THE CAUSES AND EFFECTS OF THE LEHMAN BROTHERS BANKRUPTCY

HEARING

BEFORE THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

OCTOBER 6, 2008

Serial No. 110–207

Printed for the use of the Committee on Oversight and Government Reform

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

55–766 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HENRY A. WAXMAN, California, *Chairman*

EDOLPHUS TOWNS, New York
PAUL E. KANJORSKI, Pennsylvania
CAROLYN B. MALONEY, New York
ELIJAH E. CUMMINGS, Maryland
DENNIS J. KUCINICH, Ohio
DANNY K. DAVIS, Illinois
JOHN F. TIERNEY, Massachusetts
WM. LACY CLAY, Missouri
DIANE E. WATSON, California
STEPHEN F. LYNCH, Massachusetts
BRIAN HIGGINS, New York
JOHN A. YARMUTH, Kentucky
BRUCE L. BRALEY, Iowa
ELEANOR HOLMES NORTON, District of Columbia
BETTY McCOLLUM, Minnesota
JIM COOPER, Tennessee
CHRIS VAN HOLLEN, Maryland
PAUL W. HODES, New Hampshire
CHRISTOPHER S. MURPHY, Connecticut
JOHN P. SARBANES, Maryland
PETER WELCH, Vermont
JACKIE SPEIER, California

TOM DAVIS, Virginia
DAN BURTON, Indiana
CHRISTOPHER SHAYS, Connecticut
JOHN M. McHUGH, New York
JOHN L. MICA, Florida
MARK E. SOUDER, Indiana
TODD RUSSELL PLATTS, Pennsylvania
CHRIS CANNON, Utah
JOHN J. DUNCAN, JR., Tennessee
MICHAEL R. TURNER, Ohio
DARRELL E. ISSA, California
KENNY MARCHANT, Texas
LYNN A. WESTMORELAND, Georgia
PATRICK T. McHENRY, North Carolina
VIRGINIA FOXX, North Carolina
BRIAN P. BILBRAY, California
BILL SALI, Idaho
JIM JORDAN, Ohio

PHIL SCHILIRO, *Chief of Staff*
PHIL BARNETT, *Staff Director*
EARLEY GREEN, *Chief Clerk*
DAVID MARIN, *Minority Staff Director*

CONTENTS

THE CAUSES AND EFFECTS OF THE LEHMAN BROTHERS BANKRUPTCY

MONDAY, OCTOBER 6, 2008

HOUSE OF REPRESENTATIVES,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The committee met, pursuant to notice, at 10:09 a.m., in room 2154, Rayburn House Office Building, Hon. Henry A. Waxman (chairman of the committee) presiding.

Present: Representatives Waxman, Maloney, Cummings, Kucinich, Tierney, Watson, Higgins, Yarmuth, Braley, Norton, McCollum, Cooper, Van Hollen, Sarbanes, Welch, Davis of Virginia, Shays, Mica and Turner.

Staff present: Kristin Amerling, general counsel; Caren Auchman, press assistant; Phil Barnett, staff director and chief counsel; Jen Berenholz, deputy clerk; Alison Cassady, professional staff member; Brian Cohen, senior investigator and policy advisor; Zhongrui "JR" Deng, chief information officer; Greg Dotson, chief environmental counsel; Miriam Edelman, Jennifer Owens, and Mitch Smiley, special assistants; Earley Green, chief clerk; David Leviss, senior investigative counsel; Karen Lightfoot, communications director and senior policy advisor; Leneal Scott, information systems manager; Roger Sherman, deputy chief counsel; Lawrence Halloran, minority staff director; Jennifer Safavian, minority chief counsel for oversight and investigations; A. Brooke Bennett, minority counsel; Brien Beattie, Molly Boyl, Alex Cooper, Adam Fromm, Todd Greenwood, and Mark Marin, minority professional staff members; Larry Brady, John Cuaderes, and Nick Palarino, minority senior investigators and policy advisors; Patrick Lyden, minority parliamentarian and Member services coordinator; and Brian McNicoll, minority communications director.

Chairman WAXMAN. The meeting of the committee will please come to order.

On Friday, Congress passed a $700 billion rescue package for Wall Street. This was something no Member wanted to do. If Wall Street had been less reckless, or thorough regulators had been more tentative, the financial crisis could have been prevented. But we voted for the $700 billion rescue because the consequences of doing nothing were even worse.

The excesses on Wall Street have caused a credit freeze that threatened our entire economy. The $700 billion rescue plan is a life-support measure. It may keep our economy from collapsing, but it won't make it healthy again. To restore our economy to health, two steps are necessary. First we must identify what went wrong, then we must enact real reforms for our financial markets.

Over the next 3 weeks, we will start this process in this committee. We will be holding a series of five hearings on the financial meltdown on Wall Street. We'll examine how the system broke down, what could have been done to prevent it, and what lessons we need to learn so this won't happen again.

Today's hearing examines the collapse of Lehman Brothers, which, on September 15th, filed for bankruptcy, the largest bankruptcy filing in American history. Before the Lehman Brothers bankruptcy, Treasury Secretary Paulson and Federal Reserve Chairman Bernanke told us our financial system could handle the collapse of Lehman. It now appears they were wrong. The repercussions of this collapse have reverberated across our economy. Many experts think Lehman's fall triggered the credit freeze that is choking our economy, and that made the $700 billion rescue necessary.

Lehman's collapse caused a big money market fund to break the buck, which caused investors to flee to Treasury bills and dried up a key source of short-term commercial paper. It also spread fear throughout the credit markets, driving up the costs of borrowing.

Over the weekend we received the testimony, the written testimony, of Richard Fuld, the CEO of Lehman Brothers. Mr. Fuld takes no responsibility for the collapse of Lehman. Instead he cites a, "litany of destabilizing factors," and says, "in the end, despite all our effort, we were overwhelmed."

In preparation for today's hearing, the committee received thousands of pages of internal documents from Lehman Brothers. Like Mr. Fuld's testimony, these documents portray a company in which there was no accountability for failure. In one e-mail exchange from early June, some executives from Lehman's money management subsidiary Neuberger Berman made this recommendation: Top management should forego bonuses this year. This would serve a dual purpose. First, it would represent a significant expense reduction; second, it would send a strong message to both employees and investors that management is not shirking accountability for recent performance.

The e-mail was sent to Lehman's executive committee. One of its members is George H. Walker, President Bush's cousin, who is responsible for overseeing Neuberger Berman. And here is what he wrote the executive committee. "Sorry, team. I'm not sure what is in the water at 605 Third Avenue today. I'm embarrassed, and I apologize."

Mr. Fuld also mocked the Neuberger suggestion that top management should accept responsibility by giving up their bonuses. His response was, "don't worry, they are only people who think about their own pockets."

Another remarkable document is a request submitted to the compensation committee of the board on September 11th, 4 days before Lehman filed for bankruptcy. It recommends that the board give three departing executives over $20 million in, "special payments." In other words, even as Mr. Fuld was pleading with Secretary Paulson for a full rescue, Lehman continued to squander millions on executive compensation.

Other documents obtained by the committee undermine Mr. Fuld's contention that Lehman was overwhelmed by forces outside of its control. One internal analysis reveals that Lehman saw warning signs, but did not move early/fast enough, and lacked discipline about capital allocation.

In 2004, the Securities and Exchange Commission relaxed a rule limiting the amount of leverage that Lehman and other investment banks could use. As this chart—Lehman chart shows—and if we could have that posted, I would appreciate it—that proved to be a temptation the firm could not resist. So in 2004, the SEC allowed greater leverage, and Lehman and other banks couldn't resist that and took on more leverage.

At first Lehman's bets paid out. As Mr. Fuld's testimony recounts, Lehman achieved 4 consecutive years of record-breaking financial results between 2004 and 2007. These were lucrative years for Lehman's executives and Mr. Fuld. Lehman paid out over $16 billion in bonuses. And we do have the chart now on the screen. Lehman paid out over $16 billion in bonuses. Mr. Fuld himself received over $40 million in cash bonuses. His total compensation during these 4 years exceeded $260 million.

But while Mr. Fuld and other Lehman executives were getting rich, they were steering Lehman Brothers and our economy toward a precipice. Leverage is a double-edged sword. When it works as it did in 2004 to 2007, it magnifies investment gains. But when asset failures decline as the subprime market did, leverage rapidly consumes a company's capital and jeopardizes its survival.

Mr. Fuld's actions during this crisis were questionable. In a January 2008 presentation, he and the Lehman board were warned that the company's liquidity can disappear quite fast. Yet despite this warning, Mr. Fuld depleted Lehman's capital reserves by over $10 billion through year-end bonuses, and stock buybacks and dividend payments. In one document a senior executive tells Mr. Fuld that if the company can secure $5 billion in financing from Korea, "I like the idea of aggressively going into the market and spending 2- of the 5- in buying back lots of stock and hurting Einhorn bad. This action might have inflicted short-term losses on a short seller Lehman despised, but it would have burned through even more capital." Mr. Fuld's response: "I agree with all of it."

What is fundamentally unfair about the collapse of Lehman is its impact on the economy and taxpayers. Mr. Fuld will do fine. He can walk away from Lehman a wealthy man who earned over $500 million, but taxpayers are left with a $700 billion bill to rescue Wall Street and an economy in crisis.

Risk taking has an important role in our economy, but Federal regulators are supposed to ensure that these risks don't become so large that they can imperil our entire economy. They failed miserably. The regulators had a blind faith in the market and a belief that what was good for Mr. Fuld and other executives on Wall Street was good for America, and we are now all paying a terrible price.

We can't undo the damage of the past 8 years. That is why I reluctantly voted for the $700 billion rescue plan. But we can start the process of holding those responsible to public account and identifying the reforms we need for the future. These are the goals of today's hearing and the other hearings we will be holding this month.

[The prepared statement of Hon. Henry A. Waxman follows:]

ONE HUNDRED TENTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

2157 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515–6143

MAJORITY (202) 225-5051
FACSIMILE (202) 225-4784
MINORITY (202) 225-5074

www.oversight.house.gov

Opening Statement of Rep. Henry A. Waxman
Chairman, Committee on Oversight and Government Reform
Causes and Effects of the Lehman Brothers Bankruptcy
October 6, 2008

On Friday, Congress passed a $700 billion rescue package for Wall Street. This was something no member wanted to do. If Wall Street had been less reckless or if federal regulators had been more attentive, the financial crisis could have been prevented.

But we voted for the $700 billion rescue because the consequences of doing nothing were even worse. The excesses on Wall Street had caused a credit freeze that threatened our entire economy.

The $700 billion rescue plan is a life-support measure. It may keep our economy from collapsing, but it won't make it healthy again.

To restore our economy to health, two steps are necessary. First, we must identify what went wrong. Then we must enact real reform of our financial markets.

Over the next three weeks, we will start this process in this Committee. We will be holding a series of five hearings on the financial meltdown on Wall Street. We'll examine how the system broke down, what could have been done to prevent it, and what lessons we need to learn so this won't happen again.

Today's hearing examines the collapse of Lehman Brothers, which on September 15 filed for bankruptcy, the largest bankruptcy filing in American history.

Before the Lehman bankruptcy, Treasury Secretary Paulson and Federal Reserve Chairman Bernanke told us our financial system could handle the collapse of Lehman.

It now appears they were wrong. The repercussions of this collapse have reverberated across our economy. Many experts think Lehman's fall triggered the credit freeze that is choking our economy and made the $700 billion rescue necessary. Lehman's collapse caused a big money market fund to "break the buck," which caused investors to flee to Treasury bills and dried up a key source of short-term commercial paper. It also spread fear throughout the credit markets, driving up the costs of borrowing.

Over the weekend, we received the written testimony of Richard Fuld, the CEO of Lehman Brothers. Mr. Fuld takes no responsibility for the collapse of Lehman. Instead, he cites a "litany of destabilizing factors" and says: "In the end, despite all our efforts, we were overwhelmed."

In preparation for today's hearing, the Committee received thousands of pages of internal documents from Lehman Brothers. Like Mr. Fold's testimony, these documents portray a company in which there was no accountability for failure.

In one e-mail exchange from early June, some executives from Lehman's money management subsidiary, Neuberger Berman, made this recommendation:

> Top management should forgo bonuses this year. This would serve a dual purpose. Firstly, it would represent a significant expense reduction. Secondly, ... it would send a strong message to both employees and investors that management is not shirking accountability for recent performance.

The e-mail was sent to Lehman's executive committee. One of its members is George H. Walker, President Bush's cousin, who was responsible for overseeing Neuberger Berman. Here's what he wrote to the executive committee: "Sorry team. I'm not sure what's in the water at 605 Third Avenue today. ... I'm embarrassed and I apologize."

Mr. Fuld also mocked the Neuberger suggestion that top management should accept responsibility by giving up their bonuses. His response was: "Don't worry – they are only people who think about their own pockets."

Another remarkable document is a request submitted to the compensation committee of the board on September 11, four days before Lehman filed for bankruptcy. It recommends that the board give three departing executives over $20 million in "special payments."

In other words, even as Mr. Fuld was pleading with Secretary Paulson for a federal rescue, Lehman continued to squander millions on executive compensation.

Other documents obtained by the Committee undermine Mr. Fuld's contention that Lehman was overwhelmed by forces outside its control. One internal analysis reveals that Lehman "saw warning signs" but "did not move early/fast enough" and lacked "discipline about capital allocation."

In 2004, the Securities and Exchange Commission relaxed a rule limiting the amount of leverage that Lehman and other investment banks could use. As this Lehman chart shows, that proved to be a temptation the firm could not resist.

At first, Lehman's bets paid out. As Mr. Fuld's testimony recounts, Lehman achieved "four consecutive years of record-breaking financial results" between 2004 and 2007.

These were lucrative years for Lehman's executives and Mr. Fuld. Lehman paid out over $16 billion in bonuses. Mr. Fuld himself received over $30 million in cash bonuses. His total compensation during these four years exceeded $260 million.

But while Mr. Fuld and other Lehman executives were getting rich, they were steering Lehman Brothers and our economy towards a precipice.

Leverage is a dangerous double-edged sword. When it works — as it did from 2004 to 2007 — it magnifies investment gains. But when asset values decline — as the subprime market did — leverage rapidly consumes a company's capital and jeopardizes its survival.

Mr. Fuld's actions during this crisis were questionable. In a January 2008 presentation, he and the Lehman board were warned that the company's "liquidity can disappear quite fast." Yet despite this warning, Mr. Fuld depleted Lehman's capital reserves by over $10 billion through year-end bonuses, stock buybacks, and dividend payments.

In one document, a senior executive tells Mr. Fuld that if the company can secure $5 billion in financing from Korea, "I like the idea of aggressively going into the market and spending 2 of the 5 in buying back lots of stock (and hurting Einhorn bad!!)." This action might have inflicted short-term losses on a short seller Lehman despised, but it would have burned through even more capital. Mr. Fuld's response: "I agree with all of it."

What's fundamentally unfair about the collapse of Lehman is its impact on the economy and taxpayers. Mr. Fuld will do fine. He can walk away from Lehman a wealthy man who earned over $500 million. But taxpayers are left with a $700 billion bill to rescue Wall Street and an economy in crisis.

Risk-taking has an important role in our economy. But federal regulators are supposed to ensure that these risks don't become so large they can imperil our entire economy. They failed miserably. The regulators had a blind faith in the market and a belief that what was good for Mr. Fuld and other executives on Wall Street was good for America. We are now all paying a terrible price.

We can't undo the damage of the past eight years. That's why I reluctantly voted for the $700 billion rescue plan. But we can start the process of holding those responsible to public account and identifying the reforms we need for the future.

These are the goals of today's hearing and the other hearings we will be holding this month.

Chairman WAXMAN. I would now like to recognize Mr. Davis for his opening statement.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman. We have Members on this side who would like to make opening statements. What is the position to be today?

Chairman WAXMAN. The rules of the committee provide that the chairman and the ranking member may make opening statements. We have many Members here. We have many witnesses that will also be here to—also here to make their presentations. So the Chair will stick by the rules. Opening statements only by the chairman and the ranking member.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman.

Mr. SHAYS. I'd just like to ask unanimous consent that Members be allowed to make an opening statement. This is a hugely important hearing. It is the beginning of five hearings, and frankly there is some——

Chairman WAXMAN. There is objection to that. The rules don't provide for it, and the committee will not give unanimous consent for it.

Mr. SHAYS. I haven't finished my motion.

Chairman WAXMAN. The Chair has recognized Mr. Davis for an opening statement.

Do you wish to make a motion, Mr. Shays?

Mr. SHAYS. I wish to make a unanimous consent motion that we be allowed to—because I believe there is a cover-up going on, and I'd like to make a statement.

Chairman WAXMAN. We'll follow the rules. Mr. Davis is recognized for his opening statement.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman, for convening a series of hearings to examine the many complex and interlocking causes and effects of the economic paralysis gripping our Nation and most of the industrialized world. Today, tomorrow and in the coming weeks we'll ask some tough questions about the role of investment firms like Lehman Brothers Holding, insurers like AIG, hedge funds, credit-rating agencies, regulators and Congress in feeding the boom that has now gone so painfully bust.

I particularly appreciate you calling Lehman Brothers up today before us. Mr. Fuld, a very active contributor to Democratic causes, along with Mr. Janulis, Mr. Demura, Mr. Collerton and others, have been bypassed by other committees, and I appreciate your having the courage to call him up here today.

The scope of these hearings effectively rebuts the simplistic premise peddled by some that laissez-faire Republicanism and mindless deregulations alone caused the collapse of global capital markets. That's the political cartoon version of a very complicated life-and-death reality. Partisan fingerpointing adds nothing to serious oversight of the intricate web of individuals, institutions, market incentives and cyclical trends that have brought us to the brink of economic abyss.

For more than a decade, all the Wall Street and Washington players engaged in an increasingly elaborate game of high-takes musical chairs driven by the mesmerizing siren song of perpetually rising housing costs. But when the music stopped, as it always does, many formally upstanding financial giants found themselves without a safe or a sound place to sit. Suddenly the phrase "too big to fail" measured only the limits of our foresight, not the size of the all too foreseeable failure.

So today we start with the case of Lehman Brothers, a venerable investment house that sank into insolvency while others were being thrown Federal lifelines. One lesson from Lehman's demise: Words matter. Rumors and speculative leaks fed the panic and accelerated a flight of confidence in capital from that company.

Words matter here as well. Look at the TV monitors. As we watch them, the markets are watching us. In this volatile environment, unsupported allegations, irresponsible disclosures can inflame fears and trigger market stampedes. As these hearings proceed, we should watch the pulse of Wall Street and choose our words with great care.

But it must be said the driving factor in the loss of value and confidence in Lehman was the financial undertow created by falling home prices and resulting losses on mortgage-backed assets of all kinds. And central to that crisis in the $12 trillion mortgage securities market were imprudent policies and cozy practices of the two government-sponsored housing finance giants, Fannie Mae and Freddie Mac. We have asked that former Fannie Mae CEO Franklin Raines be invited to testify at a future hearing because that company's failure offers Congress lessons that we dare not overlook. You can't have a complete analysis without looking at Freddie and Fannie.

Many in Congress did turn a blind eye to clear warnings of impending danger sounded as early as 1998. They missed golden opportunities to treat localized problems before they metastasized throughout the economic system. Out of well-intentioned zeal to promote homeownership, Members from both parties and both Chambers not only tolerated, but encouraged the steady erosion of mortgage-lending standards. When an alarm sounded, Fannie and Freddie, holding low-income borrowers as political hostages, mobilized armies of expensive lobbyists to block calls for greater accountability and transparency. Using lobbying fees and campaign contributions, the mortgage giants bought their way around attempts by Senate and House Banking Committees to pierce their profitable pyramid scheme. The Clinton administration was rebuffed by a Republican Congress, and this administration had no more success with the Democratic Congress in advancing needed reforms.

This committee cannot ignore that sad history in our inquiries into the causes and effects of the current economic crisis. But now that the $700 billion economic rescue bill has been enacted, the debate is no longer whether the Federal Government should intervene in the credit markets, but how that intervention should be managed to stabilize capital flows and protect taxpayers. Although it comes too late to help Lehman Brothers, the so-called bailout program will have to make wrenching choices, picking winners and losers from a shattered and fragile economic landscape.

These hearings should help mark the land mines and potholes on the path to a restoration of trust and economic vitality. Trust. There is a moral dimension to economics we don't often want to confront. Economics is not an objective discipline, but a political art grounded in certain assumptions about human nature and civilized behavior. As the process of deleveraging unfolds, breaking the economy's delusional addiction to debt beyond our reasonable means to repay, the goal has to be a restoration of the moral bond between labor and capital. We need to restore faith in production, savings and investment over consumption, spending and speculation. Our witnesses today can help us do that. We appreciate their being there.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you very much, Mr. Davis.

Mr. DAVIS OF VIRGINIA. I also ask unanimous consent for our staff analysis to be included in the hearing record.

Chairman WAXMAN. Without objection, that will be the order.

[The information referred to follows:]

Examining the Causes of the Credit Crisis of 2008
Minority Staff Analysis

U.S. House of Representatives
Committee on Oversight and Government Reform

Tom Davis, Ranking Member
October 6, 2008

I. Executive Summary

In the midst of the most serious financial crisis in a generation, some claim that deregulation is entirely to blame. This is simply not true and more importantly serves to grossly oversimplify a problem whose roots run deep and involve myriad actors and issues. The simple truth is that many share the blame, and pointing to just one person or organization does a disservice to the American people.

In a time of crisis, the American people cannot afford the same old partisan finger pointing; they need and deserve real, non-partisan oversight. We need a series of hearings that will focus on the root causes and how we can fix a system in order to avoid financial meltdowns in the future. This minority staff analysis attempts to objectively explore the causes of the financial crisis we are in and how companies like Lehman Brothers and AIG contributed to this crisis.

The current credit crisis is a complex phenomenon with its roots in a number of places involving a myriad of people and institutions. Key players and institutions include Members of Congress, well-respected members of Republican and Democratic administrations, the Federal Reserve Board, Fannie Mae, Freddie Mac, the Department of Housing and Urban Development (HUD), the Securities and Exchange Commission (SEC), the major private sector credit rating agencies, banks, mortgage brokers, and consumers.

There is no single issue or decision one can trace as a cause of the current financial crisis; rather it was multiple decisions and issues involving many actors over time that led us to where we are today. However, we can point to organizations that contributed greatly to the problem and how their role was the catalyst for others to become involved and eventually fail. Fannie Mae and Freddie Mac fall into this category. They were the central cancer of the mortgage market, which has now metastasized into the current financial crisis. With the help of a loose monetary policy at the Federal Reserve, an over-reliance on inaccurate risk assessment and a fractured regulatory system, this cancer spread throughout the financial industry.

A few key elements are critical in understanding how we got to where we are today.

The Role of Fannie Mae and Freddie Mac in Creating the Credit Crisis

- If Congress had successfully restructured Fannie Mae and Freddie Mac in 2005 after the Office of Federal Housing Enterprise Oversight (OFHEO) reported on their fraudulent accounting activities, we would likely not be in the crisis we have today. The over $ 1 trillion dollar binge into subprime and mortgage backed securities that Fannie Mae and Freddie Mac embarked upon from 2005 to 2007 would likely not have happened.

- By 2005, Federal Reserve Chairman Alan Greenspan was so concerned that he characterized the concentration of systemic risk inherent in the ever-growing portfolios of Fannie and Freddie as, "placing the total financial system of the future at a substantial risk." Recent events have unfortunately proved him right.

- The transformation of Fannie Mae and Freddie Mac into the "Affordable Housing Center" was a laudable goal, but to push predatory subprime lending to unspeakable heights and to encourage questionable lending practices believing housing prices would continue to soar was beyond reason.

- The politicization of Fannie Mae and Freddie Mac over the last decade seriously undermined the credibility of the organizations and prevented their restructuring and reform, with Democrats viewing any attempt at curtailing their behavior as an attempt at curtailing affordable housing. Between 1998 and 2008, Fannie and Freddie combined spent nearly $175 million lobbying Congress, and from 2000 to 2008 their employees contributed nearly $15 million to the campaigns of dozens of Members of Congress on key committees responsible for oversight of Fannie and Freddie. Those who opposed the restructuring of Fannie Mae and Freddie Mac were unwittingly helping to build a house of cards on risky mortgage backed securities.

- The motivations for Fannie Mae and Freddie Mac to gamble with taxpayer money on bad nonprime mortgage bets was not entirely a matter of good intentions gone awry. Greed and corruption were unfortunately part of the equation as well. The size and growth of Fannie Mae and Freddie Mac leading up to their collapse were nothing short of astonishing. From 1990 to 2005, Fannie Mae and Freddie Mac grew more than 944% to $1.64 trillion, and their outstanding liabilities grew 980% to $1.51 trillion. These liabilities were equal to 32.8% of the total publicly-held debt of the U.S. Government, which in 2005 stood at $4.6 trillion.

Lehman Brothers, AIG and the Challenges of Statistical Risk Modeling

- Lehman Brothers didn't cause this mess but it certainly jumped head first into trying to make money on securitizing mortgage-backed instruments. They followed on the heels of Fannie Mae and Freddie Mac and for precisely the same reasons. If we understand the initial cause of the cancer at Fannie and Freddie, then we can understand how it metastasized to Lehman Brothers, Wachovia, Countrywide, and beyond.

- AIG is somewhat different; bad management decisions were made in thinking that the mortgage-backed securities and derivatives could be insured. Yet underlying its bad decisions was the same mistaken reliance on sophisticated but inaccurate computer models, trusting the rating agencies were accurate and that Fannie Mae and Freddie Mac couldn't possibly fail.

Regulation and the Credit Crisis

- Democrats are wrong in insisting that de-regulation is the primary cause of the financial crisis. Deregulation is not the problem, rather it is the fractured regulatory system that has banks, investment institutions, mortgage brokers, and insurance companies all being overseen by different and often competing federal and state agencies. The problem is a lack of coherent regulatory oversight that has led mortgage brokers and lending institutions to write questionable loans and investment institutions to play fast and loose with other people's money in purchasing bad mortgage-backed assets.

- The words "regulation" and "deregulation" are not absolute goods and evils, nor are they meaningful policy prescriptions. They are political cant used to describe complex policy discussions that defy simplistic categorization. The key to successfully regulating markets is not to either create more or less regulation in an unthinking way. Government needs to design smart regulations that align the incentives of consumers, lenders and borrowers to achieve stable and healthy markets.

Credit Rating Agencies and the Practice of "Rating Shopping"

- Some firms that bundled subprime mortgages into securities were engaging in "rating shopping" – picking and choosing among each of the three credit rating agencies in order to find the one willing to give their assets the most favorable rating. Rating agencies willing to inflate their ratings on subprime mortgage-backed securities lobbied Congress to prohibit "notching" – the downgrading of assets that incorporate risky, unrated assets – by their competitors, on the grounds this constituted an anti-competitive practice. Unfortunately, the Republican Congress was swayed by this argument and codified it in law.

