As Crisis Loomed, Geithner Pressed But Fell Short

Before Timothy Geithner became Treasury chief, he regulated major U.S. banks. Now he says: "We're having a major financial crisis in part because of failures of supervision."

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In September 2005, Timothy Geithner made one of his most visible moves as a supervisor of the U.S. banking system. He summoned the nation's top financial firms and their regulators to streamline an antiquated system that threatened Wall Street's boom.

Billions of dollars worth of financial instruments known as credit derivatives were being traded daily, as banks and investors worldwide tried to protect against losses on increasingly complex and risky financial bets. But the buying and selling of these exotic instruments was stuck in a pencil-and-paper era. Geithner, then head of the Federal Reserve Bank of New York, pressed 14 major financial firms to build an electronic network that would cut backlogs and make the market easier to monitor.

Geithner's summit, held at the New York Fed's fortress-like headquarters near Wall Street, was a success. By fall 2006, the new system had all but eliminated the logjam, helping derivatives trade more efficiently. One financial industry newsletter honored Geithner as part of a "Dream Team" for his leadership of the effort.

Yet as Geithner and the New York Fed worked to solve narrow mechanical issues in the derivatives market, they missed clear signs of a catastrophe in the making. When the housing market collapsed, derivatives stoked the fires that ignited inside some of the biggest banking companies. The firms' failure to assess an array of risks they were taking has emerged as a key element in the multitrillion-dollar meltdown of the global financial system.

Although Geithner repeatedly raised concerns about the failure of banks to understand their risks, including those taken through derivatives, he and the Federal Reserve system did not act with enough force to blunt the troubles that ensued. That was largely because he and other regulators relied too much on assurances from senior banking executives that their firms were safe and sound, according to interviews and a review of documents by The Washington Post and the nonprofit journalism organization ProPublica.

A confidential review ordered by Geithner in 2006 found that banking companies could not properly assess their exposure to a severe economic downturn and were relying on the "intuition" of banking executives rather than hard quantitative analysis, according to interviews with Fed officials and a little-noticed audit by the Government Accountability Office. The Fed did not use key enforcement tools until later, after the credit crisis erupted, according to its records and interviews.

Geithner defended his tenure as New York Fed president in an interview last week. He said he had been "deeply concerned about risk in the system" and worked assiduously behind the scenes to cajole banking
institutions to do more to identify weaknesses and protect the financial system. But he also took some responsibility for falling short.

"These efforts to improve risk management did change behavior, but they did not achieve enough traction," Geithner said. "We're having a major financial crisis in part because of failures of supervision."

Even as critics have questioned how he used existing power before the crisis, Geithner, as Treasury secretary, now leads the push for the biggest expansion of financial regulation since the Great Depression. His sweeping plan to overhaul the U.S. financial system would empower regulators to broadly analyze risk and would grant more authority to the Fed and its 12 reserve banks.

Geithner says he is applying lessons from his five years at the most important of the Fed's reserve banks. This week, he assumed an even more prominent platform, joining President Obama in London at a meeting with the Group of 20 industrialized nations to discuss global financial regulatory reform.

Looking back at his time at the New York Fed, Geithner said: "I wish I had worked to change the framework, rather than to work within that framework."

Geithner, 47, adopted the diplomatic approach to supervision that had long held sway at the New York Fed, a hybrid institution that is owned by the banks but implements monetary policy for the Federal Reserve. Like the other regional Feds, it also shares supervisory authority with the central bank. Six of its nine board members are chosen by the commercial banking companies it supervises. The board plays a role in the selection of the New York Fed president.

Although the Federal Reserve system, and the New York Fed in particular, was responsible for watching for systemwide risks, Geithner said that the Fed was limited by a lack of explicit authority over financial institutions outside the banking system. One key example was insurance giant American International Group, whose derivative transactions helped fuel the financial collapse last fall.

As part of Geithner's confirmation process for Treasury secretary, Democratic and Republican senators questioned why he and the New York Fed did not take a tougher approach with the troubled institutions it did regulate, such as Citigroup, then the largest under its supervision and the one hardest hit by the financial crisis.

Geithner, who maintained ties to senior bank executives and others in the financial world, had a particularly close relationship with former Treasury secretary Robert E. Rubin, a mentor then serving as a senior executive at Citigroup. In 2007 and 2008, Geithner held discussions with Citigroup officials dozens of times, more than with any other firm, according to interviews and documents, including Geithner's daily calendar.

Some lawmakers in both parties are asking whether bank regulators in general were too close to the institutions they oversaw. Geithner says meetings with executives from Citigroup and other firms were a routine part of his job. He said checks and balances built into the Federal Reserve system preserve the independence of Fed officials.

"The effectiveness of the New York Fed clearly does depend on frequent and open dialogue between the Fed and the leaders of the major financial institutions," Corrigan said.

"Striking that balance is never easy," he said. "On the whole, Tim did a reasonably good job."

