for due diligence; Citi then won the bid to do a government-assisted deal with the FDIC board invoking the "systemic risk exception" of the Federal Deposit Insurance Act that in effect protected all uninsured stakeholders of Wachovia. Then Wells, with more time to consider the matter and the benefit of a favorable tax ruling from the IRS, jumped in with an unassisted offer to purchase the company before Citi had closed the deal. That unassisted bid won the day, and all Wachovia depositors and creditors were fully protected without any government assistance.

The OCC's examiners, though dismayed by the speed of Wachovia's demise, felt that the unassisted acquisition by Wells Fargo effectively validated their earlier assessment that Wachovia's fundamental financial condition was much stronger than widely perceived – and to that point, the acquisition has proven to be successful for Wells. In the end, Wachovia was a casualty of the crisis whose extreme distress was precipitated primarily by its incredibly bad timing in acquiring Golden West.

The last institution I want to discuss is Citigroup, and in particular, its national bank subsidiaries, which I will collectively refer to as "Citibank." This is a more complicated story, but as I will discuss, I strongly believe the OCC's supervision of Citibank, especially once the crisis began, was successful in achieving the agency's core supervisory goal of avoiding financial panic while the overall organization lowered its risk profile, recapitalized, repaid its government assistance, and regained market confidence.

Let me begin with a bit of context. Unlike all the other Large Banks that the OCC supervised as the crisis began, Citi was unusual in that its national bank subsidiaries constituted only about half of the overall assets of the consolidated holding company – for other organizations, the national bank held the overwhelming majority of the company's assets. It was also one of only two Large National Banks that had a major broker-dealer and structured credit operation housed outside of the bank. As a result, the supervision of Citigroup was very much a shared operation among supervisors, with the OCC primarily responsible for the bank, the SEC primarily responsible for the broker-dealer, and the Federal Reserve primarily responsible for both the overall holding company and the nonbank subsidiaries that engaged in such activities as subprime mortgage lending. I should also add that, because of this structure, Citigroup as a whole did not have the broad and stable base of U.S. core deposit funding that the other large national banking organizations had. As a result, it was much more exposed to the skittishness of short-term wholesale market funding, though not nearly to the same extent as major nonbank trading houses such as Merrill Lynch, Bear Stearns, and Lehman.

Both before and during the crisis, the OCC required Citibank to remain in a considerably stronger financial condition than the rest of Citigroup. The bank had much higher levels of capital, and that capital was overwhelmingly common equity. (Indeed, the OCC and the other bank regulators had never permitted hybrid capital, such as trust preferred, to count as Tier 1 capital at the bank level; that was only allowed to count at the holding company by the Federal Reserve.) The bank also had strong levels of reserves that were increased substantially during the crisis. And the bank had a much stronger and more stable funding base than the rest of the company.

This is not to say, however, that the bank was free of supervisory problems, because it certainly was not. The bank clearly had asset quality issues. And more to the point, in the fall of 2007, when Citigroup sustained its massive, outsized losses related to collateralized debt obligations that were primarily structured in nonbank subsidiaries, a sizable portion of those losses were translated to the bank through obscure guarantee-like instruments called "liquidity puts." These losses and the risk management failures associated with them resulted in the replacement of management and a re-composed Citigroup board of directors. It also resulted in a new strategy to downsize, eliminate non-core businesses, reduce risk-taking, raise capital, and increase liquidity on hand. In addition, as is public due to a report by the Financial Crisis Inquiry Commission,[2] the OCC took action in the spring of 2008 under which its regulatory scrutiny of Citibank intensified and remained intensified for the duration of the crisis.

The losses Citigroup sustained in the fall of 2007 and the crisis events that followed exposed the fragility of the overall institution. Regulators were very concerned about the ongoing level of market confidence in Citigroup, which ebbed and flowed on a number of occasions over the next two years. The company took, and regulators directed the company and the bank to take, concrete actions to improve its financial condition and risk profile. But it was clear that that process would take time. In the meantime, the overriding concern was that, if

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[2] FINANCIAL CRISIS INQUIRY COMMISSION REPORT, at 304 (2011).

markets truly lost confidence in the institution, it would exacerbate the financial panic that had already begun or start a new one once the height of the panic of 2008 had begun to subside. Every action the OCC took during this period regarding Citibank – every single one of them – was motivated *solely* by this concern.