II. Mortgage Markets: A Primer

Prospective homebuyers apply for mortgages from primary market lenders such as banks, thrifts, mortgage companies, credit unions, and online lenders. Primary lenders evaluate borrowers' ability to repay the mortgage based on an assessment of risk that combines such factors as income, assets and past performance in repaying loans. If a borrower does not meet the minimum requirement, the borrower is refused a loan.

Prime mortgages are traditionally the gold standard and go to borrowers with good credit who make down payments and fully document their income and assets. Borrowers with poor credit and/or uncertain income streams represent a higher risk of default for lenders and therefore received subprime loans. Subprime loans have existed for some time but really took off in popularity around 1995, rising from less than 5% of total new mortgages in 1994 to more than 20% in 2006.[1] Borrowers who fall in between prime and subprime standards who may not be able to fully document their income or provide traditional down payments are sometimes referred to as near-prime borrowers. They generally can apply only for Alternative-A ("Alt-A") mortgages.[2] Starting in 2001, subprime and near-prime mortgages increased dramatically as a proportion of the total mortgage market. These mortgages increased from only 9% of newly originated securitized mortgages in 2001 to 40% in 2006.[3]

Subprime borrowers, in addition to being below the standard risk threshold lenders traditionally deemed creditworthy for mortgages, were increasingly taking advantage of so-called "alternative mortgages" that further increased the risk of default. For example, low- or zero-down payment mortgages permit borrowers who cannot afford the traditional 20% down payment on a house to still receive a loan. Instead some mortgages allow them to pay 10%, 5%, or even 3% of the purchase price of the home. The riskiest loans even allow borrowers to pay no money down at all for 100% financing. Another option is to allow borrowers to take out a "piggyback" or "silent second" loan – a second mortgage to finance the down payment. This is possible because the larger first mortgage means some lenders give borrowers a more favorable rate on the second mortgage. Interest-only mortgages are another alternative type that allows borrowers to for a time pay back only interest and no principal. However, either the duration of the mortgage must be extended or the payments amortize the remaining principal balance over a shorter period of time, increasing the monthly payment, and ultimately the total size of the loan, a borrower will eventually have to repay. Negative amortization mortgages are even riskier, allowing borrowers to pay *less* than the "minimum" monthly interest payment, adding the remaining interest to the loan principal and again increasing the payments and size of the loan.[4]

---

[1] Barth, James R., et al., Milken Institute, Perspectives on the Subprime Market 3

[2] DiMartino, Danielle and John V. Duca, "The Rise and Fall of Subprime Mortgages," Insights from the Federal Reserve Bank of Dallas, Vol. 2, No. 11, Nov. 2007.

[3] Tilton, Andrew, "The Subprime Slump and the Housing Market," Goldman Sachs, Feb. 23, 2007 in DiMartino and Duca.

[4] Murphy, Edward Vincent, "Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets," Apr. 18, 2008.

Adjustable rate mortgages (ARMs) are the most common of the alternative mortgages. ARMs offer a low introductory mortgage rate (the cost of borrowing money for a home loan; it is generally related to the underlying interest rate in the macro economy) which then adjusts in the future by an amount determined by a pre-arranged formula. There are different formulae used to determine the new mortgage rate on an ARM, but in general one can think of these new rates as being related to the performance of the U.S. economy. If interest rates go down during the introductory period of the ARM, the adjusted mortgage rate will be lower, meaning the borrower's monthly payment will go down. If interest rates go up, the borrower's monthly payment will be larger. The prevalence of ARMs as a percentage of the total mortgage market increased dramatically during the housing bubble, from 12% in 2001 to 34% in 2004.[5]

Unlike the above-mentioned alternative mortgages, however, there are sound reasons for borrowers to take out ARMs, under certain macroeconomic conditions. In 1984, for example, 61% of new conventional mortgages were ARMs.[6] However, this was a rational response to the very high interest rates at that time. High interest rates translate into high mortgage rates (the cost of borrowing money). This meant that borrowers at that time were willing to bet that when their mortgage rates adjusted, they were likely to adjust downward due to falling interest rates. This was a sensible bet and one that turned out to be correct.

From 2001 to 2004, however, interest rates were abnormally low because the Federal Reserve led by Chairman Alan Greenspan lowered rates dramatically to pump up the U.S. economy following the attacks of September 11, 2001. Correspondingly, from 2004 to 2006, mortgage rates on 30-year fixed-rate mortgages were around 6%, relatively low by historical standards. Borrowers responding only to these macroeconomic conditions would have been wise to lock in these rates with a traditional 30-year fixed-rate mortgage. The continuing popularity of ARMs, at least until about 2004, relates in part to the abnormally wide disparity between short- and long-term interest rates during this period. Since ARMs tend to follow short-term rates, borrowers could get these mortgages at even lower costs and, as long as they were confident that housing prices would continue to rise, plan on refinancing before their ARMs adjusted upward.[7]

Low short-term rates until 2004 are only part of the puzzle, however. By 2005 short-term interest rates were actually rising faster than long-term rates, yet ARMs remained very popular. By 2006 housing prices had started to slow significantly and yet introductory periods remained popular. In the words of a report by the Congressional Research Service, "The persistence of nontraditional terms could be evidence that some borrowers intended to sell or refinance quickly – one indicator of speculative behavior." However, the report goes on to note that, in addition to speculation, "alternative mortgages were

[5] Ibid.

[6] Federal Housing Finance Board, "2006 Mortgage Market Statistical Annual – Vol. 1, p. 17" in Edward Vincent Murphy, "Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets," Apr. 18, 2008.

[7] Ibid.

marketed as affordability products to lower income and less sophisticated borrowers during the housing boom."[8] Some other force was clearly at work.

III. The Role of Fannie Mae and Freddie Mac in Creating the Credit Crisis

Successive Congresses and Administrations have used Fannie Mae and Freddie Mac as tools in service to a well-intentioned policy to increase the affordability of housing in the United States. In the process, the U.S. Government created an incentive structure for Fannie and Freddie to facilitate the extension of risky nonprime and alternative mortgages to many borrowers with a questionable ability to pay these loans back. Ultimately, Fannie and Freddie may have purchased or guaranteed up to $1 trillion of risky nonprime mortgages. This, along with a healthy dose of unethical and corrupt behavior by the management of Fannie Mae and Freddie Mac, has contributed perhaps more than any other single factor to the growth of the subprime housing bubble from 2005 to 2007, which in turn was the root cause of the current financial crisis.

In the mortgage market, primary lenders may choose to hold a mortgage until repayment or they may sell it to the secondary mortgage market. If the primary lender sells the mortgage, it can use the proceeds from the sale to make additional loans to other homebuyers. This increase in the funding available to mortgage lenders to lend was the goal behind the creation of Fannie Mae and Freddie Mac.

Prior to the existence of the secondary mortgage market, there was no national U.S. mortgage market. Instead, the mortgage industry was mainly concentrated in urban centers, leaving broad swaths of the country unable to afford home financing. In response, Congress created the Federal National Mortgage Association, or Fannie Mae, in the National Housing Act of 1934 as a purely public agency. After a number of legislative iterations, Fannie Mae morphed into a private company, a "government-sponsored enterprise" (GSE), with no federal funding by 1970. Congress created the Federal Home Loan Mortgage Corporation, or Freddie Mac, in 1970 to facilitate secondary market trading of conventional mortgages, but in 1989 rechartered it to be a privately-owned corporation to fulfill the same role as Fannie Mae. That purpose was to, "provide capital to primary market mortgage originators in support of an overall federal policy to assure ready availability of financing for housing."[9]

Congress granted Fannie and Freddie certain benefits not available to other private financial institutions. Perhaps most importantly, Fannie Mae and Freddie Mac were able to borrow at rates almost as low as the Federal interest rate, significantly lower than *de facto* non-governmental institutions because investors purchasing Fannie and Freddie's debt believed implicitly (and rightly as it turned out) that the GSEs were backed by the full faith and credit of the U.S. Government due to their origins as government entities.[10]

---

[8] Ibid.

[9] Weiss, N. Eric and Michael V. Seitzinger, Congressional Research Service, "Fannie Mae and Freddie Mac: A Legal and Policy Overview," Feb. 28, 2008.

[10] Weiss and Seitzinger.

This was a critical factor in making them very competitive vis-à-vis their private sector rivals, which could not borrow money at such favorable rates. This advantage also had the effect of padding the profit margins of Fannie and Freddie, making them extremely lucrative operations.

1992 was a turning point in the history of Fannie and Freddie. In that year, Congress created a new dual oversight structure for the GSEs. However, it also developed an affordable housing "mandate" for the entities under which Fannie and Freddie were to seek to increase mortgage lending among low and moderate income borrowers. Congress was rightfully concerned that such large corporations with ambiguous ties to the Federal Government and with huge and undiversified investment in residential mortgages presented a significant risk to the American taxpayer if they ever got into financial trouble. Indeed, investors' willingness to buy the companies' debt at such low rates indicates they believed the Federal Government would likely bail them out if they got into trouble. Yet Congress also sought to transform Fannie and Freddie into tools of affordable housing policy.

Thus Congress created the Office of Federal Housing Enterprise Oversight (OFHEO) as an independent entity within the Department of Housing and Urban Development (HUD) to oversee the safety and soundness of the GSEs operations. Specifically, OFHEO was charged with ensuring Fannie and Freddie maintained adequate capital relative to their liabilities and with oversight of their management practices. On the other hand, HUD was charged with setting targets for Fannie and Freddie to lend to low- and moderate-income borrowers. Specifically this meant lending each year had to be meet quotas of families with incomes below the area median income. Additionally, Fannie and Freddie had to demonstrate that a certain percentage of their financing was to families with "low" or "very low" incomes and to businesses in "disadvantaged" localities. HUD would regularly adjust these mission goal targets and was required to evaluate any new initiative on the basis of its support for the affordable housing goals.[11]

How did Fannie and Freddie go about fulfilling their affordable housing mission? First, they purchased mortgages directly and held them in their portfolio. By doing so, they removed these mortgage obligations from the books of primary lenders, whether commercial banks, thrifts, credit unions, or non-bank lenders such as Countrywide Financial. This allowed primary lenders to go about making new mortgages, increasing the availability of funds for all borrowers. The GSEs funded these purchases by issuing bonds and other debt to investors. This was extremely profitable because, as mentioned, Fannie and Freddie could issue debt very cheaply, at rates near the Federal funds rate, giving them a competitive edge over the truly private sector.

Second, Fannie and Freddie engaged in mortgage securitization. Securitization involves taking pools of mortgages and turning them into assets known as Mortgage-Backed Securities (MBS). These securities are then sold to investors such as investment banks and pension funds. They pay investors periodic returns similar to the coupon payments on a bond. MBS also often redirect the interest and principal payments of the underlying

[11] Ibid.

mortgages to investors.[12] When an investor purchases a MBS, he is essentially lending money to homebuyers. Securitization is an innovative technique and plays a crucial role in increasing the accessibility and affordability of mortgage lending by connecting homebuyers with the broader financial market as well as by spreading the risk of default more evenly, at least in theory.

Although securitization of mortgages is a valuable innovation, there are risks. If investors are unable to accurately assess the quality of the underlying mortgages, this increases the risk of default and lowers the value of the asset. Therefore, while many private sector, non-bank mortgage lenders were engaged in the packaging of risky nonprime and alternative mortgages into MBS, it was at least believed that Fannie Mae and Freddie Mac had higher standards. However, it now appears that, under political pressure and in pursuit of profit, Fannie Mae and Freddie Mac became increasingly involved in the packaging of risky nonprime mortgages into securities for sale. This did much to fuel the irrational housing bubble and subsequent financial crisis because, as the largest purchasers of mortgages and MBS, Fannie Mae and Freddie Mac exerted tremendous influence on the actions of private sector, non-bank lenders that were underwriting the bulk of the risky nonprime and alternative mortgages which the GSEs would then purchase and market.

Recent analysis of the financial statements of Fannie and Freddie indicates that, contrary to prior assertions by GSE management and their advocates in Congress, both firms were heavily involved in purchasing nonprime mortgages and MBS between 2005 and 2007. Specifically, Fannie Mae and Freddie Mac together apparently held or guaranteed more than $1 trillion in unpaid principal balance on subprime and Alt-A junk mortgages.[13] It now appears that Fannie and Freddie, which had long maintained they operated with high standards for safety and soundness when investing in mortgages, engaged in a verbal sleight of hand in order to dip so deeply into the nonprime mortgage business while maintaining the illusion that they were engaging in low-risk investments. U.S. bank regulators define "subprime" borrowers as those with "damaged credit," to include those with a FICO score of less than 660.[14] However, Fannie and Freddie lowered their bar on the definition of "subprime" and "Alt-A" to FICO scores of 620, dramatically increasing the universe of risky nonprime mortgages they could then purchase and securitize.[15]

Fannie and Freddie did not acquire bad mortgages by accident. Rather, the lowering of their standards for mortgage loans was a steady process drawn out over at least a decade. In 1999, under pressure from the Clinton Administration to increase home ownership rates among low and moderate income borrowers, Fannie Mae CEO Franklin Raines lowered his company's lending standards to include, "individuals whose credit is

---

[12] http://www.investopedia.com/terms/m/mbs.asp

[13] Wallison, Peter J. and Charles W. Calomiris, "The Last Trillion-Dollar Commitment," American Enterprise Institute, Sept. 30, 2008.

[14] Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, "Expanded Guidance for Subprime Lending Programs," 2001, in Wallison and Calomiris.

[15] Wallison and Calomiris

generally not good enough to qualify for conventional loans."[16] Mr. Raines clearly got the message because by 2004, in joint remarks with Freddie Mac CEO Richard Syron before the Mortgage Bankers Association, he said that they, "made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders." Raines went on to say that, "We have to push products and opportunities to people who have lesser credit quality."[17] The GSEs regulator, OFHEO, has also explicitly drawn a connection between the companies and subprime mortgage lending. In testimony before the Senate Banking Committee, OFHEO Director James Lockhart said that Fannie and Freddie purchased and guaranteed, "many more low-documentation, low-verification and non-standard" mortgages in 2006 and 2007 than in the past. He also asserted that the companies did so against the express warnings of his agency. According to Lockhart, about 33% of the GSE's business involved such risky mortgages, up from just 14% in 2005.[18] This reality did little to impinge on Raines' assertions that his company's investments in home mortgages were very nearly "riskless" investments, as he asserted before a Congressional hearing in 2004.[19]

As the largest purchasers and securitizers of mortgages and MBS in the world, Fannie Mae and Freddie Mac exert a powerful influence on the rest of the mortgage lending market. By signaling their willingness to dip ever deeper into the pool of risky subprime and Alt-A mortgages, they created powerful incentives for non-bank lenders like Countrywide Financial and Lehman Brothers to continue scraping the bottom of the mortgage barrel. This fueled the disastrous housing bubble that collapsed with such dire consequences for the U.S. and global financial system.

The motivations for Fannie Mae and Freddie Mac to gamble with taxpayer money on bad nonprime mortgage bets was not entirely a matter of good intentions gone awry, however. Greed and corruption were unfortunately part of the equation as well. The size and growth of Fannie Mae and Freddie Mac leading up to their collapse were nothing short of astonishing. From 1990 to 2005, Fannie Mae and Freddie Mac grew more than 944% to $1.64 trillion and their outstanding liabilities grew 980% to $1.51 trillion. These liabilities were equal to 32.8% of the total publicly-held debt of the U.S. Government, which in 2005 stood at $4.6 trillion.[20]

This phenomenal growth was a function of a very profitable business model that allowed Fannie and Freddie to borrow money cheaply because investors believed (rightly it turned out) that the U.S. Government would never allow the companies to fail and thus gave them low rates of lending. The executives at Fannie and Freddie then invested this

---

[16] Holmes, Steven A. "Fannie Mae Eases Credit to Aid Mortgage Lending," The New York Times, Sept. 30, 1999, C2.

[17] Morse, Neil, "Looking for New Customers," Mortgage Banking, Dec. 1, 2004 in Wallison and Calomiris, "The Last Trillion-Dollar Commitment", American Enterprise Institute Financial Services Outlook, Sept. 30, 2008.

[18] Goldfarb, Zachary A., "Affordable-Housing Goals Scaled Back," The Washington Post, Sept. 24, 2008, A11.

[19] Raines, Franklin Delano, testimony before the House Committee on Financial Services, Oct. 6, 2004.

[20] Weiss, N. Eric and Michael V. Seitzinger, "Fannie Mae and Freddie Mac: A Legal and Policy Overview," Congressional Research Service, Feb. 28, 2008.

money in mortgages and MBS, many of which it turns out were risky nonprime loans. Thus, Fannie and Freddie executives developed a storied tradition of enriching themselves and their private shareholders at taxpayers' expense.

For example, Franklin Raines, Fannie Mae CEO (1998-2003) and former Clinton Administration Budget Director, earned over $90 million during this period. Of that sum, over $52 million was directly tied to achieving profitability targets. In 2003, Fannie's safety and soundness regulator, OFHEO, discovered that Raines and his management team had "manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing." OFHEO found that Raines and his team had managed earnings, "to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems internal controls and risk management."[21] Similarly, Fannie Mae Vice-Chairwoman and former Clinton Administration Justice Department official Jamie Gorelick earned over $26 million between 1997 and 2003.

This level of executive compensation would not have been possible absent the corrupt use of improper accounting practices by executives at Fannie and Freddie that further padded their salaries and the dividends of their shareholders. In the wake of the Enron and WorldCom accounting scandals, Freddie Mac announced in January 2003 that it was preparing to issue a major revision of its prior financial statements. It turned out that Freddie Mac had been underreporting earnings on derivatives and bonds that had dramatically increased in value due to falling interest rates between 2000 and 2003. Freddie Mac's leadership chose to underreport this income because it sought to protect its image as a sound investment in a stable housing market. Freddie Mac's earnings were eventually revised upward by $5 billion.[22] Then in 2004, OFHEO announced that Fannie Mae had "deviated from generally accepted accounting principles in order to conceal losses, reduce volatility in reported earnings, present investors with an artificial picture of steadily growing profits, and to meet financial performance targets that triggered the payment of large bonuses" to its executives.[23] The Securities and Exchange Commission (SEC) conducted an independent review of OFHEO's findings and within weeks the leadership team led by Mr. Raines resigned from Fannie Mae. The company's earnings were eventually revised downward by $6.3 billion.

Corrupt practices at Fannie Mae and Freddie Mac extended beyond internal accounting irregularities, however. There also appear to have been inappropriate links between a major private sector mortgage lender and the two GSEs as well. The now defunct Countrywide Financial Corporation was the largest private sector originator and securitizer of mortgages during the height of the housing bubble.[24] As such, Countrywide was in the position of being both a major competitor and a major customer of Fannie Mae and Freddie Mac. Indeed, in July 1999 Fannie Mae and Countrywide

---

[21] OFHEO Report, "Fannie Mae Façade," May 23, 2006.
[22] Jickling, Mark, "Accounting and Management Problems at Freddie Mac," Congressional Research Service, Nov. 7, 2007.
[23] Jickling, Mark, "Accounting Problems at Fannie Mae," Congressional Research Service, Dec. 7, 2006.
[24] "The Non-Agency MBS Market Hit an All-Time High," Inside MBS & ABS, Issue 2006, Vol. 2, Jan. 13, 2006.

entered into a "strategic agreement" under which, "Countrywide agreed to deliver a large portion of Fannie's annual loan volume in exchange for special financing terms."[25] However, this was not the only special arrangement between the two firms.

A federal grand jury in Los Angeles is currently investigating allegations that Countrywide CEO Angelo Mozilo operated a special lending unit called "Friends of Angelo," the sole purpose of which was to provide "VIPs" Countrywide mortgages with preferential rates and lower fees, a perquisite unavailable to the general public. According to 2003 real estate records, Fannie Mae CEO Franklin Raines received a favorable rate of 5.125% on the first 10 years of a $982,253 refinancing mortgage. Weeks later, Fannie Vice-Chairwoman Jamie Gorelick received a rate of 5% for the first 10 years of a $960,149 refinancing. These loans were around a full point lower than the prevailing 6% mortgage rate at the time. Former Fannie Mae CEO James Johnson (1991-1998) also benefited from Mr. Mozilo's largesse, receiving more than $10 million in preferential loans from Countrywide.[26]

IV. <u>Enter Lehman Brothers and Countrywide</u>

These sweetheart mortgages fit within a larger picture of relationships among top Democrat Party leaders with ties to the subprime mortgage lending industry. Often, the nexus of Fannie Mae, Countrywide Financial and other firms such as Lehman Brothers involved in packaging and marketing nonprime and alternative mortgages functioned as a revolving door for this mortgage-lending brain trust. For example, immediately prior to assuming his post as Fannie Mae CEO in 1991, James Johnson served as a managing director of Lehman Brothers, the now-defunct investment bank which collapsed under the weight of its bad subprime mortgage bets. After Countrywide Financial, Lehman Brothers was the second-largest marketer of mortgage backed securities during the height of the housing bubble.[27] Similarly, the "Friends of Angelo" program also gave a preferential mortgage to Charles Campion in 2003, who at the time was a lobbyist on the payroll of Fannie Mae and who later left to lobby for Countrywide. Perhaps most disturbingly, Countrywide also singled out Members of Congress with influence over the mortgage-lending sector. Senator Christopher Dodd, the Chairman of the Baking Committee, also is reported to have received a preferential rate of 4.25% for 5 years on a $506,000 loan.[28]

Certainly these questionable lobbying and business practices by leaders of Fannie Mae, Freddie Mac, Countrywide, and Lehman Brothers, can be explained in part by the greed of the individuals in question. However, why would Fannie Mae and Freddie Mac, after years of shying away from the riskiest mortgages and MBS, suddenly plunge headlong

[25] Simpson, Glenn R., "Countrywide Made Home Loans to Gorelick, Mudd," <u>The Wall Street Journal</u>, Sept. 25, 2008.
[26] Ibid.
[27] "The Non-Agency MBS Market Hit an All-Time High," <u>Inside MBS & ABS</u>, Issue 2006, Vol. 2, Jan. 13, 2006.
[28] Simpson.

into such bad assets in 2005? Following the accounting scandals of 2003-2004, it appears that Fannie Mae and Freddie Mac sought to stave off congressional reform efforts by doubling down on its affordable housing mission that is very popular with key allies in Congress.

Following the revelations about the use of unethical and improper accounting practices by Fannie and Freddie executives, calls for meaningful reform of the two companies became increasingly insistent. In a hearing before the Senate Banking Committee in 2004, Federal Reserve Chairman Alan Greenspan, although previously supportive of the role of Fannie and Freddie in using the innovation of mortgage securitization to provide a secondary mortgage market, expressed his grave concerns about the amount of risk these firms were starting to create for the entire financial system. He correctly identified the ability of Fannie and Freddie to borrow at cheaper rates as an implicit, anticompetitive government subsidy that padded their profit margins by as much as 50% of their total value. This gave the firms an unfair edge over the competition, allowing them to corner over 75% of all single-family home mortgages in the U.S.[29]

> **By 2005, Chairman Greenspan was so concerned that he characterized the concentration of systemic risk inherent in the ever-growing portfolios of Fannie and Freddie as, "placing the total financial system of the future at a substantial risk."[30] Chairman Greenspan likely had no idea at the time how soon his prophetic words would come to pass.**

Republicans in the Senate Banking Committee led by Senators Hagel, Sununu, Dole, and McCain took up Chairman Greenspan's call in 2005 by introducing reform legislation that would have created new regulatory oversight and limited the size of the portfolios of mortgages and MBS Fannie Mae and Freddie Mac are allowed to hold. While this would not have interfered with their appropriate role in providing a secondary mortgage market, it would have cut into the companies' lucrative profit margins and the salaries and bonuses of their executives. In response, Fannie and Freddie, along with their allies in the homebuilding and realty industries, lobbied Congress hard to oppose the legislation. As a result, the GSE's allies in Congress ensured the legislation was never brought to a vote on the Senate floor.[31] This is incredibly significant, since it is likely that if this legislation was passed, the worst of the housing bubble would have been nipped in the bud, averting the current financial crisis.

Fannie Mae and Freddie Mac have a storied history of lobbying Members of Congress to shield them from regulatory scrutiny. Between 2000 and 2008, their employees contributed nearly $15 million to the campaigns of dozens of Members of Congress on key committees responsible for oversight of Fannie and Freddie.[32] Between 1998 and

[29] Greenspan, Alan, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 24, 2004.
[30] Greenspan, Alan, Testimony before the House Financial Services Committee, Feb. 17, 2005.
[31] Wallison, Peter J., "Regulating Fannie Mae and Freddie Mac: Now It Gets Serious," American Enterprise Institute, May 2005.
[32] Common Cause, "Ask Yourself Why...They Didn't See This Coming," Sept. 24, 2008 in Wallison and Calomiris.

2008, Fannie and Freddie combined spent nearly $175 million lobbying Congress.[33] They not only hired lobbyists to influence Congress, they also hired lobbyists to *not* lobby against their interests. These Herculean influence peddling efforts were just part of managing what CEO Franklin Raines referred to as "political risk", or the chance that Congress might in fact take its responsibility to protect the American taxpayers from wanton risk-taking by Fannie and Freddie seriously.

In return, Members of Congress benefited from the efforts of Fannie Mae and Freddie Mac to deliver affordable housing to key constituencies. For example, a press release from key GSE ally Senator Charles Schumer (D-NY) read, "Schumer Announces up to $100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch." A follow-up informed the world that the Senator "urge[ed]" them to "step up" their efforts.[34] If Freddie Mac were truly a private enterprise, it would hardly need "urging" to act on a particular project.[35] The affordable housing mission of Fannie Mae and Freddie Mac is extremely popular with some Members of Congress. For example, at a hearing before the House Financial Services Committee to examine corrupt accounting practices at Fannie and Freddie, Members of the Committee strongly expressed their continuing commitment to providing nonprime and alternative mortgages as tools of the affordable housing policy. These were the same tools that contributed greatly to the housing bubble and financial crisis. For example, Representative Maxine Waters praised the "innovation" of "100% loans" – another term for the risky no down payment alternative mortgages described above. She also advocated that any investigation of corrupt accounting at Freddie and Fannie ought to be limited in such a way "as not to impede their affordable housing mission."[36]

Thus it is perhaps no coincidence that Fannie Mae and Freddie Mac delved more deeply than ever into pools of bad nonprime mortgages in 2005. It was at exactly this time that they were struggling to recover from their accounting scandals and avoid having their lucrative profits reduced by Congressional reform efforts aimed at limiting their portfolios of mortgages and MBS. Yet it was these very portfolios that, according to Alan Greenspan, presented a grave systemic risk to the global financial system. Fannie and Freddie sold their souls to curry favor with key allies in Congress, who blocked reform efforts which, if enacted, would likely have averted the current financial crisis.