'Biggest Casino'
Geithner is trim, boyish-looking and thoughtful, parsing his ideas with academic care. Unlike some of his predecessors at the Fed, he did not bring a banker's résumé to the job. A protege of former secretary of state Henry Kissinger at his consulting firm, he joined the Treasury and rose through the ranks with support from two Clinton-era secretaries, Rubin and Lawrence H. Summers. Geithner eventually served as undersecretary for international affairs, where he oversaw the department's response to the Asian financial crisis in the late 1990s.

When he arrived at the New York Fed in fall 2003, the derivatives market had begun to soar. One type of derivative known as a credit-default swap is a contract that operates much like insurance for complex financial transactions. They greatly enhanced Wall Street's ability to package mortgages into exotic securities that could be resold to investors. That, in turn, fueled the housing bubble by expanding the supply of money for home loans.

But by 2005 the paperwork for derivatives contracts was swamping the back offices of big financial firms. Stacks of documents sat unattended. The archaic system was not only bad for business, it impeded the market from properly pricing deals. "They didn't know what their positions were," Geithner said in the interview. "This was a huge collective-action problem."

Under Geithner's direction, the banks formally agreed after months of meetings in early 2006 to fix the problem together.

At the time, many bankers and regulators were convinced that credit derivatives had in just a few years strengthened the world's financial system. Alan Greenspan, then chairman of the Federal Reserve, set the rhetorical tone for the Fed's advocacy of such deals.

"The development of credit derivatives," Greenspan said in a May 2005 speech, "has contributed to the stability of the banking system by allowing banks, especially the largest, systemically important banks, to measure and manage their credit risks more effectively."

Geithner often cited the merits of credit derivatives as well, saying in a May 2006 speech at New York University that they "probably improve the overall efficiency and resiliency of financial markets."

By then, some financial institutions already were worried about the subprime mortgages underlying exotic securities. AIG's Financial Products unit, one of the largest issuers of credit-default swaps, stopped offering that insurance. Even so, few understood the magnitude of the looming disaster.

"What nobody knew was that credit derivatives had moved from a risk diversification and risk management vehicle to the world's biggest gambling casino," said H. Rodgin Cohen, a New York attorney for large financial companies such as J.P. Morgan Chase and Wachovia.

Although he later said he didn't see the larger danger, Geithner at the time expressed concern about whether the large banks he supervised fully understood their vulnerabilities. In the NYU speech, he said they would need to take a "cold, hard look" at the interlocking effects of such deals across the financial system.

That same year he initiated a Fed-wide review of how well the financial giants were able to measure their ability to survive the stresses of a market downturn. William Rutledge, the New York Fed's executive vice president for bank supervision, said the reviews turned up several weaknesses. They found that banking companies were pretty good at measuring the risks to specific parts of their businesses but had little understanding of the dangers to the institution as a whole. The firms also failed to account for the kind of worst-case scenarios that would later cripple several banking giants.

The New York Fed followed up the study of the stress tests by holding private discussions with bank managers. The Fed officials sought among other things to "encourage" firms to improve their "credit
risk-management practices" and to engage in "careful reflection" of their assessment of the global economy's health, Rutledge said in a written response to questions. Cohen, the banking lawyer, said that Geithner privately "was pushing the system to reform." But because of limited resources, Geithner was reliant on the big banks for information about their activities, Cohen said.

GAO auditors who recently reviewed the confidential Fed study said the banks pushed back against the idea of expanding their stress tests. Executives "questioned the need for additional stress testing, particularly for worst-case scenarios that they thought were implausible," Orice Williams, the director of financial markets at the GAO, told the Senate subcommittee on securities, insurance and investments last month.

Williams said that regulators "did not take forceful action" to correct the risk-management deficiencies "until the crisis occurred."

Records and interviews show that Geithner and his colleagues did not employ some of the harsher tools at their disposal to bring the banks into line. From 2006 through the start of the credit crisis in the summer of 2007, they brought no formal enforcement actions against any large institution for substandard risk-management practices. The Fed also did not use its confidential process during that period to downgrade any large bank company's risk rating, according to two people familiar with the process, a step that could have triggered costly consequences for the firms.

A spokesman for the New York Fed said it does not comment on private supervisory actions.

The New York Fed led a broader review of the large banks' risk management in early 2007, just months before the credit crisis began. Unlike the 2006 study, the review, titled "Large Financial Institutions' Perspectives on Risk," gave an upbeat assessment of their ability to handle potential vulnerabilities. Relying on bank assurances that the quality of their loans and investments remained "strong," the Fed concluded that there were "no substantial issues of supervisory concern."

When Congress learned of the Fed reports during last month's hearing, some lawmakers questioned the close relationships between the regulators and banks. They suggested that the Fed's practice of keeping its findings confidential may have contributed to the crisis.

"There might have been earlier, prompter and more effective action to deal with some of these issues that are bedeviling us at the moment," said Sen. Jack Reed (D-R.I.). "In many respects you are captives of the information of the organization you're regulating."