Unfortunately, many of the individual actions taken by the company during the first part of 2008, including raising nearly $40 billion in Tier 1 capital, proved insufficient to restore confidence in Citi for an extended period. The same was true of the government's initial investment of TARP preferred stock in the holding company, which also counted as Tier 1 capital. And even the extraordinary assistance provided to Citi in late November of 2008, consisting of even more TARP preferred stock and an asset guarantee by the government, failed to restore full market confidence. Through Citi and others, we learned one of the most important lessons of the crisis: at the end of the day, creditors and counterparties cared first, foremost, and perhaps exclusively about adequate levels of tangible common equity in assessing the financial condition of a banking organization – and this lesson is precisely what caused the increased common equity ratios required by Basel III. While Citigroup had relatively high levels of Tier 1 capital, it had relatively low levels of tangible common equity – and its prospects for raising new common equity in that period of deep market uncertainty were virtually nil.

At that point, in the first few months of 2009, when Citi's stock price briefly touched below $1, the issue confronting Citi's regulators and the Treasury Department was how to effectively recapitalize the company and restore market confidence. Should the government nationalize the company by using TARP money to purchase the company's stock? We now know that this was a debate that was actively going on between Treasury and the White House. Or should the government try to purchase bad assets from the company in order to clean up its balance sheet? Such purchases would almost certainly have led to nationalization as well because of the losses that Citi would have sustained if forced to sell distressed assets at then depressed market prices. Or was there another solution available that would avoid a government takeover of the institution?

The Treasury Department was very concerned with any solution that would involve the government totally taking over an institution the size of Citi. After all, the FDIC's takeover of IndyMac in the summer of 2008 had resulted in enormous relative losses -- $9 billion on an asset portfolio of $36 billion, or nearly 25 percent. Applying that same type of "haircut" to the $2 trillion dollar Citigroup would have produced losses in the staggering amount of $500 billion – not to mention the many issues that would arise from the government trying to operate and restructure a major money center banking organization while trying to preserve its franchise value. Furthermore, in the fragile markets of that period, nationalizing Citigroup could well have undermined confidence in other banks at the very time that our policy, which proved successful, was to encourage private capital investment in those banks.

During this period, Citigroup's management approached the OCC with a very creative but complex idea for recapitalizing the company through the conversion of hybrid capital instruments into common equity. That proposal would result in the massive dilution of existing common shareholders, all but wiping out the value of the common stock, but that was a small price to pay – and actually a very fitting price – if it could successfully recapitalize the company. The OCC was very supportive of this plan, and it gained real traction with regulators. But it would take time to execute, and it would also need to be clear that, with the restructuring, the company would have enough common equity to pass the stress test that the regulators applied to all large banking companies in the spring of 2009.

While Citi did not pass that first stress test outright, the results showed that, taking the substantial additional common equity from the restructuring into account, it would need only $5 billion in additional common equity to pass, which it was able to raise quickly. Then, at the end of 2009, with its newly increased common equity ratios and a return to profitability, Citi was able to raise an additional $16 billion in common equity. This was a very clear signal that market confidence in Citi had been restored, and a year later, the federal government was able to sell its last remaining interest in the company, which with other payments netted the taxpayer an aggregate profit of $12 billion.

In short, in just two years Citigroup moved from a devastating loss of market confidence and extraordinary government assistance to a completely recapitalized balance sheet, very high levels of common equity, severe dilution of pre-existing shareholders, a total exit from government ownership, renewed market confidence, and a profit for the taxpayer – all with the core objective achieved of avoiding a systemic disruption. I consider that an extraordinary success in crisis management by the government. The OCC played an important role in this process, and we were strongly supportive of the key paths chosen at every major fork in the road. The results could have been much different if other choices had been made, with far more disruption, massive costs for the taxpayer, and the lingering distortions of continued government involvement in the marketplace. Thankfully, they were not.

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In closing, the financial crisis and its aftermath were a critically challenging time for financial regulators, including the OCC. I am very proud of the role the agency played during this period, and I particularly salute the unsung efforts of senior officials and key supervisors on the ground in helping to prevent the crisis from mushrooming into something far worse than we experienced. There is critical value in having an agency whose core mission is to preserve the safety and soundness of the institutions it supervises. While the OCC certainly made mistakes both before and during the crisis, its net contributions to help restore financial stability were exemplary.

Thank you very much.