V. <u>The Challenges of Statistical Modeling for Risk Assessment</u>

Although Fannie Mae and Freddie Mac bear tremendous responsibility for the current credit crisis, this is a complex problem with other contributing factors. One very significant problem is the difficulty investors have determining the real risk of complex

---

[33] Center for Responsive Politics, "Lobbying: Top Spenders," 2008 in Wallison and Calomiris.
[34] Office of Senator Charles Schumer, "Schumer Announced up to $100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch," Nov. 20, 2006 in Wallison and Calomiris.
[35] Wallison and Calomiris.
[36] Video footage of House Financial Services Committee hearing, accessed at http://www.youtube.com/watch?v=hN31-nKndg8

financial instruments such as mortgage backed securities and collateralized debt obligations. Collateralized debt obligations (CDO) are a type of mortgage backed security that creates separate pools of pass-through rates for different classes of bondholders with varying maturities known as tranches, which pay off investors in an order related to the risk level those investors were willing to pay for.[37]

Some of the responsibility lies with the complex econometric models firms use to estimate risk. Lenders and investors rely these days on econometric models to sift large numbers of variables related to risk. These models use statistical methods to assess the likelihood of a given outcome. For example, mortgage lenders use them to rate borrowers' creditworthiness and the likelihood they will default on a given loan. Buyers and sellers of MBS, CDO, and other assets, such as Lehman Brothers, use them to estimate the underlying risk of these financial instruments. Insurance companies like AIG use them when trying to decide whether to provide insurance for mortgage-backed financial assets based on the likelihood of default.

Statistical modeling is a powerful and innovative tool that has improved the way we live our lives and do business. However, these models are only as good as the quality of their underlying assumptions and the quality of the data plugged into them. They are in essence mathematical machines – data is input and a final product comes out the other side. If the widgets inside the machine are broken, the result will be skewed. And if the inputs are of poor quality, so will be the final product. Incorrect assumptions in the structure of the model and poor data on the asset or outcome being assessed will lead to incorrect decision-making. Despite the sophistication of modern mathematical modeling, the old adage about "garbage in, garbage out" is important to remember.

One particularly egregious assumption made by many in the financial sector who relied on modeling to assess their exposure to risk was that risk itself is evenly distributed. In other words, they believed that risk resembles a coin toss, where on every flip of the coin there is a 50% chance of heads or tails. In fact, markets are incredibly complex and dynamic systems, where seemingly insignificant events in one part of the system can cause disproportionately significant consequences throughout the entire system.[38] The only way to control for such events in designing a statistical model is to anticipate all possible outcomes, and this is essentially impossible. Hence, an over-reliance on modeling without building in appropriate "wiggle room" is unwise. Unfortunately, very few people who use these models to do their daily business understand them completely, and when competition for business in the marketplace is fast and furious, there may seem to be little time to question underlying statisitical assumptions.

Econometric modeling gave many mortgage lenders confidence to dramatically increase the volume of their nonprime lending. Former Federal Reserve Chairman Alan Greenspan has noted that, "where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by

[37] Investopedia, http://www.investopedia.com/terms/c/cmo.asp

[38] Rickards, James G., "A Mountain, Overlooked: How risk modeling failed Wall St. and Washington," The Washington Post, Oct. 2, 2008.

individual applicants and to price that risk appropriately." At least, this is the theory. However, Greenspan also noted there are concerns about the transparency and completeness of the data being fed into these equations, raising important questions about the ability of lenders and investors to accurately assess risk. [39]

AIG also relied on econometric models when it was trying to decide whether to provide insurance for MBS and CDO packaged by the securities industries, including Lehman Brothers, and fed by the nonprime lending industry including Fannie Mae, Freddie Mac, and Countrywide Financial. AIG provided insurance for these assets using a derivative known as a credit default swap (CDS). Simply explained, this instrument provides its purchaser with a payment in the event that the credit asset (i.e., a MBS or CDO) being insured defaults. AIG had its own internal models, but the accuracy of these models is only as effective as the data provided by the creator of the asset AIG is thinking of insuring – and the originators are relying on their own models. This tiered system of statistical modeling was almost certainly complicated by the extremely proprietary attitude of financial firms toward their econometric models. This is an understandable response when one considers that these models are in fact complex pieces of intellectual property – designing and maintaining econometric models costs these firms a lot of money.[40] However, when viewed at an intellectual distance, piling models upon models and assumptions upon assumptions is the making of a house of cards. Former AIG CEO Robert Willumstad was likely aware of this fact, as the presence of a highlighted trade publication article submitted to the Committee discussing this very problem indicates.[41]

VI. <u>Credit Rating Agencies and the Practice of "Rating Shopping"</u>

Unfortunately, responsibility does not end with statistical modeling. Unscrupulous actors in the financial industry were able to convince Members of Congress and the SEC to insert themselves into the equation by abetting the practice of "rating shopping". Congress' response in the case of "rating shopping" is an example not of "under-regulation", which the heated rhetoric of many in Congress now simplistically blame for the origin of the credit crisis. Instead, it is a case of bad regulation, produced by a Congress that all too often enshrines in law the wishes of special interests seeking their own gain before carefully considering the ramifications of its actions.

Underwriting by commercial banks and credit unions are regulated by the Federal Financial Institutions Examinations Council (FFIEC).[42] Fannie Mae and Freddie Mac are regulated by the Office of Federal Housing Enterprise Oversight (OFHEO)[43]. Non-

---

[39] Greenspan, Alan, Remarks at the Federal Reserve System's Fourth Annual Community Affairs Research Conference, Washington , D.C., April 8, 2005.
[40] Document provided by AIG responsive to Committee request, bates HHOGR00014473.
[41] Ibid.
[42] The FFIEC consists of: Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).
[43] OFHEO and the Federal Housing Finance Board (FHLBoard) will be replaced by a new, unitary Federal Housing Finance Agency (FHFA) on July 30, 2009 pursuant to P.L. 110-289.

bank lenders, on the other hand, are often outside the safety and soundness guidance of federal regulators. Between 1997 and 2006, the share of mortgages securitized grew from 49.2% to 67.7%. In dollar terms this was an increase from $423 billion to $2 trillion. Stimulated by the demand of large purchasers of mortgages such as Fannie Mae and Freddie Mac, this growth may have facilitated more lending by institutions not subject to the regulation of federal bank examiners and lowered overall underwriting standards in the mortgage market.[44] The sheer growth potential in securitizing mortgage-backed assets demonstrated by these dollar amounts indicates there was a lot of money to be made up and down the line of this industry.

Assets that bundle these mortgages into mortgage-backed securities and collateralized debt obligations are typically rated by the big three Nationally Recognized Statistical Rating Organizations (NRSRO) – Moody's Corporation, Standard & Poor's, and Fitch Ratings. These firms issue credit ratings recognized by the SEC that provide a signal to potential investors as to the quality of an asset. The ratings of the NRSRO have a tremendous impact on the price an asset can fetch on the market. Typically, a top-level security will be rated by all three agencies, and the rating is generally the same. For example, top-level Aaa/AAA ratings are the same across the three NRSRO 98% of the time. However, for lower-quality assets like subprime MBS rated lower than Aaa/AAA, discrepancies among the three NRSRO may occur almost 50% of the time.[45]

As a result, some firms that securitized nonprime mortgages into MBS and bundled them into CDO were engaging in "rating shopping" – shopping these assets at each of the three NRSROs in order to find the agency willing to give the asset the best possible rating. If the bundler didn't like a particular NRSRO's response because he deemed it "too low", he could simply choose to have all or part of the asset rated by the agency willing to provide a favorable rating. However, not having all three NRSROs rate a given security hurts its marketability. A further layer of complexity was introduced when certain tranches of MBS not rated by all three NRSRO were unbundled or combined into another CDO, often after numerous changes in ownership of the asset. When the NRSRO that refused to rate the original security was asked to do so again, the agency would do only with the caveat that it would lower its overall rating of the total security by a few notches. This process is commonly referred to as "notching".

In response to the "notching down" of securities by credit rating agencies seeking to protect their reputation, some in the financial sector sought to change the rules to suit their own ends. According to a paper published by the Federal Reserve Bank of Kansas City:

> "Rating agencies that offered more favorable subprime MBS ratings reportedly lobbied Congress to prohibit notching, complaining that this constituted an anti-competitive practice, and arguing that the dominant players (Moody's and S&P)

[44] Murphy, Edward Vincent, Congressional Research Service, "Securitization and Federal Regulation of Mortgages for Safety and Soundness," Sept. 17, 2007.
[45] Calomiris, Charles W., Letter to Nancy M. Morris, Secretary, Securities and Exchange Commission, May 4, 2007.

> should instead accept ratings of other agencies without adjustment when rating CDO pools."[46]

Unfortunately, the Republican Congress was swayed by this argument and codified it in law.[47] This prompted the SEC to issue regulations in 2007 prohibiting "notching".[48] It appears that clever lobbyists sold Congress a bill of goods by marketing "anti-notching" regulations as an "anti-competitive" practice.

VII. <u>Regulation and the Credit Crisis</u>

Some in Congress assert that "deregulation" is to blame for the credit crisis, as if "deregulation" is a unified and simple policy prescription that has actual meaning. The words "regulation" and "deregulation" are not absolute goods and evils, nor are they meaningful policy prescriptions. Rather they are usually political cant used to describe complex policy discussions that defy such simplistic categorization. Serious students of economics and organizations understand that the key to successfully regulating markets is not to either create more or less regulation in an unthinking way. Rather, intelligently designed regulations help to *align the incentives* of actors within an organization to achieve some desired end. The organization in question can be a company, a government bureaucracy or even the U.S. economy writ large.[49] If undesired outcomes such as the collapse of credit markets occur, knee-jerk attempts to create new regulations or slash old ones are usually ill-advised and can create unforeseen and unwanted effects down the road. Instead, government needs to design smart regulations that align the incentives actors such as consumers, lenders and borrowers in the economy to achieve stable and healthy markets.

An illustrative example that relates to the credit crisis is the failure of prudential bank regulations to align the financial institutions' incentives with those of the public. During periods of economic growth and increasing asset values, such as the housing bubble, financial leverage always goes up. Leverage is the use of various financial instruments or borrowed capital to increase the potential return on an investment.[50] Banks tend to increase their leverage during economic boom times because it is profitable, and as debt increases so do the risks to investors and the public. Fannie Mae and Freddie Mac are classic examples of this behavior, made all the worse because they were able to borrow even more money than normal because lenders believed rightly that taxpayers were on the hook if Fannie and Freddie collapsed.

---

[46] Calomiris, Charles W., "The Subprime Turmoil: What's Old, What's New, and What's Next," Oct. 1, 2008 (updated version provided by the author).
[47] Cf. P.L. 109-291, "Credit Rating Agency Duopoly Relief Act of 2006".
[48] Speech by SEC Staff: Remarks Before the SEC Open Meeting: Final Rules Implementing the Credit Rating Agency Reform Act of 2006, May 27, 2007.
[49] For a comprehensive discussion of organizational theory cf. Olson, Mancur, <u>The Logic of Collective Action, Public Goods and the Theory of Groups</u>, Cambridge, MA: Harvard University Press, 1971.
[50] Investopedia.

Banking regulations require financial institutions to limit their asset risk per unit of capital, but writing regulations that simply mandate an appropriate level is unlikely to work for very long because it is in the interest of bankers to find ways around these requirements in pursuit of profit. For example, banks used the securitization of mortgages to avoid prudential regulations that sought to limit their exposure to risk.[51] Many economists have advocated that government could improve banking regulations by imposing a minimum subordinated debt requirement as part of the capital requirement of banks.[52]

Subordinated debt is a loan or security that ranks below other loans or securities with regard to claims on assets or earnings. In the case of default, creditors with subordinated debt are not paid out until after the senior debtholders are paid in full, making subordinated debt more risky than unsubordinated debt.[53] Financial institutions with a minimum subordinated debt requirement on their balance sheets would be far more cautious about securitizing risky subprime mortgages and other such assets because they would stand to lose money in the case of default.

In 1999, Senator Phil Gramm proposed creating such a minimum subordinated debt requirement to protect taxpayers from institutions such as Fannie Mae and Freddie Mac that used high leverage to turn large profits. He included a requirement in the Gramm-Leach-Bliley legislation that required the Federal Reserve Board to conduct a study of this proposal.[54] Unfortunately, following intensive lobbying by the commercial banking industry, the Clinton Administration failed to follow up on the Fed's research.[55] This is only one of many examples of possible regulatory improvements Congress could consider. Instead of simply falling back on worn-out tropes like "deregulation", Speaker Pelosi could commit to a top-down review of U.S. financial regulations, seeking to align the incentives of economic actors with the public good with smart regulations. What is not needed is a ham-handed layering of yet more ill-conceived regulations that produces unforeseen and undesirable consequences while limiting the economic growth that produces jobs and wealth.

---

[51] Calomiris, "The Subprime Turmoil".
[52] Shadow Financial Regulatory Committee, Reforming Bank Capital Regulation, AEI Press, 2000 in Calomiris, "The Subprime Turmoil".
[53] Investopedia.
[54] Cf. P.L. 106-102, Sec. 108.
[55] Calomiris, "The Subprime Turmoil".

Mr. SHAYS. Mr. Chairman, a parliamentary inquiry.

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. SHAYS. Thank you.

In my request for permission to have the Members give an opening statement, I'd like the Chair to please cite the provision of committee rules or House rules on which he relies for the proposition that only the Chair and ranking member may make opening statements.

Chairman WAXMAN. The rule provides—in general the House and committee rules do not address the common practice of opening statements by Members at hearings and meetings. The only exception is House Rule 11, clause (2)(k)(1), which provides that the chairman at a hearing shall announce in an opening statement the subject of an investigation. Because there is no limitation on opening statements in the rule, every member of the committee has the right to—has a right to seek recognition, but that as a matter of House rules, the refusal of the Chair to recognize a Member for an opening statement is not appealable. As a practical matter, controversy relating to handling of opening statements are normally dealt with by consensus within the committee. The committee has always operated on the basis of the chairman and the ranking member, and that is the way we'll continue to do so.

Mr. MICA. Mr. Chairman, parliamentary inquiry.

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. MICA. Mr. Chairman, I have been on the committee with you for 16 years. I had the opportunity to chair two subcommittees.

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. MICA. I am stating, but I have to have a preface for my——

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. MICA. During the entire tenure of my chairmanship, I afforded as a courtesy every Member on either side in every hearing the opportunity for an opening statement. Now, it may not be in the rules, Mr. Chairman, and you have the ability to now reject my request for an opening statement.

Chairman WAXMAN. The chairman——

Mr. MICA. I would ask you in fairness an opportunity for all sides to be heard on this important hearing, the opportunity—I'm asking you honor the ability of my—of the rules just stated to allow me to present a 5-minute opening statement.

Chairman WAXMAN. Well, the chairman notes the presence of many, many Members. To allow you to make an opening statement and not others would be unfair. The rules do not provide for all Members to have the right to an opening statement. There are occasions when Members have been given that opportunity, especially when it is a small subcommittee, as you chaired. But we have too many Members here and too many witnesses to be heard. So the Chair did not hear a parliamentary inquiry, but a personal appeal, which the Chair denies.

We have with us the following witnesses: Nell Minow, chairman of the board and editor of the Corporate Library; Gregory W.

Smith, general counsel, Colorado Public Employees' Retirement Association; Robert F. Wescott, Ph.D., president of Keybridge Research LLC; Luigi Zingales, Ph.D., professor at the University of Chicago Graduate School of Business; and Peter J. Wallison, Arthur F. Burns fellow in Financial Policy Studies, American Enterprise Institute.

And it is the policy of this committee that all witnesses that testify before us do so under oath, so I'd like to ask each of you to please stand and raise your right hands.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that each of the witnesses answered in the affirmative.

Your prepared statements will be in the record in full. We would like to ask each of you to be mindful that we have a clock that will indicate when 5 minutes is up. We'd like you to stay as close to the 5 minutes as possible. There will be a green light for 4 minutes, a yellow light for the last minute. And then when it turns red, the 5 minutes has expired.

Dr. Zingales, am I pronouncing your name correctly? OK. There is a button on the base of your mic. Be sure it is in, and we'd like to hear from you first.

STATEMENTS OF LUIGI ZINGALES, PROFESSOR OF FINANCE, UNIVERSITY OF CHICAGO; ROBERT F. WESCOTT, PRESIDENT, KEYBRIDGE RESEARCH LLC; NELL MINOW, CHAIRMAN OF THE BOARD AND EDITOR, THE CORPORATE LIBRARY; GREGORY W. SMITH, GENERAL COUNSEL, COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION; AND PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

STATEMENT OF LUIGI ZINGALES

Mr. ZINGALES. OK. Thank you. Chairman Waxman, Ranking Minority Member Davis, members of the committee, thank you for inviting me.

The demise of Lehman Brothers is the result of a very aggressive leverage policy in the context of a major financial crisis. The roots of this crisis have to be found in bad regulation, lack of transparency, and market complacency brought about by several years of positive returns.

A prolonged period of real estate price increases and the boom of securitization relaxed lending standards. The quality of these mortgages should have been checked by the capital market that bought them, but several problems made this monitoring less than perfect. First, these mortgages were priced based on historical records, which did not factor in the probability of a significant drop in real estate prices at the national level. Nor did they factor the effect of the changes in the lending standards on the probability of default.

Second, the massive amount of issuance by a limited number of players, which Lehman was one, changed the fundamental nature of the relationship between credit-rating agencies and the investment banks issuing the securities. As a result, instead of submitting an issue to the rating agency's judgment, investment banks shopped around for the best ratings and even received handbooks on how to produce the riskiest security that qualified for a AAA rating.

The market was not completely fooled by this process. AAA-rated asset-backed securities had a higher yield than corporate AAA, a clear indication of the higher risk.

Unfortunately, regulatory constraints created inflated demand for these products. Fannie Mae and Freddie were allowed, even induced, to invest their funds in these securities, creating an easy arbitrage. They issued AAA-rated debt and invested in higher-yield AAA-rated debt.

Another source of captive demand were money market funds. Being required to hold only highly rated securities, money market funds loved these instruments and satisfied the regulatory requirements and boosted their yields.

Most managers of these firms were aware of the gamble they were taking, but could not resist taking it under an intense competition for yield-hungry customers. These managers were also hoping that if a shock occurred, all their competitors would face the same problem, thereby reducing the reputational costs and possibly triggering a government support. The September 19th decision to insure all money market funds validated this gamble, forever destroying money market managers' incentives to be careful in regard to the risks they take.

The pooling of mortgages, while beneficial for diversification purposes, became a curse as the downturn worsened. The lack of transparency in the issuing process made it difficult to determine who owned what. Furthermore, the complexity of these repackaged mortgages is such that small differences in the assumed rate of default can cause the value of some tranches to fluctuate from 50 cents on the dollar to zero. Lacking information on the quality and hence the value of banks' assets, the market grew reluctant to lend to them for fear of losing out in case of default.

In the case of Lehman and other investment banks, this problem was aggravated by two factors, the extremely high level of leverage and the strong reliance on short-term debt financing. While commercial banks cannot leverage their equity more than 15 to 1, Lehman had a leverage of more than 30 to 1. With this leverage, a mere 3.3 percent drop in the value of assets wipes out the entire value of equity and makes the company insolvent.

In turn, the instability created by a leverage problem was exacerbated by Lehman's large use of short-term debt. Reliance on short-term debt increases the risk of runs similar to the ones bank face when they are rumored to be insolvent. The Lehman CEO will likely tell you that his company was solvent, and it was brought down by a run. This is a distinct possibility. The problem is that nobody knows for sure. When Lehman went down, it had $26 billion in book equity, but the doubts about the value of its assets combined with the high degree of leverage created a huge uncertainty about the true value of this equity. It could have been worth $40 billion or negative $20.

It is important to note that Lehman did not find itself in that situation by accident. It was the unlucky draw of a consciously made gamble.

Lehman Brothers' bankruptcy forced the market to assess risk. As after a major flood, people start to buy flood insurance. After the demise of Lehman, the market started to worry about several risks previously overlooked. This risk reassessment is crucial to support a market discipline. The downside is that it can degenerate into a panic.

Chairman WAXMAN. Thank you very much, Dr. Zingales.

[The prepared statement of Mr. Zingales follows:]

Testimony of

Luigi Zingales

on
"Causes and Effects of the Lehman Brothers Bankruptcy"

Before the
Committee on Oversight and Government Reform

United States House of Representatives
October 6, 2008

Causes and Effects of the Lehman Brothers Bankruptcy

Luigi Zingales*

October 2008

Abstract

I argue that the demise of Lehman Brothers is the result of its very aggressive leverage policy in the context of a major financial crisis. The roots of this crisis have to be found in bad regulation, lack of transparency, and market complacency brought about by several years of positive returns. Lehman's bankruptcy lead to a reassessment of the risk, in particular in the market for credit default swaps.

*University of Chicago Graduate School of Business, National Bureau of Economic Research and Center for Economic Policy Research. Address correspondence to Luigi Zingales, University of Chicago Graduate School of Business, 5807 South Woodlawn Avenue, Chicago, IL 60637 or e-mail at luigi@chicagogsb.edu.
I thank Federico De Luca for excellent research assistantship.

The demise of Lehman Brothers can only be understood within the context of the current financial crisis, the biggest financial crisis since the Great Depression. The roots of this crisis have to be found in bad regulation, lack of transparency, and market complacency brought about by several years of positive returns. I will start by explaining these three roots and then I will discuss how Lehman contributed to its own demise and what the consequences of its filing for bankruptcy are.

1. Market Complacency

The seeds of current crisis were sewn during the real estate boom. As Figure 1 shows, a prolonged period of low interest rates lead to a rise in house prices that was completely abnormal by historical standards. From March 1997 to June 2006 the Case and Shiller national index of real estate prices increased every month, except for two. During the same period the average increase in real estate prices was 12.4% per year. This increase was in part fueled by extraordinary low interest rates. Between January 2002 and January 2004 the average 3-month T-bill rate was 1.3%, while the average in the previous forty years was 6.1%.

This sustained price increase engenders the illusion in many actual and aspiring home owners that prices will always go up. In a 2005 survey of San Francisco home buyers Case and Shiller find that the mean expected price increase over the next ten years was 14% per year, while the median 9% per year (Shiller, 2008).

As Table 1 shows, during the real estate boom delinquency rates dropped. The reason was not only the relatively good economic conditions, but the sustained real estate price increase. First of all, home owners fight hard to be able to pay their mortgages when their home equity increases.

Second, the availability of innovative mortgage options, like interest only and negative amortization, allowed buyers to purchase houses for which they could not sustain the mortgage payments in equilibrium counting on the ability to refinance them continuously at higher prices. As Table 2 shows, the share of interest-only mortgages went from zero to 38%.

As a result of these favorable conditions, lending standards deteriorated. Dell'Ariccia et al. (2008), for instance, show that lending standards declined in areas of high home price appreciation and attribute this decline to increased competition among lenders. As Table 2 shows, the share of low documentation mortgages went from 29% to 51% and the debt-to-income ratio from 39.6 to 42.4. This relaxation was exacerbated by securitization, i.e. the practice of pooling mortgages together to resell them in packages. For the first time, this practice, which had been used for decades on standard mortgages with beneficial results for both mortgage rates and home ownership, was applied to lower quality mortgages. Knowing that they would not bear the ultimate risk of default, many mortgage originators further relaxed their lending standards. As Keys et al. (2008) show, loans with a higher probability of being securitized default at a rate 20% higher for comparable FICO score.

The quality of these mortgages should have been checked by the capital market that bought them, but several problems made this monitoring less than perfect.

First, pooled mortgages were resold in tranches that had different seniority. By using the historical record of defaults, the senior tranches were considered extremely safe; but historical records did not factor in the probability of a significant drop in real estate prices at the *national* level since we did not experience any since the Great Depression and all the most commonly used time series do not go back that far. Nor did these models factor the effect of the changes in the lending standards on the probability of default. As Rajan et al. (2008) show, a default model fitted in a low securitization period breaks down in a high securitization regime in a "systematic" and "predictable" way: it underpredicts defaults especially at low FICO scores. Finally, these models did not properly account for the cross-correlation among defaults and between defaults and the rest of the economy. In the words of Darrell Duffie, one of the intellectual fathers of these models, "Banks, insurance companies and other financial institutions managing portfolios of credit risk need an integrated model, one that reflects correlations in default and changes in market spreads. Yet no such model exists," Duffie (2004).

Second, the massive amount of issuance made by a limited number of players (of which Lehman was one) changed the fundamental nature of the relationship between credit rating agencies and the investment banks issuing these securities. In their sample of 1,257 mortgage securitization deals Nadauld and Sherlund (2008) find that Lehman alone had 128 deals.

In the past each customer, issuing only a couple of securities, had no market power over the rating agencies. With the diffusion of collateralized debt obligations, the major investment banks were purchasing hundreds of rating services a year. As a result, instead of submitting an issue to the rating agency's judgment, investment banks shopped around for the best ratings and even received manuals on how to produce the riskiest security that qualified for a AAA rating. For example, the Standard & Poor's website used to provide a CDO Evaluator Manual (Benmelech and Dlugoszb, 2008). The CDO Evaluator is an optimization tool that enables issuers to achieve the highest possible credit rating at the lowest possible cost. One of the outputs of this evaluator was to provide the issuer with a measure of "excess collateral" which, according to S&P, "tells what percentage of assets notional needs to be eliminated (added) in order for the transaction to provide just enough (i.e. ROC equals to 100%) support at a given rating level." (Benmelech and Dlugoszb, 2008).

The market was not completely fooled by this process: AAA-rated assets backed securities had a higher yield than corporate AAA, a clear indicator of the higher risk. Benmelech and Dlugoszb (2008), for instance, reports that in their sample average spread over the Libor for AAA tranches in our sample is 32 basis points.

2. Bad Regulation

Unfortunately, regulatory constraints created inflated demand for these products. Fannie Mae and Freddie Mac were allowed, even encouraged, to invest their funds in these securities (Mian et al, 2008).

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the Department of Housing and Urban Development (HUD) to ensure that Fannie Mae and Freddie Mac operate in compliance with their charter purposes. This act mandates that HUD carry out specific responsibilities that include setting annual housing goals for the GSEs and monitoring and enforcing the GSEs' performance in meeting these housing goals.

In 2004, to encourage Fannie Mae and Freddie Mac to facilitate greater financing and home ownership opportunities for families and neighborhoods targeted by the housing goals, especially first-time homebuyers, the HUD established goals for the two Government Sponsored Entities (GSE). These goals are expressed as percentages of the total number of mortgages purchased by the GSEs that finance the purchase (not refinance) of single-family and owner-occupied properties located in metropolitan areas for low and moderate income people. Table 3, obtained from a HUD press release, reports these goals for 2005 with the relative performance of the two GSE along these lines.

While there is no penalty for failure to meet these goals, it is clear from the press release that HUD exerts political pressure. Since these goals could be met also with the purchase of subprime collateralized debt obligations (CDOs), such pressure found no resistance from the GSE who loved the arbitrage this opportunity created: they could issue AAA-rated debt and invest in higher-yield AAA debt, gaining the spread.