Dates with Citi

The recent criticism of the New York Fed raises questions about its dual mandate to be both a supervisor and the government's eyes and ears on the nation's financial markets.

Like his predecessors, Geithner relied on extensive contact with senior banking officials to collect information and influence their practices. "He had a remarkable ability to gain information without giving up information or without giving up his independence," said Cohen, the banking lawyer.

Cohen, who was in the running earlier this year to be Geithner's deputy at the Treasury, is among hundreds of people listed in Geithner's 2007 and 2008 appointment calendars, which were made available by the New York Fed. Geithner's outside contacts include senior banking managers, Treasury officials, regulators from other nations and journalists. The appointments range from breakfasts and lunches with bankers to tennis with Alan Greenspan and "Dinner w/Dr. and Mrs. Kissinger, et. al."

No institution shows up as frequently as Citigroup, the biggest bank company under the New York Fed's supervision. Among the numerous senior Citigroup officials recorded were Geithner's mentor Rubin, chief
executive Charles Prince and his successor, Vikram Pandit.

Citigroup officials declined to comment for this report.

The calendar entries offer few details on the meetings, but the New York Fed had no shortage of topics to discuss with the bank holding company about its far-flung operations and its increasing exposure to subprime mortgages.

In 2005, as regulators abroad investigated Citigroup for imprudent trading practices, the Fed banned it from making new acquisitions. The ban was lifted in April 2006 after Citigroup assured the New York Fed it had tightened its compliance. At the end of that year, without public explanation, the Fed also terminated a three-year-old public-enforcement agreement that required Citigroup to beef up its risk management and file regular reports with the Fed.

At the time, Citigroup was taking on more risk. It was reporting record profits while also doubling its exposure to the subprime market. In 2006 Citigroup originated nearly twice as many subprime mortgages as the year before. It also issued twice as many exotic securities known as collateralized debt obligations -- including many composed of subprime loans.

By fall 2007, Citigroup began to recognize huge losses from these and other bets. At the urging of Geithner and the Fed, Citigroup began raising more capital to fill the growing holes in its balance sheets and reassure the markets of its solvency.

Citigroup's level of capital exceeded regulatory minimums. But the Fed did not require the banking company to raise the level to that of its peers. At the end of 2007, the capital level also fell below Citigroup's internal target.

A few months later, banking analysts raised questions about Citigroup's capital reserves. During the company's annual conference in early May, Pandit was asked whether there was tension between the banks, the auditors and the regulators over that issue. Pandit said that Citigroup was in "perfect agreement" with regulators and auditors. When an analyst expressed skepticism, another Citigroup executive backed up Pandit, saying there was "kind of an unusual symmetry."

In June 2008, Geithner told the Economic Club of New York that the guidelines for bank capital needed to be reworked -- but not yet. "After we get through this crisis, and the process of stabilization and financial repair is complete, we will put in place more exacting expectations on capital, liquidity and risk management for the largest institutions," he said.

By the fall, the only place beleaguered Citigroup could find capital was the Treasury. The government initially injected $25 billion to keep the company afloat. That wasn't enough. A few weeks later it came up with another $20 billion in cash and guarantees that would cover nearly $250 billion in losses on its toxic assets. No banking firm has received a larger federal bailout.

Geithner was working on the second Citigroup rescue, when, on Nov. 21, word leaked that President-elect Barack Obama wanted to name him Treasury secretary. Geithner had two meetings that day with top Citigroup executives, according to his calendar. Then he quickly stepped aside from further involvement in the rescue of financial institutions.

Before his confirmation hearing Geithner paid courtesy calls in the Senate. He mostly got a warm reception. When he went to see Sen. Ron Wyden, the Oregon Democrat quizzed him about his supervision of Citigroup.

"I quoted to him from the U.S. code," Wyden said, "about the clear responsibilities of the New York Fed." Wyden wanted to know why the "alarm bells" about Citigroup hadn't prompted the Fed to "enforce existing
laws."

A few days later Geithner appeared before the Senate Finance Committee. Wyden once again asked why Geithner missed the boat with Citigroup.

Geithner acknowledged that "supervision could have been more effective." Before he could continue, Wyden pressed him: "Should your supervision have been more effective?"

"Absolutely," Geithner said.

As the Fed prepares to take on even more responsibility in a new financial regulatory architecture, it also is engaged in what Fed vice chairman Donald Kohn describes as a "comprehensive 'lessons-learned' review" of the credit crisis. In an interview, Kohn, who is leading the review, declined to discuss the findings so far.

Roger T. Cole, the central bank's head of banking supervision, told Congress two weeks ago that one lesson among many is that regulators must no longer be lulled by good times or put off by industry arguments.

"When bankers are particularly confident, when the industry and others are especially vocal about the costs of regulatory burden and international competitiveness, and when supervisors cannot yet cite recognized losses or write-downs," Cole said, "we must have even firmer resolve to hold firms accountable for prudent risk management."