ADVISOR PERSPECTIVES

Henry Paulson: An Inside Look at the Financial Crisis

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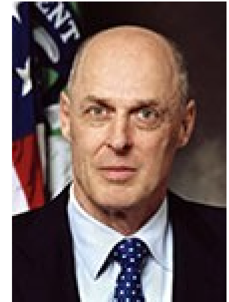

Former Treasury Secretary Henry Paulson candidly spoke about the details of his efforts to rescue the economy during the financial crisis, and offered some optimistic thoughts about the potential for growth in the US economy in the face of new financial regulation. Paulson spoke on Wednesday at a keynote session, moderated by Schwab economist Liz Ann Sonders, at the Schwab IMPACT conference.

Under pressure from his family, Paulson said that he twice refused the job of Treasury Secretary before accepting the assignment. His mother, in particular, was upset by his working for President George Bush, which Paulson said resulted in one of the few times she cried.

Paulson negotiated to be the president's primary advisor on both domestic and international finance issues and to have open access to the president. He vowed not to get involved in politics, and worked hard to build a relationship with the president, which he said recognized would be essential to successfully fulfilling his role.

Paulson said it was a wonderful experience and that Bush was "a good boss."

When he began as Treasury Secretary, Paulson said he knew there were "excesses" and that a financial crisis was "long overdue," but he did not foresee what would cause it. He thought that housing was "contained" because, since World War II, there had never been a nationwide price decline. He also believed, at the time, that subprime mortgages were not a sufficiently big part of the US economy to cause the problems that later unfolded.

Once the crisis was in full swing, Paulson said he wanted to ask Congress for "unlimited" authority to rescue failing institutions, but was convinced by his staff to instead ask for "unspecified" authority, because that was believed to be more politically palatable. Eventually, he had to threaten to use a "bazooka" in order to comfort the market – a metaphor for permanently guaranteeing the debt of and nationalizing Fannie Mae and Freddie Mac.

Bear Stearns, Paulson said, may not have been too big to fail but was too interconnected to fail. He said he "got lucky" when J.P. Morgan wanted to buy it, because he did not have the ability to orchestrate a bankruptcy or wind-down. The biggest lesson he took away from the Bear Stearns episode was the vulnerability of the investment banks and how little regulators understood liquidity issues.

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By contrast, Lehman was allowed to fail because there was no buyer. Two potential buyers, Bank of America and Barclays, fell through, in one case because of the Merrill acquisition and the other because British regulators blocked the deal. Paulson said a loan to Lehman would not have been adequate for a rescue. Lehman was also a much bigger problem, in terms of capital, than Bear Stearns, he said.

Paulson described an event which, Sonders said, has been since called the "circus meeting." When he was attempting to build support for TARP, he said he knew that it would be a politically unpopular vote for almost everyone in Congress, particularly House Republicans. He spoke regularly with candidates John McCain and Barack Obama because, he said, he "would have been defenseless" if either criticized his plan. At one point, McCain stopped campaigning and returned to Washington, which made Paulson very concerned. The circus meeting took place between Paulson and key members of both parties. A shouting match developed, which Vice President Dick Cheney later described as unprecedented. Paulson was very worried things would break apart and met with the Democrats, who he said had circled around Obama. Ultimately, Paulson bent down on one knee to plead with Nancy Pelosi, which Paulson said was to break the tension. Ultimately, of course, TARP passed with bilateral support.

One of his toughest challenges, he said, was to compromise with Barney Frank and work toward financial reform. He said he realized how broken and outdated the regulatory system was – there were multiple regulations in some places and "huge holes" in others. An example he gave of the latter was that the holding company for AIG was largely unregulated, as were the markets for repos, secured lending, and derivatives.

Paulson said he is "much more positive than negative about financial regulation." A key improvement, he said was the systemic risk regulatory council, which has the authority to intervene and act. He also cited the wind-down authority and the presumption that a big institution will be liquidated in such a way as to protect the economy. He supports the regulation of all big financial institutions by the Federal Reserve.

"We will have greater growth with better regulated financial institutions," he said.

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