Another source of captive demand were money market funds. Being required to hold *only* highly rated securities, money market funds loved these instruments because they satisfied the regulatory requirements and boosted their yields. Most managers of these funds were well aware of the gamble they were taking, but could not resist taking it, under an intense competition for yield-hungry customers (see for example, Table 4). These managers were also hoping that if a shock occurred, all their competitors would face the same problem, thereby reducing the reputational costs and possibly triggering a Government support. The September 19th decision to insure all money market funds validated this gamble, forever destroying money market managers' incentives to be careful in regard to the risks they take.

To be fair, the problem was even more severe in the ultra short bond funds. Unlike money market funds, these funds are not restricted as to which types of instruments they can own. Their aim is to beat money market funds without delivering much more volatility. In the last year, the ultrashort-term bond category has performed very poorly. The category's worst performers have lost between 10% and 30% over the past year (Dolan, 2008). As the mutual find rater *Morningstar* admits, "We can't say that we saw this coming. We didn't. There were risks in these portfolios that were hard to see and had never materialized in the past, so backward-looking risk measures such as standard deviation and past losses proved unreliable. Given the near-term maturities of the bonds in the portfolio, we underestimated the damage that subprime and other low-quality bonds could cause."

More generally, regulation relied heavily on credit-rating agencies measures of risk without understating the incentives this creates on the regulated to game the system and lobby the credit-rating agencies for sweet deals.

First of all, the bin-approach to risk advocated by Basel risk-based capital requirements induce banks to invest in the highest risk security in each bin, sensibly altering the distribution of asset risk. For example, most non-OECD countries attach a zero percent risk weight to their own government paper. As a result, during the Argentina crisis, domestic banks loaded up on government bonds, in spite of the declaration of default, because they provided a regulation arbitrage: a very high yield and zero capital requirement (Rojas-Suarez, 2008).

This problem is present also in the United States. Banks are allowed to allocate zero capital to loans which are hedged with credit default swaps. But the insurance buy is less than certain because of the possibility that the insurer will default – what it is known as counterparty risk – since the amount of collateral posted for this contract is often zero.

Second, this regulation failed to appreciate the enormous pressure it put on the shoulder of credit-rating agencies. As figure 2 shows, Moody's revenues from structured finance ratings increased from a little more than $100 million in 1998 to more than $800 million in 2006, representing more than 80% of its total rating revenues. Since Standard and Poor's is a division of McGraw Hill it does not disclose disaggregated data, but the pattern is likely to be similar. Given the high degree of concentration of the issues of structured products among a few investment banks, it is hard to see how this change in the revenue source will not alter the balance of power between credit rating agencies and their customers.

To worsen the problem, at least as far as investment banks are considered, comes a Security and Exchange Commission ruling in April 2004, which relaxed the pre-existing limits on leverage. As a consequence, the leverage of the five independent investment banks shot up (Labaton, 2008).

The accounting of subprime mortgages deserves a separate discussion. Many commentators have accused the so-called mark-to-market method (more properly called fair value accounting) for the spreading of the crisis. Before passing any judgment it is helpful to review what are the rules that regulate the accounting of these instruments contained in Financial Accounting Statement (FAS) 115 (for a thorough discussion see Ryan, 2008). First of all, buyers have an option to treat these securities as trading or available for sale (AFS) or held to maturities (HTM). AFS securities are accounted for at the lower of cost or fair value (see FAS 157). HTM securities are accounted for at amortized costs, subject to other-than-temporary impairments. Originators usually treat mortgages as available for sale.

FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FAS 157 provides a hierarchy of inputs that go to determine the fair value. The first level are market prices for identical items. This is extremely rare for mortgage-backed securities (MBS), since they are tailor-made. The second level is represented by market data for similar items or illiquid market data for the same item. At the beginning of the crisis most MBS were valued in this way. But as the crisis made the market increasingly illiquid, MBS started to be valued using level three, i.e., unobservable, firm-supplied estimates (also called mark-to-model valuations).

While this system was designed to increase the transparency of reporting it did encounter some problems, especially at the time of a major generalized crisis.

First, as market liquidity dried out, more and more firms had to move to mark-to-model. Given the relative novelty of this approach, there was not a well-established method to deal with this. Hence, firms were at the mercy of their external auditors, who had different approaches. Since, there is not an adequate disclosure of all the assumptions that go in the models, a rule that was invented to increase transparency lead to more opacity at a time the market needed transparency the most.

Second, write-offs calculated in this way had major impact in the rating-firm decisions to downgrade financial institutions, which in turn had strong effect on their ability to survive. In a different scenario the credit rating agencies could have helped reduce the impact of write-offs by using their direct knowledge of the firm balance sheets to overrule the verdict of some excessively conservative accounting decisions. Unfortunately, given the limited credibility credit rating agencies enjoy in this moment, they could not afford to be seen as overruling the implications of the write offs.

Finally, as Morris and Shin (2002) have shown in a situation where there are multiple equilibria, increasing public information is not necessarily welfare enhancing, because it can lead to inefficient bank runs (Diamond and Dybvig, 1983).

3. Lack of Transparency

The other major source of problems that contributed to the crisis was the lack of transparency in major markets. As Figure 3 shows, during the last ten years the market for credit default swaps (CDS) grew unregulated from almost zero to more than $44 trillion (more than twice the size of the U.S. stock market). More importantly, the level of collateral posted for these contracts was very low or non-existent, generating the possibility of a systemic failure. If in the middle of the hurricane season all of a sudden all Florida homeowners lost the insurance for their house, there would be an enormous run to buy new insurance. Given that in the short term, insurance capacity is limited, the prices will go to the roof. If some home owners could not afford these prices, their mortgages will automatically default, triggering foreclosures and a real estate crisis. This is one of the reasons why the insurance market is regulated.

The same would be true if a large CDS player, like AIG, defaulted. As Table 5 shows, large commercial banks have massive exposure to CDS. Most of their positions are hedged; hence the net exposure is much smaller. Nevertheless, if they a major player defaults, all the other ones will find themselves un-hedged, triggering a run to buy insurance, with consequences not dissimilar from the case described above. In spite of its potential systemic effects, the market for CDS is completely unregulated.

The same is true for the mortgage-backed security market. In 2007 there were almost 6 trillion mortgage-backed securities outstanding (Gorton, 2008). Most of these securities were issued under the 144A rule, with limited disclosure. This lack of transparency in the issuing process made it difficult to determine who owned what. Furthermore, the complexity of these repackaged mortgages is such that small differences in the assumed rate of default can cause the value of some tranches to fluctuate from 50 cents on the dollar to zero. Lacking information on the nature and hence the value of banks' assets, the market grew reluctant to lend to them, for fear of losing out in case of default. One often-used measure of this reluctance is the spread between Libor and the overnight indexed swap (OIS) rate of the same maturity. Before the beginning of the crisis the multi-year average of this spread was 11 basis points. On August 10 2007 it was over 50 basis points and it was over 90 basis points by mid-September. While fluctuating it has mostly remained above that level ever since (Gorton, 2008).

4. Lehman Financial Policy

In the case of Lehman (and other investment banks), this problem was aggravated by two factors: the extremely high level of leverage (asset-to-equity ratio) and the strong reliance on short-term debt financing. While commercial banks are regulated and cannot leverage their equity more than 15 to 1, at the beginning of the crisis Lehman had a leverage of more than 30 to 1, i.e. only $3.30 of equity for every $100 of loans (Table 6). With this leverage, a mere 3.3% drop in the value of assets wipes out the entire value of equity and makes the company insolvent.

In turn, the instability created by the leverage problem was exacerbated by Lehman's large use of short-term debt, which financed more than 50% of the asset at the beginning of the crisis (Table 6). In a low interest rate environment, reliance on short-term borrowing is very profitable, but increases the risk of "runs" similar to the ones bank face when they are rumored to be insolvent. Any doubt regarding the solvency of the borrower makes short-term lenders leery to renew their lending. These doubts can be self-fulfilling, in that if enough short-term lenders withdraw their funds, the borrower faces a liquidity shortage, which cannot be easily dealt with in the current economic environment, forcing a firm to default.

After the beginning of the crisis, Lehman did try to reduce its leverage and reduce its reliance on short term debt (see Table 6). But it was too little, too late. Lehman succumbed.

The Lehman CEO will likely tell you that his company was solvent and that it was brought down by a run. This is a distinct possibility. The problem is that nobody knows for sure. When Lehman went down, it had $20 billion in book equity, but the doubts about the value of its assets combined with its high degree of leverage created a huge uncertainty about the true value of this equity: it could have been worth $40 billion or negative 20. It is important to note that Lehman did not find itself in that situation by accident; it was the unlucky draw of a consciously-made gamble.

5. Consequences of Lehman default

Lehman's bankruptcy forced the market to reassess risk. As after a major flood people start to buy flood insurance, after the demise of Lehman the market started to worry about several risks previously overlooked. One way to valuate quantitatively this reassessment of risk is to look at the price of credit default swaps. Figure 4 reports the cost of insuring an index of junk bond issuers during the last one and a half year. Before the crisis it cost only $2.50 to insure $100 invested in junk bonds. In July 2007 the price moved above $4. During the Bear Stearns crisis, the price shot above $6, to return to about $4.50 in June. After the demise of Lehman the price returned slightly above \$6, a very high level, but comparable to the one experienced around the time of the Bear Stearns crisis. Given that two different policy responses -- Bear Stearns was saved, while Lehman not – lead to the same market response, the most likely interpretation is that these extreme events force the market to reassess the risk, regardless of the policy response adopted.

Lehman's filing for bankruptcy had a more dramatic impact on money market funds. On September 16th Primary Fund, a \$62 billion fund, announced that because of the total loss it suffered on its \$785 million holding of Lehman Brothers debt, it was forced to put a seven-day freeze on redemptions, since the net asset value of its shares fell below \$1. By contradicting a long-standing belief that money market fund will never "break the buck," this decision did contribute to increase the sense of uncertainty. The guarantee offered by the Government, however, has minimized this side effect.

References

Ashcraft, Adam B. and Til Schuermann, 2008, "Understanding the Securitization of Subprime Mortgage Credit", Wharton Financial Institutions Center Working Paper No. 07-43.

Benmelech, Efraim and Jennifer Dlugoszb, 2008, "The Alchemy of CDO Credit Ratings", Harvard University Working Paper.

Dell'Ariccia, Giovanni, Deniz Igan and Luc A. Laeven, 2008, "Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market", CEPR Discussion Paper No. DP6683.

Diamond, D. and P. Dybvig, 1983, "Bank runs, Deposit Insurance and Liquidity", *Journal of Political Economy.*

Demyanyk, Yuliya and Otto Van Hemert, 2008, "Understanding the Subprime Mortgage Crisis", Working Paper.

Dolan, Karen, 2008, "Ultrashort-Term Bond Funds Suffer Massive Blow", *Moningstar.com*, 09-03-08.

Duffie, Darrell, 2004, "Irresistible Reasons for Better Models of Credit Rating", *Financial Times,* Apr 16, 2004.

Evans, David, 2007, "Unsafe Havens", *Bloomberg Markets,* October 2007.

Gorton, Gary, 2008, "The Panic of 2007", NBER working paper n. 14358.

Keys, Benjamin J., Tanmoy Mukherjee, Amit Seru, Vikrant Vig, 2008, "Did Securitization Lead to Lax Screening? Evidence From Subprime Loans", University of Chicago Working Paper.

Labaton, Stephen, 2008, "Agency's '04 Rule Let Banks Pile Up New Debt, and Risk", *New York Times,* 10-3-2008.

Mian, Atif R. and Amir Sufi, 2008, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis", University of Chicago Working Paper.

Mian, Atif R., Amir Sufi, and F. Trebbi, 2008, "The Political Economy of the U.S. Mortgage Default Crisis", University of Chicago Working Paper.

Morris, S and H. Shin, 2002, "Social Value of Private Information", *American Economic Review.*

Nadauld, Taylor D. and Shane M. Sherlund, 2008, "The Role of the Securitization Process in the Expansion of Subprime Credit", Ohio State Working Paper.

Rajan, U, A. Seru, V. Vig, 2008, "The Failure of Models That Predict Failure: Distance, Incentives and Defaults", University of Chicago Working Paper.

Rojas-Suarez, Liliana, 2008, *Can International Capital Standards Strengthen Banks In Emerging Markets?*, Institute for International Economics Working Paper.

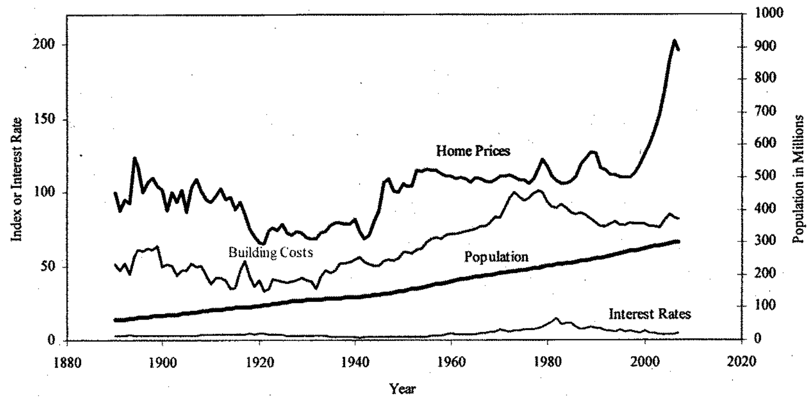
Ryan, G. Stephen, 2008, "Accounting in and for the Subprime Crisis", Stern School of Business, New York University, March 2008.

Shiller, Robert J., 2005, "Irrational Exuberance", Princeton University Press 2nd edition.

Shiller, Robert J., 2008, "The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about It", Princeton University Press.

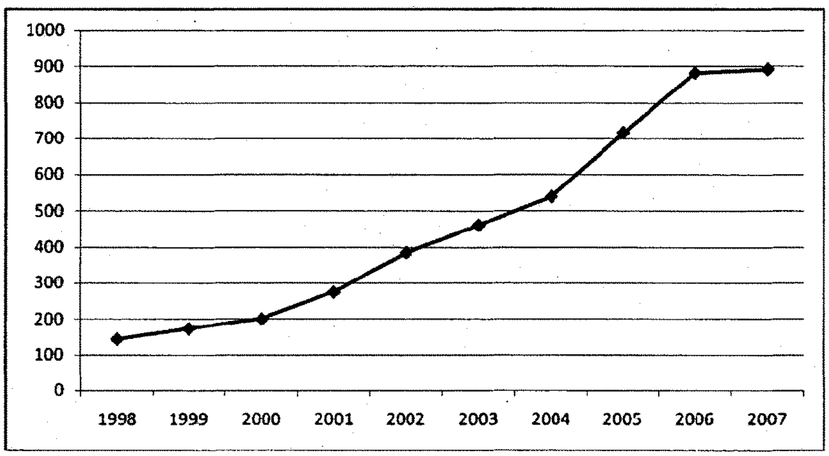
Whalen, R. Chrisopher, 2008, "The Subprime Crisis: Cause, Effect and Consequences", Networks Financial Institute Policy Brief No. 2008-PB-04.

Figure 1: Abnormal rise in house prices in the new millennium



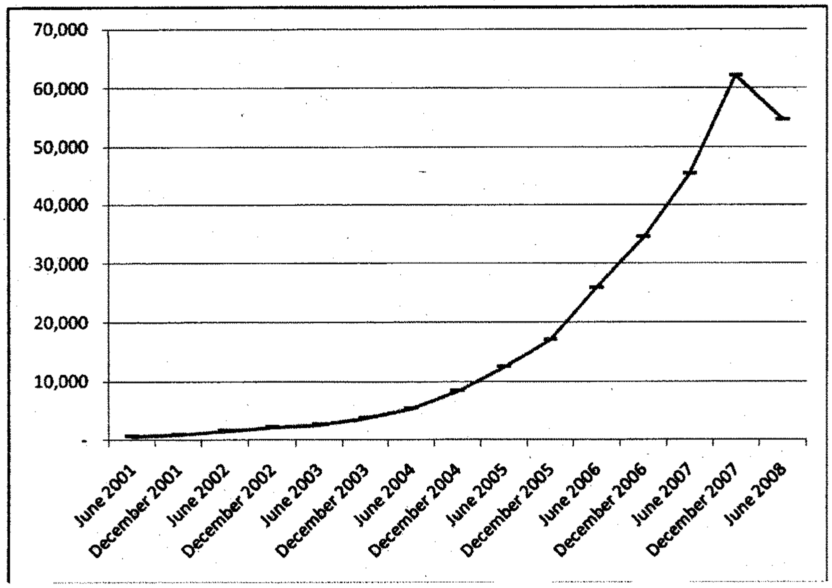
Source: Shiller (2005).

Figure 2: Importance of Structured Finance Products for Credit Rating Agencies (Rating revenues by business unit: Structured Finance (in Millions of Dollars))



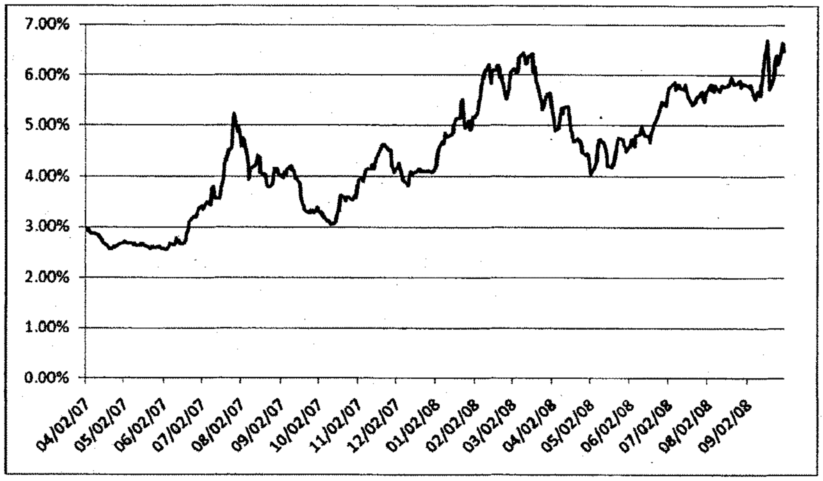
Source: Moody's Annual Reports

Figure 3: Outstanding Value of Credit Default Swaps (in Billions of Dollars)



Source: International Swaps and Derivatives Association (ISDA) Market Survey.

Figure 4: Increase in the cost of CDS in the last year (CDX HY8)
Cost of insuring a basket of junk bond-rated debt securities as a percentage of the nominal value.



Source: Markit quotes

Table 1: Decline in Delinquency Rates During the Boom Among Major Investor Groups

Year-end	CMBS (30+ days and REO)	Life Companies (60+ days)	Fannie Mae* (60+ days)	Freddie Mac (60+ days)	Banks & Thrifts (90+ days)
12/31/1996	n.a.	1.79%	0.68%	1.96%	1.58%
12/31/1997	0.39%	0.90%	0.37%	0.96%	1.18%
12/31/1998	0.54%	0.48%	0.29%	0.37%	0.94%
12/31/1999	0.51%	0.25%	0.12%	0.14%	0.73%
12/31/2000	0.81%	0.28%	0.04%	0.04%	0.69%
12/31/2001	1.26%	0.12%	0.33%	0.15%	0.92%
12/31/2002	1.47%	0.28%	0.13%	0.13%	0.86%
12/31/2003	1.72%	0.12%	0.13%	0.05%	0.78%
12/31/2004	1.29%	0.08%	0.10%	0.06%	0.61%
12/31/2005	0.85%	0.05%	0.27%	0.00%	0.53%
12/31/2006	0.41%	0.02%	0.08%	0.05%	0.56%
12/31/2007	0.40%	0.01%	0.08%	0.02%	0.80%

Source: Mortgage Bankers Association (Commercial-multifamily delinquency survey).

Definitions of delinquency rate for the respective companies:

- CMBS: 30+ days delinquent or in REO;
- Life company portfolios: 60+days delinquent;
- Fannie Mae: 60 or more days delinquent;
- Freddie Mac: 60 or more days delinquent;
- Banks and thrifts: 90 or more days delinquent or in non-accrual.

Table 2: Underwriting Standards for Subprime Mortgages

Year	Adjusted Rate Mortgages Share	Interest Only Share	Low/No Documentation Share	Debt-to-Income Ratio	Average Loan-to-Value Ratio
2001	73.00%	0.00%	28.50%	39.7	84
2002	80.00%	2.30%	38.60%	40.1	84.4
2003	80.10%	8.60%	42.80%	40.5	86.1
2004	89.40%	27.20%	45.20%	41.2	84.7
2005	93.30%	37.80%	50.70%	41.8	83.2
2006	91.30%	22.80%	50.80%	42.4	83.4

Source: Gorton (2008).

Table 3: HUD's official 2005 housing goals and Special Affordable Multifamily subgoal performance figures for Fannie Mae and Freddie Mac

Housing goals	Goal Targets	Fannie Mae Results	Freddie Mac Results
Low- and Moderate-Income	52%	55.06%	54.00%
Central Cities, Rural Areas, and Other Undeserved Areas	37%	41.43%	42.27%
Special Affordable	22%	26.28%	24.28%
Special Affordable Multifamily Subgoal			
Fannie Mae =	$ 5.49 Billons	$ 10.39 Billons	$ 12.35 Billons
Freddie Mac =	$ 3.92 Billons		

Source: U.S. Department of Housing and Urban Development's Homes and Communities (http://www.hud.gov/news/release.cfm?CONTENT=pr06-136.cfm)

Table 4: Investments of Some of the Largest Money Market Funds in CDO Commercial Paper.

Money Market Fund	Millions of Dollars invested in CDO Commercial Paper	Percentage of Holdings
AIM	2,300	10.20%
Credit Suisse	1,800	8.00%
Fidelity Investments	1,500	1.50%
Morgan Stanley	1,060	4.00%
Wells Fargo	586	5.10%

Source: Evans (2007).

Table 5: Distribution of Credit Derivative Contracts: Top 25 Commercial Banks and Trust Companies in Derivatives. JUNE 30, 2008
Millions of Dollars (NOTE: DATA ARE PRELIMINARY)

					TOTAL CREDIT DERIVATIVES		BOUGHT		SOLD	
RANK	BANK NAME	TOTAL ASSETS	TOTAL DERIVATIVES	TOTAL CREDIT DERVATIVES	BOUGHT	SOLD	CREDIT DEFAULT SWAPS	TOTAL RETURN SWAPS	CREDIT DEFAULT SWAPS	TOTAL RETURN SWAPS
1	JPMORGAN CHASE BANK NA	1,378,468	83,436,951	7,850,264	4,028,873	3,821,391	3,994,756	15,004	3,817,140	2,771
2	BANK OF AMERICA NA	1,327,429	36,961,254	2,710,538	1,342,595	1,367,943	1,326,855	12,276	1,344,015	22,353
3	CITIBANK NATIONAL ASSN	1,228,445	33,922,675	3,209,678	1,672,423	1,537,255	1,636,972	35,240	1,527,573	8,439
4	WACHOVIA BANK NATIONAL ASSN	670,639	4,061,830	385,616	198,917	186,699	188,712	10,205	178,621	8,078
5	HSBC BANK USA NATIONAL ASSN	177,466	2,822,877	1,240,227	600,803	639,424	584,320	16,333	623,283	16,141
6	WELLS FARGO BANK NA	503,327	1,513,682	2,238	1,411	827	1,411	0	817	0
7	BANK OF NEW YORK	130,062	1,047,852	1,677	1,675	2	1,514	161	2	0
8	STATE STREET BANK&TRUST CO	138,859	836,971	238	238	0	238	0	0	0
9	SUNTRUST BANK	171,501	265,718	3,104	1,806	1,298	831	975	313	975
10	PNC BANK NATIONAL ASSN	128,348	205,342	5,352	3,655	1,697	3,655	0	1,697	0
11	NORTHERN TRUST CO	65,200	183,923	254	254	0	254	0	0	0
12	MELLON BANK NATIONAL ASSN	39,476	183,003	0	0	0	0	0	0	0
13	KEYBANK NATIONAL ASSN	98,048	127,983	8,714	4,684	4,030	4,684	0	3,645	385
14	NATIONAL CITY BANK	151,165	108,341	2,408	1,360	1,048	1,360	0	1,048	0
15	U S BANK NATIONAL ASSN	242,308	85,278	2,170	627	1,543	56	0	0	0
16	REGIONS BANK	139,354	79,872	283	35	248	35	0	248	0
17	BRANCH BANKING&TRUST CO	132,884	63,472	52	52	0	0	52	0	0
18	MERRILL LYNCH BANK USA	58,042	50,421	9,146	9,146	0	9,146	0	0	0
19	RBS CITIZENS NATIONAL ASSN	132,051	57,391	234	214	20	2	0	20	0
20	FIFTH THIRD BANK	67,272	55,663	313	72	241	0	0	0	0
21	UNION BANK OF CALIFORNIA NA	60,228	35,486	0	0	0	0	0	0	0
22	LASALLE BANK NATIONAL ASSN	68,379	32,781	1,820	412	1,409	0	0	0	0
23	UBS BANK USA	27,316	34,160	0	0	0	0	0	0	0
24	DEUTSCHE BANK TR CO AMERICAS	46,071	28,690	5,197	5,197	0	100	5,097	0	0
25	LEHMAN BROTHERS COML BK	6,418	28,086	0	0	0	0	0	0	0

Source: Office of the Comptroller of the Currency

Table 6: Lehman Brothers Liabilities and Shareholders' Equity

PERIOD ENDING		**31-May-08**	**29-Feb-08**	**30-Nov-07**	**31-Aug-07**
Current Liabilities					
	Accounts Payable	70,888,000	96,148,000	80,346,000	68,986,000
	Short/Current Long Term Debt	163,148,000	428,555,000	359,415,000	336,456,000
	Other Current	29,355,000	28,829,000	29,363,000	24,935,000
Total Current Liabilities		-	-	-	-
Long Term Debt		349,765,000	207,671,000	199,449,000	207,106,000
Other Liabilities		-	-	-	-
Deferred Long Term Liability Charges		-	-	-	-
Minority Interest		-	-	-	-
Negative Goodwill		-	-	-	-
Total Liabilities		**613,156,000**	**761,203,000**	**668,573,000**	**637,483,000**
Stockholders' Equity					
Misc Stocks Options Warrants		-	-	-	-
Redeemable Preferred Stock		-	-	-	-
Preferred Stock		6,993,000	2,993,000	1,095,000	1,095,000
Common Stock		61,000	61,000	61,000	61,000
Retained Earnings		16,901,000	19,880,000	19,698,000	18,915,000
Treasury Stock		-4,922,000	-5,149,000	-5,524,000	-5,658,000
Capital Surplus		11,268,000	11,129,000	9,733,000	9,802,000
Other Stockholder Equity		-4,025,000	-4,082,000	-2,573,000	-2,482,000
Total Stockholder Equity		**26,276,000**	**24,832,000**	**22,490,000**	**21,733,000**
Leverage ratio (assets over equity)		**24.6**	**32.7**	**30.7**	**30.4**
Short term ratio (short term debt over assets)		**25.51%**	**54.59%**	**52.05%**	**51.09%**

Source: Lehman Annual Reports.

Chairman WAXMAN. Dr. Wescott.

STATEMENT OF ROBERT F. WESCOTT

Mr. WESCOTT. Chairman Waxman and members of the committee, thank you for inviting me to testify today about the financial meltdown on Wall Street. I'll focus my comments on the main causes of the financial crisis. During questions, I'm also happy to discuss its economic effects and also the lessons we might draw about it for public policy. I'll give you an economist's perspective, drawing on my experiences in forecasting the U.S. economy, in participating in the national economic policymaking process at the National Economic Council of the White House, and in researching global and economic financial risks.

In my opinion, there were three main contributors to the financial meltdown. The first was an environment of easy credit that existed in the first half of this decade. We simply left the monetary floodgates open too far and too long in the period 2002 to 2005. During this period, mortgage rates got as low as 2½ percent, and families got an inflated sense of their capacity to afford housing. This cheap credit quickly got capitalized in housing prices, and housing prices doubled and even tripled in some neighborhoods in the span of just a few years. This caused a housing frenzy, and many Americans developed unrealistic expectations and assumed that housing prices could only go up.

The second key development was mortgage securitization, the bundling of pools of mortgages, their underwriting and their sale to institutional investors. This increased liquidity and made mortgage money cheaper than—because we could tap the savings of global savers. On the downside, however, it also meant that the mortgage originator was no longer going to hold the mortgage to maturity. So it did not have a strong incentive to perform due diligence on the loan.

In this environment of easy credit, there was lots of competition. Lenders began loosening standards to win business and increase market share. This led to an easing of down payment requirements and a proliferation of unconventional mortgages, including teaser rate mortgages, no doc mortgages, option payment mortgages and so on. Eventually homebuyers were receiving 100 percent loan-to-value mortgages, a very dangerous predictor of default risk.

The third key development was an increase in leverage by investment banks, as has just been stated. Whereas a traditional bank might have a leverage ratio of, say, four, meaning that the value of its obligations was four times the value of its shareholders' equity, investment banks increased their leverage ratios to 30 or 35 times in the past few years. Such high leverage ratios meant that there was much less cushion in hard times.

Well, how did these ingredients mix? As long as house prices kept appreciating steadily, all players in the system had a strong incentive to keep going and keep doing what they were doing. It was good for existing homeowners because they had asset appreciation, and they had great opportunities for extracting equity out of their houses through cash-out refinancings and home equity loans. Basically families started using their houses as ATM machines. It was good for new homebuyers, including speculators, because they saw almost immediate price gains. It was good for mortgage brokers. They earned hefty origination fees. It was good for rating agencies. They had great business. And it was good for investment banks because they were earning large securitization fees.

The system boomed this way for many years. The problem came when the U.S. housing sector simply reached saturation. By early 2006, almost every American who wanted a home was in one. The Fed started raising interest rates to fight inflation, and suddenly housing prices leveled off and then began to fall. Some borrowers, especially subprime borrowers, began to miss their monthly mortgage payments, and the value of subprime mortgage portfolios began to decline. Now, because of the high leverage in the investment banks, many simply did not have the cushion to fall back on.

The problems were compounded by a rapidly weakening U.S. economy. As the housing sector weakened, overall U.S. economic growth was cut roughly in half, and the drying up of home equity loans and cash-out refinancings hurt consumption. By early 2008, 10 percent of all U.S. households were underwater with their mortgages, meaning that they owed more on their house than their house was worth. These events set the stage for the financial and liquidity crisis we have today.

The cause of Lehman Brothers—basically the collapse of Lehman Brothers in September was effectively the pinprick that burst the bubble. Mr. Chairman, the collapse of Lehman shook the market's financial confidence and set off the liquidity crisis that has thrown sand into the gears of the U.S. economic engine.

What lessons should we draw? Any time the price of a major asset class or commodity increases 200 percent or 300 percent in a matter of just a few weeks—in a matter of just a few years, whether it is home prices, timber, Dutch tulips, oil, gold, technology, stocks, we need to ask questions. Prudent regulators need—needed to ask whether the system they regulate could tolerate a rapid return of asset prices to the historical trading range, and private executives running investment banks who wanted to maximize their shareholders' value in the long term needed to ask whether their business model could tolerate a rapid return of asset prices to their historical range.

Thank you.

Chairman WAXMAN. Thank you very much, Dr. Wescott.

[The prepared statement of Mr. Wescott follows:]

Testimony of Robert F. Wescott, Ph.D.
President, Keybridge Research LLC
Washington, DC

Before the U.S. House of Representatives
Committee on Oversight and Government Reform
Hearing on the Financial Meltdown
October 6, 2008

Chairman Waxman and Members of the Committee:

Thank you for inviting me to testify about the financial meltdown on Wall Street. My name is Robert Wescott and I am President of Keybridge Research LLC, an economic analysis and public policy research firm based in Washington, DC. I would like to share with you my observations from an economist's perspective, drawing on my nearly 30 years of experience analyzing and forecasting the U.S. economy, participating in the national economic policymaking process at the Council of Economic Advisers and the National Economic Council at the White House, and researching global economic and financial sector risks, including the Japanese credit meltdown of the 1990s. My comments are focused on three key questions:

(1) What were the main causes of the financial crisis?

(2) What are its economic effects?

(3) What lessons should we draw for public policy from these experiences?

I will concentrate on systemic issues and try to give you a view from 30,000 feet. The first section of this statement lays out the main causes of our current financial problems. The second section briefly traces through the likely impacts of the meltdown on the U.S. economy. The third section offers my views on the implications of these developments for public policy. The last section concludes with some general observations.

I. Causes of the Financial Meltdown

The current financial meltdown in America had a key driving factor — a rapid expansion of credit. It had a key vehicle — the housing market. It had a number of important enabling factors — mainly innovations in the financial sector, the erosion of underwriting standards, and heavy leveraging. Finally it had a trigger event that led to a rapid erosion of confidence in financial markets — the collapse of the investment firm Lehman Brothers in mid September 2008. Some of these factors might have been relatively benign in and of themselves, but their combination proved most dangerous. In essence America's mortgage lending system morphed rapidly from a well understood and reasonably well regulated system with natural checks and balances, into a new system in which some perverse profit incentives brought unintended consequences. The innovations were so rapid that regulators and many managers of financial firms themselves did not fully appreciate the risks they faced.

Arguably the most important contributor was the environment of easy credit that existed in the first half of this decade. In retrospect, we left the monetary policy floodgates open too wide in the 2002-05 period. Easy credit can be a useful countercyclical macroeconomic policy, but if interest rates are kept too low for too long, they fuel asset bubbles. Long after the U.S. economy had recovered from the 2001-02 recession, the federal funds rates remained at 1.0 percent. This allowed mortgage lenders to offer variable rate mortgages with initial interest rates as low as 2.5 or 3.0 percent and these low rates gave many families an inflated sense of their capacity to afford housing. This availability of cheap credit quickly became capitalized in housing prices and led to 10, 20, and 30 percent annual increases in home prices. With housing values doubling and tripling in some regions in the span of just a few years, a housing frenzy developed. Many Americans developed unrealistic expectations and assumed that housing prices could only go up.

This cycle of boom and bust in the real estate market is not unprecedented. I have experienced a few bubbles first hand. For instance, when I was a researcher at an academic research institute in Japan in 1989-90 during the peak of the Heisei Boom, I witnessed property prices in Tokyo and Osaka increase by 50 percent a year. The grounds of the Imperial Palace in Tokyo were said to be worth more than the entire state of California. You simply knew that such trends were neither sensible nor sustainable. Within 10 years property prices in Tokyo had fallen by more than 80 percent.

As we all now know, a similar mania gripped the U.S. over the past several years. By late 2005 and early 2006, housing prices here in the U.S. had risen to the point where virtually all conventional ratio tests that economists use to study such developments—like affordability measures and ratios of housing prices to median incomes—were similarly screaming "bubble." By the autumn of 2005, we at Keybridge Research were warning our financial sector clients that the U.S. housing sector was clearly in bubble territory and would soon be turning downward. We did not know exactly how sharply prices would fall, but we did warn our clients to expect "double digit" price declines. Other economists were putting out similar warnings.

A second key development was the emergence of a series of financial sector innovations that radically changed the mortgage business. Mortgage securitization—the bundling of pools of mortgages, their underwriting, and their sale to institutional investors—increased liquidity and spread risks with some benefits and some costs. Securitization gave potential borrowers access to whole new pools of savings that were not accessible before. This made mortgage money cheaper. International investors, such as German savings banks and Italian pension funds, lined up to buy the assets. New technology also brought a sharp reduction in the cost of originating mortgages. The growth of the internet and easier availability of information about potential borrowers encouraged mortgage brokers to rely more heavily upon convenient sources of information, such as credit scores, rather than more labor intensive methods. It also made searching for new borrowers easier and less costly, including through bulk email mortgage offerings.

On the downside, these innovations created what economists call an "agency problem." Since the mortgage originator was no longer going to hold the mortgage to maturity, but rather was going to immediately sell it to a securities firm and collect its fee up front, it did not have a strong incentive to perform due diligence on the loan. Lenders began loosening standards to remain competitive and increase market share. This development led to a relaxation of down payments and a proliferation of unconventional mortgages, including teaser rate, "no doc", and option payment mortgages that expanded access to the housing market to less qualified home buyers. Homebuyers were no longer required to have 20 percent "skin in the game" with their house – raising the initial loan to value ratio, a critical predictor of default risk.

Another major change was the increase in leverage by investment banks and other major financial institutions. Whereas a traditional bank might have a leverage ratio of 4, meaning that the value of its obligations was four times the value of its shareholders' equity, investment banks increased their leverage ratios to 30 or 35 in the past few years. Such high leverage ratios meant that there was much less of a cushion in hard times. Some of these firms had shareholder equity in the tens of billions of dollars, but total obligations of a trillion dollars or more. With only moderate losses, such a firm's shareholder equity could be reduced to zero and the firm would be forced into bankruptcy.

How Incentives Played Out

How did these ingredients mix? How did the incentives play out? The combination of easy credit, financial market innovations, and financial leveraging led to the massive housing bubble described above. This is evidenced by a nearly unprecedented shift in household wealth allocation—between 2000 and 2007 the share of household assets in real estate jumped by 8 percentage points. However, a system emerged in which most key actors in this story had strong incentives to keep doing what they were doing, even as the sector became more unbalanced. This was more by accident than by design.

- Existing homeowners saw the value of their homes increase. They felt wealthier, which encourages additional consumption. Financial innovation made it easier and easier to use their homes as ATM machines and extract wealth via home equity loans and cash out refinancing. According to research by former Fed Governor Alan Greenspan and James Kennedy, Americans were extracting hundreds of billions of dollars in home equity a year out of their homes during 2004-06 and using these funds to boost their consumption by about 4 percent a year beyond what they otherwise could afford from their incomes.

- New home buyers were lured in by the prospect that a home could not fail to appreciate. Given the easy availability of cheap credit, mortgage lenders encouraged home buyers to buy as much house as they could afford via low short-term interest rates. Some unscrupulous mortgage lenders encouraged buyers to buy more house than they truly could afford, knowing that no matter how things ended they would receive their fees up front. Even though some borrowers knew they could not afford their variable rate mortgage after the teaser rate ended, they proceeded with the transaction anyway. Assuming that the rapid appreciation in home prices would continue, these subprime borrowers reasoned that they could always sell their home before the interest rate reset and turn a healthy profit in the process."

- Investors and speculators were encouraged to jump into the housing market and make short-term profits by flipping houses. Historically, roughly 3 percent of all houses nationally are bought for investment purposes. During the 2004-06 period, as much as 25 to 35 percent of house in hot real estate markets – such as southern Florida, Las Vegas, and California – were bought by investors and speculators.

- Investment banks and companies that securitized mortgages used financial engineering to repackage pools of mortgages into securities of different credit ratings. A pool of mortgages that originally might have been rated BB+, for example, might have been converted into one piece that was rated AA, another piece rated AA-, and a third piece that was below investment grade (called "toxic waste" in industry terms). This toxic waste was often kept on the investment bank's books for future disposal. The firm was making enough money from the synthetic upgrading of some portions of the pool that the toxic waste was considered a cost worth incurring.

As long as home prices kept appreciating steadily and foreclosure rates remained low, all players in this system had a strong incentive to keep doing what they were doing. And there were strong benefits to the economy. There was booming construction of new homes and job growth, soaring consumer spending fueled by mortgage equity extraction, asset appreciation for the new home buyer, hefty mortgage origination fees for the mortgage broker, great business for rating agencies, and large securitization fees for the investment bank. Even speculators with an inability to make mortgage payments after the teaser loan period came out ahead because of the home price appreciation. The home price appreciation in their first 6-12 months would pay off the mortgage, cover real estate agent fees and transfer taxes, and still leave some money left over.

The Problem—What Happened When Housing Prices Stopped Rising and Started Falling

By early 2006, the U.S. housing market had simply reached a saturation point. After years of record home building by the U.S. construction industry, fueled by easy credit conditions, almost everyone who wanted a new home already had one. Competition among lenders intensified as qualified borrowers became more scarce – igniting a "race to the bottom" that was fueled by eroding lending standards for individuals that were not financially prepared for homeownership.

Meanwhile the booming economy started to raise inflation fears and the Federal Reserve had to begin to raise interest rates sharply. As interest rates increased, housing affordability declined – putting additional downward pressure on the housing market. In addition, adjustable rate mortgage issued in 2004 and 2005 were starting to reset, typically requiring monthly payments to increase by $300 or more per month. All these developments caused housing activity to retrench sharply and housing prices began to fall. Some borrowers, especially sub-prime borrowers, began to miss monthly mortgage payments. The value of sub-prime mortgage portfolios began to decline noticeably.

Why was this problem not simply contained in the sub-prime sector as many analysts at the time expected? First, the housing sector itself went into a normal housing recession, with housing starts on track to decline by half. With housing accounting for about 5 percent of U.S. GDP, this housing recession by itself was not sufficient to cause an outright economy-wide recession, but it did cause GDP growth to fall from about a 3 percent pace to about a 1.5 percent pace. This resulted in an initial tranche of rising unemployment and declining consumer confidence. Second, home price declines undermined the financial health of American households by more than many realized. By early 2008, more than 10 percent of all American households owed more on their mortgages than their houses were worth — that is, they were "under water". This hurt consumer confidence further and caused consumption spending to weaken. Auto sales and consumer durable purchases, for example, began to suffer. Third, default rates began to increase for both the Alt-A and prime mortgage markets — the market segments of higher quality mortgages — and caused growing concerns about all mortgage backed securities.

This series of events set the stage for the financial and liquidity crisis that we face today. The collapse of Lehman Brothers in September was effectively the "pinprick" that burst the bubble – an event common to all financial crises which signals severe weakness in the system, shakes market confidence, and set off a vicious circle of unwinding, deleveraging, and tightening credit conditions. Lehman was one of several firms with excessively high leverage ratios and heavy exposure to mortgage securities. Its financial position was more vulnerable than expected because as the widespread withdrawal of liquidity began to take hold and its limited capital base prevented it from covering its debt obligations – forcing it into bankruptcy. Contributing to the downfall was a lack of transparency due in part to weak regulation and overly complex financial instruments.

II. Likely Impacts on the U.S. Economy

The financial crisis comes at a time when the American economy was already highly vulnerable because of high energy prices, stagnant real incomes, and persistent job losses since the start of the year. As a result, there is a high probability that the financial crisis will help tip the economy into a formal recession. The unemployment rate is virtually certain to be higher than it otherwise would be because of the financial crisis. One key impact of the crisis will be on consumer spending. The natural correction to the 2004-06 phase when consumers were "over consuming" through equity extraction from their homes is a phase of "under consumption"—a period when households hunker down and restore their saving rate from the current near zero levels to the historically normal range of 5-7 percent. This correction was likely whether there was a financial crisis or not, but now it is likely to be more noticeable. A second key impact will be on consumer confidence. Worries about the value of one's life savings and even the security of one's money market account will likely have knock on effects on consumption. Third, the loss of financial wealth will have a negative impact on consumption. Economists typically find that for each dollar of lost financial wealth, consumption drops by 3-4 percent. This means, for example, that a sustained $100 billion loss in capitalization of the stock market would be expected to cut consumer spending by at least $3 billion in the first year after the decline. With consumer spending representing 70% of U.S. GDP, the net impact of these different factors could be severe.

The crisis is likely to have negative effects on business activity as well. Many small businesses are heavily dependent upon bank lending for commercial and industrial loans—to add to capacity, add workers, or upgrade equipment. Such lending is already being reduced as banks tighten credit standards. Larger businesses tend to source more funding in the credit markets and will almost certainly face tougher conditions as well. They also can be expected to delay hiring and postpone investment projects if the financial crisis reduces their ability to borrow. Finally the government sector, and especially the state and local government sector, is likely to be hurt. Many states, like California, raise funds in the credit markets to smooth out the lumpy timing of tax collections and may be forced to make layoffs if they cannot gain borrow on schedule.

III. Implications for Public Policy

Macro Policy

Monetary and fiscal policies have already been used heavily in 2007 and 2008 to try to provide a countercyclical boost to the economy, but further room exists for additional measures to mitigate the depth and duration of a possible recession. Bond yields on U.S. Treasuries need to be monitored carefully, however. There can be a point at which budget deficits are so large that they cause private investors to lose confidence in a country's fiscal management. A noticeable jump in government bond yields would indicate that a government's credibility is at risk, and at that point countercyclical fiscal policy could actually hurt more than it could help. The challenge for monetary policy is to ease credit conditions to encourage business investment and consumer spending for durable goods when the economy is in a recession, but then to move quickly to a neutral monetary policy—say a real federal funds rate in the range of 2 to 3 percent—as soon as the economy begins to generate positive job growth again. I believe that we will face tough economic times in coming months, but I remain optimistic about the resiliency of the U.S. economy and about its long-run growth prospects.

Regulation

Achieving the proper balance for regulation, of financial markets or anything else, requires a delicate touch. If we over-regulate our markets, we will discourage useful and productive investment. If we under-regulate our markets, we can end up with markets in which no investors will have confidence and productive investment and innovation will whither. In either case we will suffer significantly lower living standards over time. What we need to strive for is smart regulation—regulation that adapts to changing technology and changing circumstances. In some ways it appears that the pace of financial regulation fell behind the pace of financial innovation in recent years. We need regulators to fully understand the risks that financial institutions face.

There were two key failures of regulation in the recent financial meltdown. First, regulators allowed financial firms to employ levels of leverage that were simply too high and they did not force the firms to consider logical systemic risks. As long as times are good, the economy is growing, and financial asset prices are stable, high leverage ratios allow high profits to be earned. Financial institutions, however, will always be faced with less than perfect conditions in any 5-7 year window. Either there will be a recession or a bout of unanticipated inflation or a collapse of commodity prices or a stock market contraction. Leverage ratios have to be restrained so that a firm can earn fair profit in the good times while ensuring that it can survive the bad times. And firms should be pressed to stress test their portfolios on realistic risks, including not just mean reversion assumptions, but with assumptions of overshooting on the downside of a correction.

The second key failure was that regulators lost their way on the path to transparency. Transparency requires that knowledgeable market participants, investors, and regulators fully understand what obligations and benefits a particular financial asset represents. However, financial instruments that the investment banks created were often so complex that they could not be fully understood by regulators and firm managers alike. Sometimes mortgage assets were sliced and diced—packaged and repackaged—4 or 5 times based upon complex statistical rules and obtuse valuation formulas. Regulators need to insist that all instruments offered for sale to the public be able to be understood and logical to knowledgeable professionals.

One of the key lessons from the Japanese credit meltdown in the 1990s is that delays in disposing of bad assets can cripple an economy for a long time—for roughly a decade in the case of Japan. There is a clear tension between this lesson and natural worries that tough "mark to market" rules for financial instruments could exacerbate the problem and compound the damage from the unwinding process. Any change in position to relax mark to market rules must be approached cautiously. In normal times these rules provide for logical accounting of an instrument's value. However, in a cataclysmic economic or financial downturn, it is very possible for these rules to give a pro-cyclical bias to public policy. That is, forcing a synthetic calculation of an asset's value in a non-functioning market may cause a valuation to be artificial and may compound the damage. If there were to be a modification of rules, it would be logical to do this on a temporary basis as a test with a through review.

Derivatives

There has been a lot of debate about the ability of financial derivatives to spread risk among many players, both within the U.S. market and also globally. Former Federal Reserve Chairman Alan Greenspan and others have frequently stated that these instruments make our financial markets better able to handle risk and therefore safer. I would agree that these tools can help to offload idiosyncratic risk. For example, if one automobile company were to default on its bonds, credit default swaps could help to ensure that pension plans that held those bonds could have effective insurance and that the retirees supported by those plans could be protected from losses. Even in moderate downturns, such as the 2001-02 recession, the supply of credit to the economy remained unhampered and arguably helped to make that recession unusually mild. In fact, the experiences with derivatives during the recession of

2001-02 may have given investors and regulators a false sense of security and encouraged riskier behavior later.

I think the lesson of the past months, however, is that the massive use of financial derivatives has increased systemic risks in more severe episodes—in, for example, a global financial meltdown as we now appear to be experiencing. That is, up to a certain stress point, interlinked financial instruments can lead to improved risk-return outcomes. The stress point comes when multiple well-regarded financial institutions suffer losses of confidence and fail. In truly exceptional times and with truly large scale risks interlinked financial instruments can actually increase risks. Financial regulators need to wrestle with this issue and try to identify appropriate regulatory standards. In the face of uncertainty, it appears that less leverage and proportionally higher capital bases is one way to reduce systemic risks in the future.

IV. Concluding Observations

The current financial meltdown resulted primarily from two factors: 1) excess liquidity in credit markets in the first half of this decade and 2) excessive leveraging among large investment banks and other financial institutions. When housing activity that was clearly unsustainable declined as credit conditions were tightened, some important financial firms, like Lehman Brothers, found that they did not have enough capital to absorb decreases in the value of their obligations. Both public policymakers who regulated the credit markets and private-sector executives who made aggressive risk-return decisions share responsibility for the current financial crisis.

Anytime the price of a major asset class or commodity increases by 200 or 300 percent in a matter of just a few years—whether it is home prices, timber, Dutch tulips, oil, gold, or technology stocks—prudent regulators and private executives who want to maximize their shareholders' value over the long term need to ask whether the system they regulate or their business model could tolerate a rapid return of that price to its historical trading range. Activities that could not withstand such a "reversion to mean" test are prime candidates for modification or a review of the regulatory environment.

That said, the creation of wealth in capitalist societies has never been simply incremental and steady. Sometimes the massing of capital for certain activities leads to technological breakthroughs or Schumpeterian progress that can be worth the temporary cost of unwinding the "over investment." One could argue, for example, that despite the losses suffered during the "dot.com" bubble in the year 2000, the information revolution that it brought about is contributing in important ways to the quality of life and has improved American living standards in important ways.

Chairman WAXMAN. Ms. Minow.

STATEMENT OF NELL MINOW

Ms. MINOW. Thank you very much, Mr. Chairman and Members. It is an honor to participate in this hearing. I appreciate it very much. And I would give anything if what I wasn't here to say was, "I told you so."

I have testified before this committee before, and what I said then was that there is no more reliable indicator of investment—litigation and liability risk than excessive CEO compensation. CEO compensation is not just the symptom, it is actually a cause. It pours gasoline on the fire.

With that in mind, I'd like to tell you what our ratings have been. My company, the Corporate Library, rates boards of directors, and in part we look at decisions they make, like CEO pay. We have given this company a C or a D since we started rating them, with one very brief exception of a couple of months where we gave them a B.

Here is a quote from our analyst's note on the company: Although the CEO's 2007 salary is well below the median for companies of similar size, his nonequity incentive compensation of $4,250,000 exceeded the 85th percentile. While typical target bonus is two times base salary, Mr. Fuld's was more than five times his base salary. Additionally, his total annual compensation of $71,924,178 ranks in the top 3 percent for similarly sized companies.

As I've mentioned before, this is the problem. When we pay people based on the volume of business rather than the quality of business, eventually it is like a game of musical chairs. And when the music stops, the people that don't have a place to sit are the investors.

Pay that is out of alignment is one of the causes of poor performance, but it is also an important symptom of an ineffective board. Let's talk about this board for just a minute. They had a finance and risk management committee. I think that my economist colleagues here would agree, and my investor colleague, that the—in a company like this, the finance and risk management committee is a very important committee, and yet it only met twice in 2007 and twice in 2006. The crystal-clear explanations of Dr. Zingales and Dr. Wescott were—as brilliant as they are, were not unknown at the time. These were things that the risk committee should have been looking at.

An additional indicator is the meaningful stock ownership by the board. It is a public statement of their confidence in a company and a powerful reminder and motivator for them as they deliberate issues like executive compensation and risk management. With the exception of the CEO who sold the significant percentage of his stock, and the lead director, and the 23-year veteran on the committee, given their tenure, these directors did not put their money where their mouths were.

I'm really horrified by the effort by Mr. Fuld and other executives in these failing companies to absolve themselves of blame. It infuriates me when they talk about how efficient the markets are except when they are not efficient. All of a sudden, it is not their fault anymore. These are people who fight for deregulation, and now they're blaming the regulators.

They talk about a litany of destabilizing factors. Let me tell you that the most important destabilizing factor was: an inefficient and ineffective board of directors and bad judgment by the executives. People make mistakes, but what we like to see is people accepting responsibility and participating in mitigating damages and preventing the recurrence. It is indispensable for the credibility of our capital markets to align the interests of executives with the investors, and we'll have an enormously increased cost of capital if we do not make that clear throughout the world.

What we had was an executive compensation system that created an incentive for imagining derivative securities that exploited regulatory and accounting loopholes. I had a presentation at the Public Company Accounting Oversight Board where they told us that Paul Volker said he didn't understand these derivatives. I hereby propose the Paul Volker rule, that if he doesn't understand it, we shouldn't put it out on the markets. Even if executives are overwhelmed by forces beyond their control, I believe you've heard this expression before, that is why we pay them the big bucks.

Thank you.

Chairman WAXMAN. Thank you. No demonstrations. Thank you, Ms. Minow.

[The prepared statement of Ms. Minow follows:]

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
Hearing on the Bankruptcy of Lehman Brothers
October 6, 2008

Testimony from Nell Minow
Editor, The Corporate Library

Mr. Chairman and members of the committee, I thank you very much for inviting me to participate in this hearing. I appreciate your exploration of this very important topic as both example and symptom of the greater instability in the financial services sector and our capital markets.

But I'd give almost anything not to say "We told you so."

The Corporate Library is an independent research firm specializing in corporate governance. Our clients include director and officer liability insurers, executive search firms, law firms, investors, consultants, and scholars. And one of our most popular products is our rating of board effectiveness. We rate boards like bonds – A through F. And unique in this field, our ratings are not based on structural indicators like "independence," director training, or whether the governance principles are posted on the company's website but on the decisions made by the board. As we used to say when I was at EPA and OMB, The Corporate Library relies on performance standards rather than design standards. If the board handles certain crucial defining issues well, they are an effective board. If not, it really does not matter how many directors attended training classes. You can lead a director to a classroom, but you can't make him think. Of course "independence" is important. But you can tell far more about the independence of a director from the board's approval of a good compensation plan (or a poor one) than from what we call "resume independence," the kinds of employment-related disclosures required by the SEC.

With that in mind, I would like to go over the ratings our firm has given the Lehman board since we first began issuing letter grades in 2002:

March, 2002 – Coverage initiated, initial overall D rating assigned
June, 2003 – Rating upgraded to overall B
October, 2003 – Rating downgraded to overall C
June, 2004 – Rating downgraded to overall D
September, 2008 – Rating downgraded to overall F

Here is an excerpt from one of our analyst notes on the company:

> Although [CEO Richard Fuld's] 2007 salary of $750,000 is well below the median for companies of similar size, his non-equity incentive

> compensation of $4,250,000 exceeded the 85th percentile. While typical target bonus is two times base salary, Mr. Fuld's was more than five times his base salary. Additionally, his total annual compensation of $71,924,178 ranks in top 3% for similarly-sized companies. This figure includes $40,278,400 from value realized on the exercise of options and $26,470,870 from value realized on vesting of shares. This raises serious concerns over the alignment of compensation practices with shareholder interests.

And here is a summary of his compensation over the past five years:

5-year compensation - Fuld		
Base Salary	$	3,750,000
Annual Bonus	$	41,150,000
Equity Value Realized	$	225,068,018
All Other Compensation	$	391,012
5-year total	**$**	**269,968,018**

As I have mentioned in previous testimony before this committee, there is no more reliable indicator of litigation, liability, and investment risk than pay that is not linked to performance. I think it is fair to say by any standard of measurement that this pay plan is as uncorrelated to performance as it is possible to be.

Pay that is out of alignment is one of the causes of poor performance but it is also an important symptom – of an ineffective board.

We have looked at bad boards for several years and we often see patterns other than poorly designed pay packages that recur in the boards later proved to be the most dysfunctional. A number of those patterns are present in the Lehman board. They include inadequate expertise and too-long tenure.

While some of the individual director backgrounds at Lehman reflect more experience in banking and financial services than some of the other recent failed firms, overall it did not have the depth of experience it needed. Notes Dennis K. Berman of the Wall Street Journal:

> Nine of them are retired. Four of them are over 75 years old. One is a theater producer, another a former Navy admiral. Only two have direct experience in the financial-services industry.... Until the 2008 arrival of former US Bancorp chief Jerry Grundhofer, the group was lacking in current financial-knowledge firepower. A number of the members did have past financial-markets expertise, but most of their working lives were tied to a different era: The one before massive securitization, credit-default swaps, derivatives trading, and all the risks those products created.

Until recently, one director was actress Dina Merrill, daughter of E.F. Hutton. She retired in 2006 at age 83 after 18 years of service. At the time of her retirement Ms. Merrill was a member of Lehman's Nominating & Corporate Governance and Compensation & Benefits Committees.

Currently serving on the board is Broadway producer Roger Berlind, 76, the longest tenured member of the Lehman board, his only public company directorship. While we do not recommend over-boarding, it is usually not a good idea to have people on boards who have no other board or sector experience. Mr. Berlind is a member of Lehman's Audit and Finance & Risk Management Committees. Also on the board is Marsha Johnson Evans, 60, a former Rear Admiral with the US Navy and head of the American Red Cross and Girl Scouts of the USA. Ms. Evans is a member of Lehman's Nominating and Corporate Governance, Compensation & Benefits, and Finance & Risk Management Committees. She is also an active director of three other large US corporations: Weight Watchers International, Office Depot, and Huntsman Corporation; she is a former director of AutoZone. Michael Ainslie, who has been on the board for 12 years, is the former Chief Executive Officer Sotheby's and former President and CEO of the National Trust for Historic Preservation.

With regard to tenure, which can impair independence of judgment, this is a board with very little turnover. Roger Berlind has been on the board for 23 years and six other directors have served for over a decade.

Another point worth noting is that Lehman's Finance & Risk Management Committee, which is chaired by 80 year old director Henry Kaufman, only met twice in 2007, and twice in 2006. Kaufman has served on the Lehman board for 14 years; he was also a member of the Freddie Mac board, from which he retired in 2004 after 13 years of service. A company in this sector should have a risk management committee that is vitally involved and has a great depth of expertise. A company that had $7 billion in losses after becoming embroiled in the global credit crisis had a risk management committee that did not understand or manage its risk.

An additional indicator is meaningful stock ownership by the board. It is a public statement of their confidence in the company and it is a powerful reminder and motivator for them as they deliberate issues like executive compensation and risk management. With the exception of the CEO (who sold a significant percentage of his stock for as much as $500 million), lead director John Macomber, and 23-year veteran Roger Berlind, given their tenure these directors did not put their money where their mouths were.

And another indicator is "related party transactions" that can impair the independence of the board. While Lehman prohibited the participation of the board members in special in-house investment opportunities after 2002, the grandfathered deals continued to pay out to participating directors, as disclosed in the company's proxy:

> The distributions shown exclude the return of the limited partners' respective capital contributions, which amounts were $96,340 for Mr. Berlind, $81,520 for Mr. Freidheim, $397,250 for Mr. Fuld, $389,400 for Mr. Gregory, $75,000 for Dr. Kaufman, $86,143 for Mr. Lowitt, $125,674 for Mr. O'Meara, $409,737 for Mr. Russo, $78,140 for the adult children of Mr. Akers and $136,580 for the adult children of Mr. Macomber. Aggregate Fiscal 2007 distributions, including the return of the limited partners' respective capital contributions, was less than $120,000 for all of the other limited partners listed above.
>
> The largest outstanding balance during Fiscal 2007 of the aggregate preferred capital contributions made by the general partner of these investment partnerships as a result of investments made by such limited partners was $285,802 for Mr. Fuld, $190,535 for Mr. Gregory, and less than $120,000 for each of the other limited partners listed above. The largest outstanding balance during Fiscal 2007 of the aggregate preferred capital contributions made by the general partner that was with recourse to the limited partners was less than $120,000 for each of the limited partners listed above.

As I said earlier, we judge boards on results. But once we have judged them, we can make an educated guess about what led to those results. In this case, the board was too old, had served too long, was too out of touch with massive changes in the industry, had too little of their own net worth at risk, and was too compromised for rigorous independent oversight. There is a lot of blame to go around in a failure like this one. But at the head of the list the blame falls on:

Roger S. Berlind

Michael L. Ainslie

John F. Akers

Richard S. Fuld Jr.

Thomas H. Cruikshank

Henry Kaufman

John D. Macomber

Sir Christopher C. Gent

Marsha Johnson Evans

Roland A. Hernandez

Jerry A. Grundhofer

Paul G. Parker

Dina Merrill

How can this be prevented?

Sarbanes-Oxley did not create this problem but it did not prevent it, either. Corporate governance is a matter of state law, so the governance-related reforms of the post-Enron era focused mostly on disclosure. For example, under Sarbanes-Oxley boards are not required to have a financial expert, but they must disclose whether they have one.

There will always be bad decisions. But we can do a better job of stopping them before they get out of hand. Clearly, from the case of Lehman and the other failing financial services firms, we must have clawbacks for the return of bonuses paid based on financial reports that are later corrected. That is a matter of fundamental fairness and economic necessity. And that is something that can be addressed by Congress.

Furthermore, we must remove obstacles that currently prevent shareholders from exercising the independent oversight and providing the market response that is an essential element of economic sustainability. The House has already passed the "say on pay" legislation with an overwhelming majority and we hope it will move forward. Shareholders should be able to remove conflicted, over-boarded, or just plain ineffective directors by voting against them. Institutional investors, including pension funds, should have to disclose their votes so that their customers, the beneficial holders of the securities, can see who is voting to enable dysfunctional board behavior.

Shareholders want executives to earn a lot of money. They just don't want them to get paid a lot of money without earning it. Addressing the issue of board effectiveness in linking pay to performance and managing risk is a key element of restoring the credibility of our capital markets.

Thank you very much and I look forward to your questions.

Chairman WAXMAN. Mr. Smith.

STATEMENT OF GREGORY W. SMITH

Mr. SMITH. Thank you, Mr. Chairman. Thank you, Members, for having me here today to express the perceptions and perspective of a major institutional investor. One of the things that I want to address—you certainly heard some good diagnosis and comments from people much more qualified than I to assess why this has happened. I'd like to put a little bit of a face to this.

We hear a lot in the media about the savior of Wall Street, and we hear a lot about major institutions and—throughout the country, Wall Street being saved. We think this is about every working American in the United States. It is about people that I work for every day. I work for a pension fund that represents 420,000 current and former public employees, public servants in the State of Colorado. We represent every State trooper, every teacher in the State of Colorado, every State employee, every judge and over 400 employers, including all of our local divisions of government. These—the individuals are the ones that are being impacted in this crisis. It is the individuals who are having to face the questions of whether their college fund for their children is going to still be around when this is over. It is these individuals who are wondering how long is it until retirement now, how long do I have to go before I can recover from what Wall Street has done to me this time.

And what it really has boiled down to is a complete collapse in investor confidence. And it is a complete collapse in investor confidence because they no longer believe in management, they no longer believe in the numbers, and they no longer believe in the regulatory framework for good reason.

We don't claim to know, I certainly don't claim to be able to articulate, why this happened, and I certainly would not predict what the result of the blame game is going to be. There is certainly going to be one, and the lawyers are going to spend a lot of time on it. What we would like to urge you to consider is what the future needs to hold to regain confidence, and what it needs to consist of is an opportunity for shareholders to be heard in a meaningful way at a meaningful time in the process of running corporate America. We need access to the proxy. We need to be able to hold the directors accountable. If they're not doing a good job, we need to be able to get them out of the boardroom and get somebody else in that will represent shareholders.

We need a regulatory framework that is aligned with the shareholder, not with corporate America, but with the shareholders, and a regulatory framework that is prepared to hold people accountable that breach their duty to the shareholder.

That's where we need to go. We need to have say on pay, and we need to be able to regain confidence that this market is about the shareholder, it is about mom and pop, it is about small businesses, and it is about the individuals that I represent all over this country.

One of the things that doesn't get talked about very much and that is really impacting the people that I work with is the credit crisis and the freezing of their accounts. People who have been the most conservative investors and who have thought, well, I don't want to get involved in these speculative things, I'm going to put my money in a money market, I'm going to fall behind inflation, I don't really worry about inflation, I want to make sure I have my money, those people don't have their money now.

We manage our cash through those types of accounts. There were times last week and 2 weeks ago that our money was on the brink of being frozen. People in this country are not going to be able to make payroll. Small businesses are not going to make payroll because they are not going to be able to access their cash.

These are the problems that we believe are yet to come. Some of them you've begun to see. But there is many more to come, and it is the working people of America that are suffering this crisis. It is not about Wall Street, it is about investor confidence, And that is what needs to be restored.

Thank you.

Chairman WAXMAN. Thank you very much, Mr. Smith.

[The prepared statement of Mr. Smith follows:]

COLORADO PERA®

Colorado Public Employees' Retirement Association
Mailing Address: PO Box 5800, Denver, CO 80217-5800
Office Locations: 1300 Logan Street, Denver
1120 W. 122nd Avenue, Westminster
303-832-9550 • 1-800-759-PERA (7372)
www.copera.org

October 6, 2008

Testimony of

Gregory W. Smith, General Counsel
Colorado Public Employees' Retirement Association

Before the
United States House of Representatives
Committee on Oversight and Government Reform
Causes and Effects of the Lehman Brothers Bankruptcy

Chairman Waxman and Members of the Committee on Oversight and Government Reform:

Thank you for the opportunity to address the Committee regarding the failure of Lehman Brothers. As an entity responsible for the retirement security of over 420,000 public servants we believe it is important at the outset to recognize that the impact of the failure of Lehman extends far beyond the fat cats on Wall Street. In light of the melt down of our capital markets in recent weeks we can safely conclude that the crisis has arrived on every main street in America. Every man or woman with a 401(k), an IRA or a retirement plan of any kind is feeling the effects of the collapse and is facing life changing adjustments to his or her financial planning.

We at the Colorado Public Employees' Retirement Association (CoPERA) are entrusted as fiduciaries with investing retirement assets of every state employee, Judge, State Trooper, K through 12 teacher (except those in Denver), and many employees of local units of government. Each and every month we are responsible for putting to work more than $125 million of contributions from our membership in a diversified portfolio. In the past year CoPERA has paid benefits of over $2.5 billion to over 80,000 retired public servants helping to fuel the economy of communities throughout Colorado. Our asset base as of our most recent audited financial statements was $43 billion.

In order to meet the needs of our membership we, like our peers that exist in virtually every state in the nation, are entirely dependent on the strength, efficiency, and transparency of our capital markets. What has become apparent in recent weeks is that the strength of our markets is ultimately entirely dependent upon the confidence of investors. Confidence that the environment in which they are considering investing is an environment that promotes investor rights and policies which further the interests of investors. Confidence that violations are the subject of enforcement actions and perpetrators are held accountable. Confidence that the financial statements presented to investors by management are compliant with accounting standards that are designed to reflect all the information relevant to financial analysis. Confidence that a rigorous audit process has verified management's representations and the adequacy of internal controls in the company to prevent fraud. In each of these critical areas of investor confidence we have experienced significant deterioration in recent years and remain at significant risk for further erosion.

We do not presume to know or be able to articulate what it will take to restore investor confidence in the markets so as to allow the current seizure of the markets to be alleviated. Nor do we profess to know the ultimate outcome of what will undoubtedly be an extensive effort to allocate blame and responsibility for the recent events including Lehman's collapse. We do believe we can provide a perspective on what resources are essential to long-term confidence and what tools are essential for investors going forward.

At the outset there must be a regulatory environment that is realigned with the interests of investors rather than the recent alignment with corporate management . Transformation of the regulatory environment requires sustained funding of the applicable regulatory bodies in a manner that does not breed conflicts or promote policies adverse to investors. Sustained investor confidence requires a regulatory framework that allows investors an opportunity to be heard in a meaningful and timely way through access to the corporate proxy by investors, through say on pay for investors regarding executive compensation, and through an unwavering commitment to pursue corporations and individual executives who disregard the duty owed to the shareholders. We respectfully refer the Committee to a compilation of articles which provide a valuable overview of the SEC's recent funding history and enforcement activities. *See* Appendix A.

Long term investor confidence would be promoted by restoring the quality of the disclosure and transparency standards historically imposed on companies that want to access the U. S. markets. The standards for accounting must not permit off balance sheet liabilities to go undisclosed, must require that valuations be based on market values of assets and must accurately reflect the operations and current financial condition of the reporting entity. The offloading of bad debt and obfuscation of leverage through the use of off balance sheet entities has devastated investor confidence. The reliability of the numbers reported by management and the perception by investors of transparency in the financial reporting by corporate America has disappeared. The shift from U.S. Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS) presently under consideration by the SEC is premature and should only occur in the event the International Standards are developed further. The current void of investor confidence would likely not be aided by a shift to unfamiliar standards that alter the nature and extent of disclosures required of companies, the thresholds of materiality and are silent on a broad array of issues addressed by GAAP. The Council of Institutional Investors (CII), a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion, has conducted extensive analysis of the convergence of accounting standards issue. We respectfully ask the Committee to consider the attached Appendix B response by CII to a recent Concept Release on the issue by the SEC and a white paper prepared at the request of CII by Professor Donna L. Street, Mahrt Chair in Accounting, University of Dayton.

The recent suggestions that mark to market or fair value accounting should be abandoned would merely provide a short term disguise for the problem and ultimately undermine market strength. The demise of fair market valuation of assets would render the balance sheets and financial reporting of affected companies essentially meaningless to any investor attempting to make a rational and informed decision regarding investing in the company. We respectfully refer for the Committees consideration a white paper titled "Fair Value Accounting: Understanding The Issues Raised by the Credit Crunch", prepared for CII by Stephen G. Ryan, Professor of Accounting and Peat Marwick Faculty Fellow, Stern School of Business, New York University. *See* Appendix C.

Finally, the most fundamental tool used in the investment process is the independently verified financial statements of a company. The accuracy and thoroughness of the financial disclosures are the critical foundation for sound financial analysis. As fiduciaries, our reliance upon audited financial statements has long been recognized as reasonable and appropriate. This reliability has been based on the fact that a qualified and independent auditor has reviewed the internal operations of the company, assessed its internal controls, as well as the systems within the organization, and conducted random statistically appropriate samplings to verify the accuracy of the accounts presented by management. Based on the examination, the auditor or audit firm has certified the accuracy of the disclosures and attested to the appropriateness of the internal controls and operations. Further, if the auditor's certification proves inaccurate or defective, they have traditionally been accountable through both regulatory sanctions and civil liability.

The importance of our ability to rely upon audited financials in our investment decision making cannot be overstated. However, the very features which have allowed us to rely upon the auditors' verification and certification have been under vigorous attack by the auditors themselves for several years. The result has been Congressional limits on accountability and judicial decisions severely limiting investor recourse against audit firms. Recently an active effort has been under way to attain even greater protections by audit firms. The audit function is a critical element in the reliability of managements' representations and thus the investors' perception of transparency. The practice standards for public company auditors and their accountability for breach of those standards must be strengthened and clearly established.

Viewed in their totality, these developments are a call to action for Congress to restore the U.S. market framework in a manner that attracts investment capital and promotes investor confidence. A return to genuine transparency within a regulatory environment where investors set priorities and have a voice that is heard and acted upon.

Thank you for the opportunity to convey our perspective during these critical times.

Respectfully submitted by
Gregory W. Smith, General Counsel
Colorado Public Employees' Retirement Association

APPENDIX A

The U.S. Securities and Exchange Commission's inability to avert the collapse of Bear Stearns Cos. may be traced to funding levels at the agency that haven't kept pace with the complexity of Wall Street's biggest companies.

May 7 (Bloomberg)

By: Jesse Westbrook

To contact the reporter on this story: Jesse Westbrook in Washington at jwestbrook1@bloomberg.net. *Last Updated: May 7, 2008 19:06 EDT*

SEC spending, which rose in response to frauds at Enron Corp. and WorldCom Inc., decreased by 1.3 percent to $875.5 million in fiscal 2007 from fiscal 2005, according to agency budget requests. The regulator also lost 386 full-time employees in the two-year period, a 10 percent drop, while headcounts at investment banks such as Bear Stearns, Merrill Lynch & Co. and Lehman Brothers Holdings Inc. increased at least 10 percent.

Revenue at the five largest U.S. securities firms climbed 74 percent from 2001 to 2006, and more than 30 percent of their earnings may have been derived from structured credit, which includes bonds backed by mortgages, according to estimates by Charles Peabody, an analyst at Portales Partners LLC in New York.

``I've been concerned for some time that flat budgets would create gaps in the SEC's oversight and enforcement efforts," said Harvey Goldschmid, a former SEC commissioner who left the agency in 2005 and is now a professor at Columbia Law School in New York. ``That may have been responsible for the failure to identify some of the problems at Bear Stearns."

The SEC's supervision of securities firms and the adequacy of its resources for monitoring them drew scrutiny today from the U.S. Senate at two hearings.

Fed Lending

Congress is examining the SEC's role in the wake of the Federal Reserve's rescue of New York-based Bear Stearns in March, after customers and lenders abandoned the fifth-biggest U.S. securities firm over concern that it faced a cash shortage. The crisis prompted the Fed to begin lending to investment banks for the first time since the Great Depression.

The Bush administration requested $913 million for the SEC for the 12 months starting Oct. 1, an increase of less than 1 percent from fiscal 2008. SEC Chairman Christopher Cox, testifying before a Senate subcommittee today, said the budget will allow the agency to regulate ``aggressively."

Erik Sirri, who heads the SEC division of trading and markets, told lawmakers today that the agency wants to ``step up" its capital and liquidity requirements for investment banks.

The SEC also plans to increase the number of agency staff members who monitor risk at securities firms to 40 from 25, Sirri said in testimony before the Senate subcommittee on securities, insurance and investment.

One-Year Target

As the investment banking industry's main regulator, the SEC tries to ensure firms have enough funds to meet expected obligations for at least a year during periods of market stress.

That test failed to account for the ``unprecedented" situation at Bear Stearns, which couldn't secure loans even when it offered ``high-quality collateral," Cox said in April 3 testimony before the Senate Banking Committee. The SEC is reevaluating its approach, he said.

Cox said the SEC's oversight of Bear Stearns succeeded in accomplishing its intended purpose, which is ensuring that the firm's brokerage clients didn't lose any money.

Ten Democratic senators, including Senate Banking Committee Chairman Christopher Dodd and Rhode Island's Jack Reed, said the SEC should receive $963 million in fiscal 2009, $50 million more than Bush has requested.

`Robust Funding'

``The SEC needs robust funding to replace gaping holes in the regulation of our capital markets," the lawmakers said in a letter dated today to Senator Richard Durbin, the Illinois Democrat who heads the appropriations subcommittee that oversees SEC funding.

The agency would ``welcome congressional consideration of dedicated funding for the SEC's oversight of investment banks," SEC spokesman John Nester said.

SEC staffing levels peaked in 2005 at 3,851 full-time employees, including 1,232 in its enforcement division, which investigates fraud. The agency had 3,465 full-time employees in the fiscal year ended last September and staffing in the enforcement unit dropped to 1,111.

``Staffing levels haven't kept pace with the urgent work needing to be done," Arthur Levitt, a former chairman of the SEC, said today in a Bloomberg Television interview. ``We need more people in enforcement and more people at the commission. Those budget cuts have got to be restored." Levitt is a board member of Bloomberg LP, the parent of Bloomberg News.

Unspent Funds

Under Cox, who became chairman in August 2005, the SEC has left money on the table. The 2007 budget included $14 million in ``available balances from prior years," according to the SEC's 2009 funding request. The $906 million Congress granted the SEC in 2008 includes $63.3 million unspent from earlier years.

``This is akin to the fire department laying off people as the house burns down," said Lynn Turner, a former SEC chief accountant.

Nester said more than 90 percent of the money carried over to the 2008 budget from earlier years can't be used for staff salaries. Most of the $63.3 million represents funding intended for contract work such as technology upgrades, he said.

Cox said in April 16 testimony before the House Appropriations Subcommittee on Financial Services and General Government that the SEC is in ``very good shape" to recruit and retain employees. He said the staff turnover rate is 25 percent lower than in the 1990s.

Congress, in approving the 2002 Sarbanes-Oxley Act, almost doubled the SEC budget after its resources were deemed inadequate to prevent accounting scandals at Enron and WorldCom. The law enabled the SEC to employ more accountants, enforcement lawyers and examiners.

SEC Enforcement Cases Decline 9%Staff Reduced Because of Budget Crunch

By Carrie Johnson
Washington Post Staff Writer
Friday, November 3, 2006; Page D03

The number of new enforcement cases brought by the Securities and Exchange Commission fell by 9 percent last year as the agency grappled with staffing cuts brought on by a recent budget crunch, according to figures released yesterday.

SEC Chairman Christopher Cox said in a statement that the agency's work in the fiscal year ended Sept. 30 had produced "solid results for investors," including settlements of $800 million with insurance firm American International Group Inc. and $400 million with District mortgage giant Fannie Mae.

The agency's reduced tally of 574 enforcement actions included 91 cases against shell companies that failed to file regular financial reports. That issue has become an SEC priority of late, but pursuing those cases takes less time and fewer resources than most other actions. Former agency lawyers said such cases amount to going after low-hanging fruit.

Cox attributed the decline to temporarily reduced staff levels. The SEC as a whole lost 155 employees last year -- including 43 in the enforcement unit -- compared with fiscal 2005. A total of 3,696 people worked at the agency in 2006, with 1,189 in the enforcement division. The agency is reviewing its staffing levels and plans to restore some of the unfilled positions, officials said.

In recent years, the SEC has faced criticism for failing to uncover widespread accounting fraud at such companies as Enron Corp. and WorldCom Inc. as well as trading abuses at mutual funds. Those scandals prompted Congress to pour hundreds of millions of dollars into the agency's coffers.

But more recent financial difficulties, including construction overruns on its new headquarters near Union Station, led to a budget shortfall last year and a hiring freeze that only recently has been lifted, officials said.

Law professors and former agency officials who follow the SEC's work said they are closely watching the agency's budget, which held relatively steady at $888 million last year. They said they are hoping it does not suffer further cuts and would prefer to see it grow modestly to accommodate merit raises for current staff members.

Cox told the Senate Banking Committee last summer that the agency did not need more resources to handle the 130 stock option backdating cases it is investigating, a stance that some analysts have questioned.

"Given the budget cutbacks in the number of people in the SEC's enforcement arm, and the ongoing corporate scandals, all investors should be worried," said Lynn E. Turner, a former chief accountant at the agency who is now director of research at the proxy advisory firm Glass, Lewis & Co. "It will put much of the enforcement burden on the shoulders of investors, just as existed before Enron was exposed, contributing to investors losing tens of billions of dollars."

Duke University law professor James D. Cox, who is no relation to the SEC leader, said: "You get what you pay for. It's been clear in the history of the SEC that as the budget goes, so goes enforcement."

Starving the agency throughout the 1990s meant that SEC officials did not have enough people to review the financial reports of the nation's largest companies every three years, an issue that came to light only after Enron collapsed into bankruptcy in December 2001 and investors learned that its books had not been examined by regulators.

Joel Seligman, author of a history of the SEC and the president of the University of Rochester, said he is not surprised that the enforcement figures have leveled off given the burst of activity following accounting frauds and mutual fund trading scandals in the past few years.

"I do not have the sense that the SEC is pulling its punches," Seligman said.

SEC Inquiries Stemming From Subprime Crisis Surge (Update1)

June 26 (Bloomberg)
The U.S. Securities and Exchange Commission's docket of probes stemming from the subprime- mortgage crisis has grown at least 40 percent since January amid mounting investor losses and the collapse of Bear Stearns Cos., a person familiar with the agency's caseload said.
By David Scheer
To contact the reporter on this story: David Scheer in New York at dscheer@bloomberg.net.
Last Updated: June 26, 2008 12:58 EDT

The SEC has more than 50 open inquiries relating to the credit-market turmoil, compared with about three dozen in January, the person said, declining to be identified because the cases aren't public. SEC lawyers are examining suspected fraud, market manipulation and breaches of fiduciary duty.

Global credit markets froze last year amid rising defaults on mortgages to the least creditworthy borrowers, triggering almost $400 billion in losses and writedowns at the world's biggest banks and securities firms. Still, the surging caseload may not lead to a wave of civil and criminal charges, as many inquiries are in early stages and hinge on accounting questions.

``The government is doing what it ought to be doing, which is looking," said David Becker, a former SEC general counsel now in private practice at Cleary Gottlieb Steen & Hamilton LLP in Washington. While the losses are severe, ``what we don't know is whether there is any fraud that took place."

Bear Stearns

Last week, the SEC teamed up with the U.S. Attorney's Office in Brooklyn to file the first federal charges over Wall Street's handling of the subprime crisis, hauling former Bear Stearns hedge-fund managers Ralph Cioffi and Matthew Tannin to court in handcuffs. They face criminal allegations they misled clients about pending losses and redemptions before two funds collapsed under bad bets on mortgage-backed securities. They are free on bond and deny wrongdoing.

SEC spokesman John Nester declined to comment on the agency's caseload.

Other hedge funds may also face scrutiny. Routine SEC inspections during the subprime crisis have uncovered cases in which investment advisers, including hedge funds, didn't live up to pledges to implement risk controls, a person familiar with the findings said. Lapses include failures to vigilantly track asset values, cap leverage and avoid concentrating bets.

``We've had some very serious matters" surface during routine checks, Thomas Biolsi, an associate director for the SEC's Office of Compliance Inspections and Examinations, told a legal conference on June 4, declining to elaborate afterward. ``We've had some hedge-fund investors complain to us."

SEC Chairman Christopher Cox last year started an agency- wide task force to deal with the subprime crisis. The SEC also has a separate working group focused on hedge-fund misconduct.

Inside Information

The Washington-based regulator has said it may look at whether firms and employees manipulated or postponed changes in asset valuations to hide losses from investors. It may check to see whether executives used inside information to profit personally before announcing losses. It is also examining whether brokers steered clients into mortgage-backed securities with inappropriate levels of risk.

U.S. lawmakers, including Senator Jack Reed, have questioned whether the SEC has sufficient resources to deal with the credit crisis. The Bush administration requested $913 million for the agency's 2009 budget, an increase of less than 1 percent. Reed and Senate Banking Committee Chairman Christopher Dodd, both Democrats, have proposed raising the allocation by $50 million.

``These are very, very fact-intensive investigations," that include ``difficult accounting issues and involve comprehensive document searches," said Gregory Bruch, a former agency attorney who is a partner at Willkie Farr & Gallagher LLP. ``The SEC has severe resource constraints, particularly with something this complex, this difficult."

`Aggressively' Regulate Cox told Congress in April that Bush's budget will let the agency ``aggressively" regulate markets.

``We always find a way to bring the resources necessary to address the problems we're confronted with," the SEC's enforcement chief, Linda Thomsen, said today in an interview. As the agency did after the collapse of Enron Corp. and the discovery of widespread stock-option backdating, ``we marshal our resources to protect investors."

Among the most recent SEC probes to emerge, American International Group Inc. said June 6 it is cooperating with federal inquiries into how it valued mortgage-linked derivatives that wiped out profit for two quarters. New York-based AIG, the world's largest insurer by assets, had downplayed potential losses in December, then said Feb. 11 that auditors found a ``material weakness" in accounting for the holdings.

Spread Lies

In March, the SEC also opened probes into whether investors including hedge funds spread lies about Bear Stearns and Lehman Brothers Holdings Inc. to profit from declines in the firms' shares, people familiar with the inquiries said at the time. Speculation that Bear Stearns was facing a cash shortage spurred client withdrawals at the 85-year-old firm, forcing its sale to JPMorgan Chase & Co.

The FBI has struggled to keep pace with the growing number of cases. The agency this month told 26 of its 56 field offices to focus on the subprime crisis and stop opening investigations into other financial crimes including price fixing, mass marketing and wire fraud.

FBI officials said last week they are probing 19 companies, including investment banks and hedge funds, for suspected accounting fraud or other white-collar crimes related to mortgage securities. It had 14 such cases in January.

``We recognize that these corporate fraud cases will increase in numbers due to an enhanced level of regulatory and internal-audit reviews by many of these Wall Street firms," FBI Director Robert Mueller said June 19. ``We will address these cases as they are identified."

Bush admin proposes less than 1 pct boost to SEC budget

Mon Feb 4, 2008 11:54am EST

WASHINGTON, Feb 4 (Reuters) - The Bush administration on Monday asked Congress to increase the U.S. Securities and Exchange Commission's budget by less than 1 percent to about $914 million for fiscal 2009.

The slight increase in funding comes as the SEC investigates companies and individuals involved in the subprime mortgage meltdown, a crisis that has roiled markets and forced major U.S. banks to take billions of dollars in write-downs.

The budget for the enforcement division, which has opened about three dozen subprime-related cases, would rise $3 million to a total of $318 million if Congress adopts President George W. Bush's budget.

The amount set aside for corporation finance, which establishes and monitors disclosure requirements, would increase $2 million to a total of $113 million.

For the current year ending Sept. 30, the agency is expected to spend about $907 million.

The SEC spending plan is part of a $3.1 trillion budget proposed by the White House and still needs to be approved by the Democrat-controlled Congress, which could alter much of it.

The SEC had no immediate comment. The House of Representatives Financial Services Committee, which oversees the investor protection agency, had no immediate comment. Calls to the Senate Banking Committee, which also oversees the agency, were not immediately returned. (Reporting by Rachelle Younglai, editing by Maureen Bavdek)

Testimony Concerning
Fiscal 2008 Appropriations Request
by Chairman Christopher Cox
U.S. Securities & Exchange Commission

Before the U.S. House of Representatives Subcommittee on Financial Services and General Government, Committee on Appropriations

March 27, 2007

http://www.sec.gov/news/testimony/2007/ts032707cc.htm

Chairman Serrano, Ranking Member Regula, and Members of the Subcommittee:

Thank you for the opportunity to testify today about the Securities and Exchange Commission's budget request for fiscal year 2008.

Before I begin, I would like to congratulate you, Mr. Chairman, on your new role as head of this subcommittee. I look forward to working with you and all the members of this subcommittee for the benefit of the nation's investors.

As you know, the President's budget requests $905.3 million for the SEC in 2008. I fully support this request for increased funding over FY 2007, which will allow the SEC to continue the important initiatives underway to protect and assist the average investor.

These initiatives all have in common that they are aimed at benefiting the average retail customer whose savings are dependent on healthy, well-functioning markets. Since I became Chairman, I have worked to reinvigorate the agency's focus on the ordinary investor. This is the SEC's traditional responsibility. Back in

Joseph Kennedy's day, our first SEC Chairman was amazed that "one person in every ten" owned stocks. But today, more than half of all households own securities, and the median income for shareholders is a very middle-class $65,000. When you then consider all of the teachers, government employees, and workers in other industries who have pensions, it becomes clear that nearly all taxpayers have a personal interest in fair and honest securities markets.

In fact, when one considers the staggering growth in Americans' participation in the markets, the enormity of the SEC's task becomes apparent. About 3,600 staff at the SEC are responsible for overseeing more than 10,000 publicly traded companies, investment advisers that manage more than $32 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the $44 trillion worth of trading conducted each year on America's stock and options exchanges.

These daunting numbers make it clear that, even if the SEC budget were to double or triple, the agency would have to carefully set priorities. That is exactly what we are doing in this proposed budget for FY 2008. We must continue to think strategically about which areas of the market pose the greatest risk, and which areas of potential improvement hold the greatest benefit for investors. And given the fast changing conditions in America's and the world's capital markets, we must remain agile and flexible enough to redirect our resources with little notice.

This risk-based and flexible approach guides the SEC's examination program as we focus the agency's energies on those practices in the marketplace, and those investment advisers and mutual funds, that are most likely to be high-risk. It also provides the basis for the selection of targets for comprehensive examination sweeps on cross-cutting issues that could present a significant threat to investors. And it drives the SEC's enforcement, rulemaking, and disclosure review functions as well. In each case, the objective is to apply the taxpayer's resources in ways that provide the biggest investor protection bang for the buck.

In recent years, the SEC has professionalized the culture of risk assessment that informs so many of our programs throughout the SEC. From relatively modest beginnings as a discrete office within the SEC established by my predecessor, William Donaldson, the risk assessment function is now wholeheartedly embraced in every major functional division and office of the agency.

If I may, Mr. Chairman, I would now like to discuss some of the major areas in which the SEC is currently focusing its energies, in order to provide the maximum benefit to America's retail investors.

Fighting Fraud Against Seniors

As you know, an estimated 75 million Americans will turn 60 over the next 20 years. And they will live longer than any generation before them. As the baby boomers turn 60 -- more than 10,000 of them every day for the next 20 years - they will need to continue to actively manage their investments for higher yield over their longer lifetimes, rather than switching into low-yield, safe investments as their parents did. This will have enormous consequences for our capital markets. Households led by people aged 40 or over already own 91% of America's net worth. The impending retirement of the baby boomers will mean that, very soon, the vast majority of our nation's net worth will be in the hands of our nation's seniors.

Following the Willie Sutton principle, scam artists will swarm like locusts over this increasingly vulnerable group - because that is where the money is. And it is already occurring. Nearly every day, our agency receives letters and phone calls from seniors and their caregivers who have been targeted by fraudsters.

That is why the SEC has focused its energies in this area, and why we organized our fellow regulators and law enforcement officials at the first-ever Seniors Summit in July 2006. This year's Seniors Summit, which will integrate even more of our national resources, will take place in just a few months. With our partners, the SEC has developed a strategy to attack the problem from all angles - from aggressive enforcement efforts, to targeted examinations, to investor education.

Fighting fraud against seniors means taking aggressive action. Over the past year, the SEC's Division of Enforcement has brought 26 enforcement actions aimed specifically at protecting elderly investors. Many of these were coordinated with state authorities.

For example, the Commission coordinated with law enforcement authorities in California to crack down on a $145 million Ponzi scheme that lured elderly victims to investor workshops with the promise of free food -- and then bilked them out of their retirement money by purporting to sell them safe, guaranteed notes.

In another case, we filed an emergency action to halt an ongoing securities fraud that targeted individuals' retirement funds. At "free" dinner and retirement planning seminars, seniors were urged to invest their savings in non-existent businesses with promises of alluringly high rates of return.

By bringing cases like these, and dozens more like them, the federal government is putting would-be fraudsters on notice that they will be caught and punished if they prey upon seniors.

SEC examiners are also working closely with state regulators across the country to stop abusive practices before seniors are actually injured. With our state partners, we're sharing regulatory intelligence about abusive sales tactics targeting seniors, and conducting focused examinations of any firms whose practices raise red flags.

For example, in Florida we initiated an examination sweep of firms selling investments to seniors, in cooperation with the State of Florida and the National Association of Securities Dealers. We subsequently expanded the sweep to include other states with large retiree populations - including California, Texas, North Carolina, Alabama, South Carolina, and Arizona. Working together with state securities regulators in those states, the NASD, and the NYSE, our goal is to see to it that the sales people at "free lunch" seminars are properly supervised by their firms, and that the seminars are not used as a vehicle to sell unsuitable investment products to seniors.

Another tool in fighting securities fraud against seniors is education. These efforts are aimed not only at seniors, but also their caregivers - as well as pre-retirement workers, who are encouraged to plan for contingencies in later life. The SEC is expanding our efforts to reach out to community organizations, and to enlist their help in educating Americans about investment fraud and abuse that is aimed at seniors. We have also devoted a portion of the SEC website specifically to senior citizens (http://www.sec.gov/investor/seniors.shtml). The site provides links to critical information on investments that are commonly marketed to seniors, and detailed warnings about common scam tactics.

Returning Funds to Wronged Investors

We at the SEC work diligently to uncover fraud against investors, gather the evidence needed to build a case, and then prosecute cases to bring fraudsters to justice. But our efforts do not end at the courthouse door. Once we succeed in convincing a court to order a penalty, we must ensure that as many of those dollars as possible go back into the hands of wronged investors as quickly as possible.

Since the Sarbanes-Oxley Act created "Fair Funds," through which penalties in SEC cases can be returned directly to injured investors, the SEC has begun to develop a considerable expertise in using this important new authority. At the time I became Chairman in 2005, this authority was only three years old, and the SEC had completed the process of disbursing funds to investors in only a few cases. Since then, we have returned over $1 billion to injured investors, including significant distributions from cases involving WorldCom, Global Analysts Research, New York Stock Exchange Specialists, Hartford, and Bristol-Myers Squibb. In addition, several large disbursements are pending and will be announced shortly.

To completely fulfill the vision that Congress wrote into Sarbanes-Oxley, however, will require a sustained effort within the Commission to train professionals in this area, to develop consistent practices, and to routinize the execution of the Fair Funds function. Too much money is still undisbursed because of the complexities of the process, leaving investors uncompensated.

That is why I have ordered the creation of a new office that will focus the efforts of all of the SEC's offices around the country, and work full-time to return these funds to wronged investors. The creation of this specialized function within the SEC will ensure that investors' money is returned as quickly as possible, while minimizing the costs of the distributions.

The efforts of this new office will be aided by a new information system, called Phoenix. The system will more accurately track, collect, and distribute the billions of dollars in penalties and disgorgements that flow from our enforcement work. The efficiency of a dedicated tracking system will remove what had been a major hindrance in our efforts to quickly distribute Fair Funds.

The agency is taking other steps in this area as well. We are collaborating with the Bureau of the Public Debt to invest disgorgement and penalty funds in interest-bearing accounts. And we are working to consolidate funds from related cases into a single distribution, where appropriate, to potentially save investors hundreds of thousands of dollars.

The SEC is dedicated to doing the very best job possible for investors in handling this responsibility. We know that you in the Congress, who entrusted us with this task, expect and deserve no less.

Interactive Data
Another major initiative I want to bring to your attention holds great potential for investors. By using what I call "interactive data," we can give investors far more information, in far more useful form, than anything they've ever gotten from the SEC before. In the very near future, investors will be able to easily search through and make sense of the mountains of financial data contained in current company disclosures.

For years, ordinary investors have been stymied by the time and effort it takes to separately look up each SEC filing for a single company they might own, and then to do that again and again for every additional company in which they're interested. Even once the right forms are located, wading through all of the legal gobbledygook to find the right numbers has been nearly impossible for the average retail investor.

That is because the SEC's online system, know as EDGAR, is really just a vast electronic filing cabinet. It can bring up electronic copies of millions of pieces of paper on your computer screen, but it doesn't allow you to manage all of that information in ways that investors commonly need.

Not surprisingly, financial firms - who can afford it - usually end up getting the bulk of their information about companies not from the SEC filings, but from middlemen all over the world who re-key the information in SEC reports and put it in more useful form. This process is expensive and inefficient, and it also creates errors in the data. Worse, it feeds the notion that the rich and the highly sophisticated have a leg up in today's markets.

Interactive data will let any investor quickly focus on the disclosure they need. With a few clicks of the mouse, investors will be able to find, for example, the mutual funds with the lowest expense ratios, the companies within an industry that have the highest net income, or the overall trend in their favorite companies' earnings. It works by giving each piece of information a unique label, written in the eXtensible Business Reporting Language (XBRL) computer language.

The agency has taken a variety of steps to expand the use of interactive data. First, the Commission created a voluntary program for companies and mutual funds to submit disclosures using XBRL, and offered expedited reviews of disclosures if firms agree to share their experiences with the agency. More than 35 companies, including some of corporate America's biggest names, are already participating in this program.

Second, the SEC is working with outside groups to develop the standardized computer labels for different kinds of numbers that appear in financial statements. The collections of these labels for each industry - the so-called "taxonomies" - will be completed in 2007. With the taxonomies available to every SEC registrant, we will have in place the basic building blocks of the universal language that explains the components of every firm's financial statements.

Third, the agency is modernizing the entire EDGAR system to convert it to one based on interactive data. As part of this effort, the SEC expects to rename the EDGAR system in 2007.

In all, the Commission is investing $54 million over several years to build the infrastructure to support widespread adoption of interactive data. Companies have told us that the costs of implementing XBRL are minimal, while the benefits are substantial. In addition to providing far more useful information to investors, we believe the use of interactive data will be more efficient for companies' internal processes, for their registration and compliance reporting to the SEC, and for the SEC's own disclosure reviews for regulatory and enforcement purposes.

Credit Rating Agencies
Finally, I want to discuss a significant new responsibility that the SEC is undertaking this year to oversee credit rating agencies. This new role was given to the SEC by Congress last year.

As you know, in 2006 the Congress gave the SEC both the responsibility and the authority to register and inspect the nation's credit rating agencies, including industry giants Standard & Poor's, Moody's, Fitch Ratings, A.M. Best, as well as several other large, medium, and smaller current and potential industry participants. Because of congressional concern that the industry faces potential conflicts of interest, imposes barriers to entry for new rating agencies, and has failed to warn the market of such significant impending financial failures as Enron and WorldCom even immediately before their collapses, the SEC is tasked with devoting significant manpower and resources to this area.

Under the new law and the SEC's proposed implementing rules, credit rating agencies will be required to register with the Commission. In addition, they will be required to submit to periodic inspections to insure that they are implementing policies to mitigate conflicts of interest, prevent leaks of material non-public information, and refrain from unfair or coercive practices. The SEC takes this new responsibility very seriously. We remain committed to finalizing the new rules by the statutory deadline, and we will assemble a team of staff to oversee the program and begin conducting inspections over the next several months.

Fiscal 2008 Request

With all of this as background, I'll take just a moment to provide some useful detail about the President's budget request for fiscal year 2008.

As you know, the request is for $905.3 million. That will permit the agency to maintain its staffing levels from 2007. This level of personnel strength, which as you know is significantly higher than five years ago, will permit the agency to vigorously pursue its mission and maintain strong regulatory, enforcement, examination, and disclosure review programs.

This funding level will allow the SEC to continue its commitment to information technology, which has the potential both to reduce regulatory costs and to give investors vastly more useful information than what they receive today. In addition to the SEC's interactive data initiative, the SEC is deploying new systems to better manage enforcement and examination resources, to help us manage a higher level of enforcement activity at existing personnel and funding levels. There is absolutely no question that these technology improvements will make the SEC more productive, and give both investors and taxpayers better value for their money.

Over the last two years, the SEC has made tremendous progress in improving its operations. The fiscal 2008 request will permit us to continue improving the agency's internal financial controls. The agency has poured tremendous energy into this area during my tenure as Chairman. I am pleased to say that these efforts have generated success: under the leadership of a new Executive Director, the SEC received a clean opinion on its audited financial statements for 2006 and, for the first time, there were no material weaknesses in internal controls. This is vitally important, Mr. Chairman, because the SEC must set the example not only for other federal agencies, but for all public companies whose financial statements and disclosures we review. For this reason, the SEC will continue to upgrade its financial system, and to beef up security over its information systems.

The President's budget request also will fund pay raises for SEC staff, in accordance with the SEC's pay parity authority and our collective bargaining agreement. This is a significant fact. Including cost-of-living increases, career-ladder promotions, and merit pay increases, these raises amount to between five and six percent each year. Given that from a budgetary standpoint the increases are essentially automatic, and given further that payroll represents about two-thirds of our budget, the agency's total budget has to increase by over 3.5% just to maintain personnel at a steady state from year to year.

Finally, and most importantly, the level of funding in this budget request will give the SEC the tools we need to address new, emerging risks in the nation's capital markets - including not only such known areas of concern as hedge fund insider trading, the safety and security of 401(k) plans, and the quality of disclosure to protect against fraud in the municipal securities market, but also those threats to market integrity and investor confidence that have yet to emerge.

Conclusion

Thank you for this opportunity to discuss the SEC appropriation for fiscal 2008. I look forward to working with you on the best ways to meet the needs of our nation's investors, and I would be happy to answer any questions you may have.

APPENDIX B

COUNCIL OF INSTITUTIONAL INVESTORS

Suite 500 • 888 17th Street, NW • Washington, DC 20006 • (202) 822-0800 • Fax (202) 822-0801 • www.cii.org

Via Email

November 9, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Concept Release on Allowing U.S. Issuers To Prepare Financial Statements in Accordance With International Financial Reporting Standards (File Number S7-20-07)

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 130 public, corporate and union pension funds with combined assets of over $3 trillion. As a leading voice for long-term, patient capital, the Council welcomes the opportunity to provide comments on the United States ("US") Securities and Exchange Commission's ("SEC" or "Commission") Concept Release to obtain information about the extent and nature of the public's interest in allowing US issuers to prepare financial statements in accordance with International Financial Reporting Standards ("IFRS") as published by the International Accounting Standards Board ("IASB") for purposes of complying with the rules and regulations of the Commission.[1]

In response to the issuance of (1) the Concept Release, and (2) the SEC's related July 11, 2007, Proposed Rule to accept from foreign private issuers their financial statements prepared in accordance with IFRS without reconciliation to US generally accepted accounting principles,[2] the Council has taken a number of steps to assist Council members and other institutional investors in better understanding the issues raised by those due process documents.[3] Those steps have included:

- A plenary session at our 2007 fall membership meeting discussing international convergence of accounting standards. That session featured Robert Herz, Chair, Financial Accounting Standards Board ("FASB"), Thomas Jones, Vice Chair, IASB, and Mark Olson, Chair, Public Company Accounting Oversight Board.
- The establishment of an informal Council working group on accounting and auditing.

[1] Concept Release on Allowing U.S. Issuers To Prepare Financial Statements in Accordance With International Financial Reporting Standards ("IFRS"), Securities Act Release No. 8831, Exchange Act Release No. 56,217, Investment Company Act Release No. 27,924, 72 Fed. Reg. 45,600 (Aug. 14, 2007) ("Concept Release").
[2] Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With IFRS Without Reconciliation to U.S. GAAP, Securities Act Release No. 8818, Exchange Act Release No. 55,998, International Series Release No. 1302, 72 Fed. Reg. 37,962 (Proposed July 11, 2007) ("Proposed Rule").
[3] Convergence of International Accounting Standards Receives Attention at SEC, on Capitol Hill, Alert 4 (Couns. Institutional Investors, Washington, DC), Oct. 4, 2007 (on file with the Council).

- A white paper prepared on behalf of the Council by Professor Donna L. Street, Mahrt Chair in Accounting, University of Dayton, entitled "International Convergence of Accounting Standards: What Investors Need to Know" ("White Paper").

The White Paper, which is attached to this letter, includes a discussion of a number of important investor related issues various parties have raised in support of, and in opposition to, the Commission potentially allowing US issuers to prepare financial statements in accordance with IFRS as published by the IASB.[4] The Council respectfully requests that the Commission carefully analyze the issues and related discussion set forth in the White Paper as part of your efforts to "better understand the nature and extent of the public's interest" in this area.[5]

Of all of the issues referenced in the White Paper, one area of particular concern to the Council is the independence of the IASB.[6] As background, on March 20, 2007, the Council's general members unanimously approved the following policy regarding the independence of accounting and auditing standard setting:

> Audited financial statements and their related disclosures are a critical source of information to institutional investors making investment decisions. The well-being of the financial markets—and the investors who entrust their financial present and future to those markets—depends directly on the quality of the information audited financial statements and disclosures provide. The quality of that information, in turn, depends directly on the quality of the standards that . . . preparers use to recognize and measure their economic activities and events . . . . The result should be accurate, transparent, and understandable financial reporting.
>
> The responsibility to issue and develop accounting . . . standards should reside with independent private sector organizations with an appropriate level of government input and oversight. Those organizations should possess adequate resources and the technical expertise necessary to fulfill this important role. Those organizations should also include significant representation from investors and other users of audited financial reports on the organizations' boards and advisory groups. Finally, those organizations should employ a thorough public due process that includes solicitation of public input on proposals and consideration of user views before issuing final standards. The United States Congress, the Securities and Exchange Commission ("SEC"), and other federal agencies and departments should respect and support the independence of the designated accounting and auditing standard setting organizations and refrain from interfering with or overriding the decisions and judgments of those bodies.[7]

---

[4] Donna L. Street, International Convergence of Accounting Standards: What Investors Need to Know 24-30 (Oct. 2007) (Attachment).
[5] Concept Release, 72 Fed. Reg. at 45,601.
[6] Attachment, at 22-23; 30.
[7] Council Policies, Pension Fund Issues, 1. Independence of Accounting and Auditing Standard Setting (Mar. 20, 2007), *available at* http://www.cii.org/policies/Policies%20on%20Other%20Governance%20Issues%2003-20-07.pdf.

Consistent with the Council's conclusion that high quality accounting standards can best be achieved by an independent private sector standard setting organization, we agree with the Commission that the "sustainability, governance and continued operation of the IASB are important factors for development of a set of high quality, globally accepted accounting standards . . . ."[8] Moreover, we believe that there are at least three related issues that are critical to the sustainability, governance and independence of the IASB and that those issues should be resolved as soon as possible and certainly *before* the Commission considers allowing US issuers to prepare financial statements in accordance with IFRS. Those issues are: (1) IASB funding; (2) the European Union ("EU") endorsement process; and (3) Investor representation on the IASB.

IASB Funding

Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 ("SOX") currently require that US public companies pay accounting support fees to the US accounting standard setter—the FASB.[9] Those sections eliminated the need for the Financial Accounting Foundation, the parent entity of the FASB, "to seek contributions from accounting firms and companies whose financial statements must conform to FASB's rules."[10]

Sections 108 and 109 of SOX were the result, in part, of a decision by the US Senate Committee on Banking, Housing, and Urban Affairs ("Banking Committee") that a source of stable funding was necessary to "strengthen the independence of the FASB . . . ."[11] More specifically, the Banking Committee found that

> witnesses overwhelmingly agreed that . . . the FASB required guaranteed sources of funding, in order to protect their independence. . . . With respect to the FASB, Michael Sutton, a former SEC Chief Accountant, testified to the Committee that '[t]o restore confidence in our standards setters, we should take immediate steps to secure independent funding for the FASB—funding that does not depend on contributions from constituents that have a stake in the outcome of the process.'[12]

---

[8] Concept Release, 72 Fed. Reg. at 45,604.
[9] Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. §§ 108-109 (2002), *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf.
[10] S. Rep. No. 107-205, at 13 (2002).
[11] *Id.*
[12] *Id.*

With this recent history in mind, we are concerned that the independence of the IASB may be compromised by the current source of its funding.[13] We note that the vast majority of the IASB's current funding is the result of voluntary commitments from less than 200 organizations.[14] Most of those organizations are from the same two constituents—companies and accounting firms—that the Banking Committee was most troubled by.[15]

Our concerns about the potential impact of the IASB's current funding on its independence are real and shared by many other parties.[16] As one example, in a September 19th presentation before the Economic and Monetary Affairs Committee of the European Parliament, a research fellow for a European think tank devoted to international economics stated:

> Given its light framework of governance and funding, maintaining independence from dominant influences . . . is a first-order priority for the international standard setter . . . .[17]

[13] As an aside, we note that one commentator has indicated that "[i]t is not clear what would happen to that funding [referring to Sections 108 and 109 of the Sarbanes-Oxley Act of 2002 ("SOX")] if companies that list in the U.S. could report their financial results using standards set by the IASB instead." David M. Katz, IFRS or GAAP: Take Your Pick?, CFO.com, May 3, 2007, at 1, *available at* http://www.cfo.com/article.cfm/9133180?f=related. Similarly, Professor Lawrence A. Cunningham commented that "[i]f IASB began to set the standards [for US-listed companies], affected companies should not be required to contribute to the FASB's budget." Letter from Lawrence A. Cunningham, George Washington University Law School, to Securities and Exchange Commission ("SEC" or "Commission") 2 (Aug. 10, 2007), *available at* http://www.sec.gov/comments/s7-20-07/s72007-1.pdf. It is surprising that neither the Proposed Rule nor the Concept Release addresses the issue of how the Commission's potential actions permitting greater use of IFRS by U.S.-listed companies will or should impact the funding provisions of Sections 108 and 109 of SOX.
[14] International Accounting Standards Board ("IASB"), Future Funding 1, http://www.iasb.org/About+Us/About+the+Foundation/Future+Funding.htm (last visited Nov. 7, 2007).
[15] *See id.*
[16] Of note, in 2002 United States Senator Carl Levin (D-Michigan) publicly released an email from David Duncan, the lead auditor of Enron Corp. ("Enron") at Arthur Andersen. The email described Enron Chief Accountant Rick Causey's inquiries about whether Enron's potential contribution to the IASB would buy access and influence to the standard setting process. Senate Floor Statement of Senator Carl Levin (D-Mich) on the Introduction of Legislation to End the Double Standard for Stock Options [S. 1940] 4-5 (Feb. 13, 2002), *available at* http://www.senate.gov/~levin/newsroom/release.cfm?id=209088.
[17] Nicolas Véron, Research Fellow at Bruegel, Presentation to the Economic and Monetary Affairs Committee of the European Parliament 3 (Sept. 19, 2007), *available at* http://veron.typepad.com/main/files/EuroParl_IFRS8_Sep07.pdf.

We welcome the recent reports from the Trustees of the International Accounting Standards Committee Foundation ("IASCF") that they (1) "have achieved multi-year financing commitments of more than £12 million of a £16 million annual target" for the IASB;[18] and (2) that the combination of national funding schemes, broad-based voluntary programs, and other sources "will bring the sources of funding from less than 200 organizations in 2006 to several thousand by 2008."[19] We, however, note that the entity that has "daily interactions" with the IASB—the FASB—raised the following serious funding concerns in their November 7th comment letter to the SEC in response to the Concept Release:

> We believe the current funding levels and staffing mechanisms of the IASB are not adequate for the tasks it will face if the improved version of the IFRS becomes the single set of global accounting standards. *Moreover, the current funding sources appear unstable, and they give rise to independence concerns.*[20]

We agree with the FASB and other commentators that a "funding mechanism that provides adequate resources while protecting the independence of the IASB" should be established before "moving U.S. public companies to IFRS . . . ."[21]

EU Endorsement Process

Another issue critical to IASB sustainability, governance and independence is the level of involvement of the EU in the development of IFRS standards, largely as a result of the EU endorsement process. The following is a summary description of that process:

> First, the European Financial Reporting Advisory Group (EFRAG) technically assesses each new standard and interpretation approved by the IASB and submits the assessment to the EC. EFRAG is an independent private body whose task is to provide the EC 'advice on the technical soundness of new standards.' EFRAG's members are academics, analysts, auditors, industry representatives, and users. To approve or disapprove an accounting standard, two-thirds of the members of EFRAG's Technical Expert Group must agree.
>
> In July 2006, the EC created the Standards Advice Review Group (SARG) to review EFRAG's opinions to ensure their objectivity and proper balance. The EC will appoint up to seven members to SARG. Members will be independent accounting experts and high-level representatives from EU national accounting standards setters. SARG will be expected to deliver its advice within three weeks of EFRAG responses.

---

[18] Press Release, International Accounting Standards Committee Foundation, Trustees Announce Strategy to Enhance Governance, Report on Conclusions at Trustees' Meeting 3 (Nov. 6, 2007), *available at* http://www.iasb.org/NR/rdonlyres/D3F8A7DA-B979-462E-BF43-32F2581BEE37/0/PRonTrusteesmeet061107final.pdf.
[19] *Id.*
[20] Letter from Robert E. Denham, Chairman, Financial Accounting Foundation ("FAF") & Robert H. Herz, Chairman, Financial Accounting Standards Board ("FASB"), to Nancy M. Morris, SEC 8 (Nov. 7, 2007) (emphasis added).
[21] *Id.*; *see also* Parveen P. Gupta et al., The Road to IFRS?, Strategic Finance 29, 33 (Sept. 2007), *available at* http://www.imanet.org/publications_sfm_bi_sep2007.asp ("International standards-setting boards would have to develop a funding stream that not only preserves their independence but meets the requirements of Congress and other international legislative bodies").

> The EC then submits a proposed standard to the European Parliament and the Accounting Regulatory Committee (ARC). The ARC is chaired by the EC and composed of representatives of the EU member states. This represents the political aspect of the endorsement process. If a majority of the member states favors a proposed standard, it is approved by the ARC.
>
> After approval by the ARC and the European Parliament, the EC formally decides on the use of new IASB standards and interpretations within the EU. Therefore, the final—and some would say most important—part of the endorsement process requires the EC to adopt new IFRSs and publish them in the *Official Journal of the EU.*[22]

The EU endorsement process has resulted in several incidents that raise serious questions about whether that process impairs the independence of the IASB. For example, in 2004 the process resulted in a carve-out of several paragraphs from International Accounting Standards 39, *Financial Instruments: Recognition and Measurement.*[23]

In March 2005, the EFRAG officially recommended that the EU not endorse International Financial Reporting Interpretations Committee 3, *Emission Rights* ("IFRIC 3").[24] Following the EFRAG's recommendation, the European Commission ("EC") officially requested that the IASB defer the March 1, 2005, effective date for IFRIC 3.[25] In late June 2005, the IASB withdrew IFRIC 3.[26]

In April 2007, the Economic and Monetary Affairs Committee of the European Parliament proposed a Parlimentary resolution calling on the EC to conduct a thorough impact assessment prior to endorsing IFRS 8, *Operating Segments* ("IFRS 8").[27] In response, the EC has taken action that has to-date delayed the endorsement of that standard.[28]

Given this expansive governmental role, it is not surprising that many parties, including PricewaterhouseCoopers, have observed that the EU endorsement process greatly influences the IASB's standard setting process.[29] In addition, the FASB has concluded more broadly that "endorsement mechanisms are inconsistent with . . . high-quality international accounting standards, and their continued operation could significantly threaten the benefits of transitioning U.S. companies to IFRS."[30]

---

[22] Robert K. Larson & Donna L. Street, The Roadmap to Global Accounting Convergence—*Europe Introduces 'Speed Bumps'*, CPA J. 5-6 (2006), *available at* http://www.nysscpa.org/cpajournal/2006/1006/essentials/p36.htm.
[23] *Id.* at 6.
[24] *Id.* at 7.
[25] *Id.*
[26] *Id.*
[27] European Parliament, Motion for a Resolution 3 (Apr. 18, 2007), *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+MOTION+B6-2007-0157+0+DOC+PDF+V0//EN.
[28] *See* European Commission, Endorsement of IFRS 8 *Operating Segment*—Analysis of potential Impacts (API) 2 (May 30, 2007), *available at* http://ec.europa.eu/internal_market/accounting/docs/ifrs8-consultation-final.pdf.
[29] PricewaterhouseCoopers, ViewPoint—Convergence of IFRS and US GAAP 4 (Apr. 2007), *available at* http://www.pwc.com/extweb/pwcpublications.nsf/docid/fc800243be0e3882852570500000c756/$File/viewpoint_convergence.pdf.
[30] Letter from Denham & Herz, at 9.

Our concern in this area has only been deepened by the November 6th combined statement of European Internal Market Services Commissioner Charlie McCreevy, Financial Services Agency of Japan Commissioner Takafumi Sato, IOSCO Executive Committee Chairperson Jane Diplock, and SEC Chairman Christopher Cox.[31] That statement included the following language:

> *International Financial Reporting Standards (IFRS) are becoming more widely used throughout the world. We have a common interest of ensuring continuing user confidence in the institutions responsible for the development of global accounting standards.* ***A natural step in the institutional development of the IASB and the IASC Foundation would be to establish a means of accountability to those governmental authorities*** *charged with protecting investors and regulating capital markets. We will work together to achieve these objectives.*[32]

In commenting on the statement, Floyd Norris of the *New York Times* opined:

> They propose to establish a 'new monitoring body' that would 'participate' with the trustees in choosing board members. 'The monitoring body would also be responsible for the final approval of Trustee nominees and would have the opportunity to review the Trustees' procedures for overseeing the standard-setting process and ensuring the I.A.S.B's proper funding.'
>
> In other words, this new monitoring body – which evidently would be chosen by politicians – would run the show. It would also work to develop 'objective procedures' to assess the costs and benefits of new accounting rules. You can bet that the costs of rules companies do not like would be deemed to be too high.
>
> You can have 'accountability.' Or you have have 'independence.' But it is an illusion to say you can have both.
>
> The effort to get a genuinely independent accounting rule maker in this country, not dependent on companies for funding, culminated in the passage of the Sarbanes-Oxley law in 2002, which allowed the Financial Accounting Standards Board to essentially impose a tax on public companies.
>
> *The risk is that the F.A.S.B. will eventually be supplanted by an I.A.S.B. whose independence will be preserved in name only.*[33]

---

[31] Press Release, Authorities Responsible for Capital Market Regulation Work to Enhance the Governance of the IASC Foundation (Nov. 6, 2007), *available at* http://www.sec.gov/news/press/2007/2007-226.htm.
[32] *Id.* at 1 (emphasis added).
[33] Bye Bye Independence, http://norris.blogs.nytimes.com/2007/11/06/bye-bye-independence/ 2 (Nov. 6, 2007, 7:25 PM EST) (emphasis added).

Investor Representation on the IASB

Finally, as indicated above in the Council's policy, we believe that having significant investor representation on the IASB is an important element of the IASB's sustainability, governance and independence. Since financial reports are used primarily for making decisions regarding the allocation of financial capital, investors are the key consumers of the product produced by accounting standard setters.

We note that the 14-member board of the IASB has only one current board member who could be characterized as an investment professional.[34] We believe that, at minimum, four members of the IASB should be drawn from the ranks of pension fund investment advisors, equity security financial analysts, equity security portfolio managers, or other users of financial reports.[35]

The Council agrees with the recent comments of the CFA Institute Centre for Financial Market Integrity that "inadequate investor representation on the IASB . . . handicaps their ability to achieve their objectives for investors."[36] We are hopeful that the IASCF will promptly commit to filling future open board seats with qualified[37] investors or other users of financial reports so that adequate representation of the key customers of financial accounting and reporting can soon be achieved.

* * * *

We appreciate the opportunity to express our views on this matter. Please feel free to contact me with any questions.

Sincerely,

Jeff Mahoney

Jeff Mahoney
General Counsel

Attachment

---

[34] In July 2007, Stephen Cooper, Managing Director and head of valuation and accounting research of UBS Investment Bank in London, was appointed to the IASB as a part-time member. IASB Home Page, http://www.iasb.org/About+Us/About+IASB/Board+Members.htm.
[35] We note that in 1992, SEC Chairman Richard C. Breeden encouraged FAF Chairman Shaun O'Malley to consider filling two open seats on the seven member FASB with individuals "from the community of users of financial statements . . . ." Letter from Richard C. Breeden, Chairman, SEC, to Shaun O'Malley, President, FAF (Oct. 22, 1992) (on file with the Council). In 1993, the FAF named Anthony T. Cope, former Director of Fixed Income Credit Research and a Senior Vice President of Wellington Management Company, to the FASB. *See* News Release, FASB, Anthony T. Cope and James J. Leisenring to Join IASB (Jan. 25, 2001), *available at* http://www.fasb.org/news/nr012501.shtml.
[36] Letter from Kurt N. Schacht, Managing Director & Gerald I. White, Chair, Corporate Disclosure Policy Council, CFA Institute Centre for Financial Market Integrity, to Nancy M. Morris, Secretary, SEC 8 (Oct. 2, 2007).
[37] We believe "qualified" IASB investor candidates should, among other required skills, possess outstanding technical accounting expertise.

ATTACHMENT

COUNCIL OF
INSTITUTIONAL
INVESTORS

INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS: WHAT INVESTORS NEED TO KNOW*

Prepared by
Professor Donna L. Street
Mahrt Chair in Accounting
University of Dayton

INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS: WHAT INVESTORS NEED TO KNOW*

Prepared by
Professor Donna L. Street
Mahrt Chair in Accounting
University of Dayton

***This report was prepared by Professor Donna L. Street at the request of the Council of Institutional Investors ("Council"). The views and opinions expressed in this paper are solely those of the author and do not necessarily represent the views or opinions of the Staff, Board of Directors, or General Members of the Council.**

INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS: WHAT INVESTORS NEED TO KNOW

TABLE OF CONTENTS

INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS: WHAT INVESTORS NEED TO KNOW

1. WHAT IS THE INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS?

While discussion and consideration has been centered around the admirable goal of 'harmonizing' accounting standards for decades, the process initially proceeded at a very slow pace and represented a challenging undertaking. More recently, however, the focus has shifted to 'convergence,' and in the last decade or so, tremendous progress has been made. Today's goal is to converge, or minimize the differences between, the two sets of globally recognized accounting standards that co-exist in the world's capital markets: U.S. GAAP and International Financial Reporting Standards (IFRS).

U.S. GAAP is developed primarily by the Financial Accounting Standards Board (FASB), while IFRS are issued by the London-based International Accounting Standards Board (IASB). The use of IFRS has become increasingly widespread throughout the world with about 100 countries now requiring or allowing the use of these standards. Additional countries are in the process of replacing their national standards with IFRS. For example, from 2005 onward, companies headquartered in the European Union (EU), with securities listed on an EU regulated market, are required to report their consolidated financial statements using 'EU-endorsed' IFRS. This requirement affects about 7,000 EU companies. Other countries including Australia and New Zealand (N.Z.), have adopted similar requirements mandating the use of IFRS, while countries including Canada and Israel plan to adopt IFRS as their national standards in the near future. Furthermore, major emerging and transition economies such as Brazil, China, India, and

Russia are adopting or considering IFRS, not U.S. GAAP, in an effort to become integrated in the world's capital markets and to attract the investment needed to finance development.

Recognizing the need to address not only domestic comparability, but also international comparability of financial information, the FASB updated its strategic plan in the 1990s. Working with the then International Accounting Standards Committee (IASC – the predecessor of the IASB) as well as national standard setters from Australia, Canada, N.Z., and the United Kingdom (U.K.), the FASB made notable progress in converging existing standards. For example, the FASB and Canadian Accounting Standards Board issued identical standards on segment reporting and accounting for business combinations, and the FASB and IASC issued similar standards on earnings per share.

Following the formation of the IASB, the IASB and FASB in 2002 issued a Memorandum of Understanding (MOU) formalizing the two accounting standard setting bodies' commitment to converging their standards. Then, in April 2005, the call for a single set of high quality globally accepted accounting standards intensified when the Securities Exchange Commission (SEC) issued its Roadmap for Convergence. The IASB and FASB responded to the Roadmap's challenge to enhance convergence by issuing an updated MOU in February 2006. The new MOU reiterated the Boards' commitment to converging their standards and was accompanied by a revised work program for 2006-2008 aimed at achieving this goal.

2. WHAT IS THE SEC CURRENTLY PROPOSING?

What is currently required for a non-domestic SEC registrant?

Under current SEC rules, foreign companies listed in the U.S. must comply with the information requirements set forth in Form 20-F by the SEC. Accordingly, the financial statements furnished by foreign private issuers disclose essentially equivalent information to statements complying with U.S. GAAP. This information may be presented in two ways. The foreign company may prepare either complete U.S. GAAP statements or statements based on its domestic GAAP or IFRS, but include a reconciliation of reported net income and shareholders' equity to U.S. GAAP.

In their '20-F reconciliation,' companies following the latter option, begin with national GAAP/IFRS net income (shareholders' equity) and then list each material difference with U.S. GAAP and indicate its numerical impact on income (equity). The reconciliation ends with total income (equity) according to U.S. GAAP. A verbal description of each material difference listed in the reconciliation is also provided to concisely explain how the national GAAP/IFRS utilized by the company differs from U.S. GAAP. Furthermore, the SEC requires foreign registrants filing under national GAAP or IFRS to provide certain U.S. GAAP disclosures.

A foreign private issuer must file its annual report, including financial statements reconciled to U.S. GAAP as appropriate, with the SEC six months after its year end. Alternatively, U.S. headquartered companies file with the SEC within 60 to 90 days following their year end.

What would the SEC proposal and concept release change?

The SEC Roadmap for Convergence details the steps that should occur before the elimination of the 20-F net income and shareholders' equity reconciliations for foreign issuers reporting under IFRS. One of the key steps noted is the evidence of sufficient progress in converging IFRS and U.S. GAAP. A SEC[a] proposal and request for comment regarding elimination of the reconciliation for foreign registrants reporting under IFRS 'as issued by the IASB' followed in July 2007. Then, in August 2007, the Commission issued a concept release posing questions aimed at determining whether U.S. headquartered registrants should also be provided with the option to report under IFRS.[b]

3. WHY IS CONVERGENCE IMPORTANT TO INVESTORS?

Among other things, the SEC Roadmap for Convergence highlights the importance of convergence. Converged standards would:

- enhance comparability and enable investors to compare 'apples to apples' as opposed to 'apples to oranges'
- reduce regulatory compliance costs without undermining investor protection or impairing market information and make it significantly less costly for non-domestic companies to access U.S. markets
- promote global financial market competitiveness while improving the information available to investors.

These and other dimensions of convergence are discussed in the following sections.

4. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD SUPPORT THE ELIMINATION OF THE RECONCILIATION REQUIREMENT?

#1 Eliminating the reconciliation is key to maintaining the premier status of U.S. markets. Doing away with the reconciliation would remove unnecessary costs and remove a barrier for foreign issuers wishing to access U.S. markets.

About 1,150 of the 13,000 SEC registrants are foreign issuers. Combined with the costs associated with complying with the requirements of other regulations, including

Sarbanes-Oxley, some allege the 20-F reconciliation requirement makes a U.S. listing costly for foreigners and is viewed as onerous by them. Thus, the current U.S. regulatory environment has prompted some foreign companies to exit U.S. markets. Moreover, few new foreign listings are materializing as other sources of capital increasingly provide alternatives to the U.S. markets. With IFRS widely accepted throughout the world, the attitude of some has become: Why bother to reconcile IFRS with U.S. GAAP?

In response to this alleged crisis, a study commissioned by political leaders in New York suggests the city (NYC) may lose its status as the world financial center within ten years unless a major shift in regulation and policy occurs. *Sustaining New York's and the US' Global Financial Service Leadership*[c] is based on analyses of market conditions in the U.S. and abroad and draws from interviews with more than 50 leaders representing the financial services industry, consumer groups, and other stakeholders. The findings indicate that NYC financial markets are becoming stifled by stringent regulations and high litigation risks. Among the high-priority goals set forth in the report as a 'national agenda' is the recognition of IFRS without reconciliation for foreign SEC registrants and the promotion of global convergence of accounting (and auditing) standards.

At a Roadmap Roundtable hosted by the SEC on March 6, 2007, some observers noted that the companies, investors, rating agencies, accounting firms, and others spoke 'in one voice' encouraging the SEC to eliminate the reconciliation to U.S. GAAP provision as soon as possible.[d] Roundtable participants indicated that the main benefit of this elimination would be a significant reduction of costs for some companies. They believe the reconciliation imposes costs in terms of ease, timing, and ability of foreign private issuers to come to the U.S. markets. During the Roundtable, the CFO of AXA indicated preparing the annual 20-F reconciliation for his company cost approximately $25 million.

The NYC report reiterates that doing away with the reconciliation without delay would eliminate unnecessary costs and remove a barrier for foreign issuers. This action, it is alleged, would clearly communicate to the global financial services community that the U.S. respects and honors approaches developed outside its borders. Eliminating the reconciliation in conjunction with accelerating convergence of accounting (and auditing) standards would unleash the potential to improve U.S. markets and facilitate access to them by non-domestic companies using IFRS. The NYC report's authors also indicate that following the report's recommendation of eliminating the reconciliation without delay would yield substantial benefits with few discernable offsetting costs. Furthermore, accelerating the convergence of two sets of high quality accounting standards will make it significantly less costly for non-domestic companies to access U.S. markets, and, in so doing, improve the international competitiveness of the U.S. as a financial center. Finally, the NYC report's authors believe that the ensuing reduction in regulatory compliance costs can be achieved without undermining investor protection or market information.

#2 IFRS are robust, 'principles-based' standards suitable for the U.S. market and are preferred by some investors over U.S. GAAP.

According to the NYC report, interviews conducted with business leaders reveal the need to accelerate convergence as well as the need to remove the unintended consequences of the 'rules-based' approach of U.S. GAAP, which can produce financial reporting that differs from economic reality. Surveyed business executives believe the need to reconcile to the 'principles-based' IFRS, which is accepted by almost every other major country other than the U.S., is unnecessary given the quality of IFRS and its widespread adoption.

Some members of the Roadmap Roundtable investors' panel indicated they were not really using the reconciliation and to some extent preferred IFRS to U.S. GAAP. Some stated that they had essentially already moved to analytic models that do not incorporate the reconciliation. For many industries and peer groups, IFRS is the most common accounting standard, so to understand that industry or sector, analysts must know IFRS. Indeed, institutional investors sometimes 'reconcile' U.S. GAAP to IFRS to facilitate comparisons and make investment decisions. According to Dzinkowski, of the 165 foreign companies rated by Moody's, only 13 have analysts within the U.S while the others are covered by foreign analysts, who neither need nor want reconciliation.[e] Many interested parties rely on foreign comparables, information that is not provided by U.S. GAAP.

#3 Removal of the reconciliation should not result in the loss of any investor or market protections afforded by underwriters, securities counsel, or auditors.

Some Roadmap Roundtable participants do not expect removal of the reconciliation to impact investors or change the way securities are priced. As noted above, for due diligence, credit rating and other purposes, most capital market players are comfortable relying on IFRS alone when engaging in transactions with foreign private issuers. Thus, Roundtable participants believe that the removal of the reconciliation should not result in the loss of any investor or market protections afforded to them by underwriters, securities counsel (and other similarly situated parties) or auditors. While the reconciliation may keep foreign issuers out of U.S. markets, some allege it is not facilitating the offering work done by other participants in the capital raising process.

#4 Reconciliation delays the release of information to U.S. investors.

A Roadmap Roundtable panel representing the investor community indicated that the timeliness of information is critical. Thus, to the extent that the reconciliation slows the availability of information to U.S. investors, it operates counter to their interests. Presently, foreign private issuers are not required to file Form 20-F with the SEC until six months after their fiscal year end. Filing deadlines for U.S. issuers, alternatively, range from 60 to 90 days. Since reconciling can be a time-consuming endeavor, the requirement to provide the reconciliation is frequently held out as one of the justifications for the extra filing time allowed foreign private issuers. In their quest for timely information, some Roundtable participants indicated that large institutional investors and analysts, and perhaps credit rating agencies, turn to foreign private issuer's home markets.

#5 With the reconciliation in place, U.S. investors may be missing out on important investment opportunities.

A critical concern by some at the Roadmap Roundtable was that the reconciliation is keeping foreign private issuers from bringing transactions to the U.S. markets. As a result, U.S. investors are denied possibilities they might otherwise have to invest in foreign capital. Thus, the reconciliation may be detrimental to not only foreign private issuers, who cannot tap the liquidity and depth of the U.S. markets, but also for U.S. investors, as they have fewer options in terms of the investment decisions they might select. Ultimately, the results of the reconciliation may make the U.S. markets disadvantaged as well.

This arguably holds true not only for institutional investors but also for some retail investors who are highly interested in securities of foreign companies that are not available in the U.S. markets. If these retail investors choose to go overseas to attain more investment opportunities, they do so without the coverage of the U.S. federal securities laws. Thus, the reconciliation may be imposing an indirect cost that appears difficult to justify.

5. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD BE CONCERNED ABOUT THE ELIMINATION OF THE RECONCILIATION REQUIREMENT?

#1 Significant differences between IFRS and U.S. GAAP remain. IFRS and U.S. GAAP are not comparable.

In a recent interview, IASB Chair Tweedie[f] predicts that by '2011–12, U.S. and international accounting should be pretty much the same - with 150 countries using IFRS and several others using U.S. GAAP. That adds up to about 170 countries accounting in much the same way.' However, despite Tweedie's optimism, research indicates the convergence of U.S. GAAP and IFRS is at an early stage.

A few studies have examined the materiality of differences between International Accounting Standards (IAS)/IFRS and U.S. GAAP as reflected in 20-F reconciliation adjustments, but findings from the initial studies should be viewed cautiously as IAS/IFRS numbers have historically not been widely reported in terms of, and thus reconciled to, U.S. GAAP. Street, Nichols, and Gray[g] and Blanco and Osma[h] examined the net income 20-F reconciliations of a small number of companies using IAS to access

U.S. markets prior to 2001. Both studies suggest that IAS and U.S. GAAP were converging. However, more recent research on larger samples suggests a different story.

With the widespread adoption of IFRS by the EU member states, Australia, and others, the significance of 20-F adjustments by larger numbers of 'IFRS-based' SEC registrants is under investigation. Street, Gray, and Linthicum[i] find that adoption of IFRS in 2005 resulted in divergence, as opposed to convergence, with U.S. GAAP for 135 European companies listed in the U.S filing 'IFRS-based' financial statements. During the pre-IFRS period of 2002-2004, European and U.S. GAAP net income measures were generally comparable (not significantly different). However, following the switch to IFRS in 2005, IFRS net income was significantly higher than U.S. GAAP net income. Furthermore, the gap between 2004 IFRS and U.S. GAAP net income significantly exceeded the difference between European GAAP and U.S. GAAP net income. These findings are in line with Gray and Morris[j] who find that the move to IFRS in 2005 resulted in significantly higher net profits under IFRS as compared to Australian GAAP.

A recent survey by Citigroup yields similar results, thereby supporting the conclusion that 'the glut of differences between the two sets of standards causes major swings.'[k] For 73 European SEC registrants, the 2005 and 2006 20-F reconciliations contain 426 reconciling differences with most of the reconciling items attributable to the treatment of tax, pensions, goodwill and intangible assets, and financial instruments. Eighty-two percent of the companies had higher net income under IFRS, with IFRS net income, on average, being 23 percent higher than U.S. GAAP net income (based on the mean). The median IFRS net income was about six percent higher under IFRS.

While the survey covers only two years, Citigroup concludes that the median is dropping, thereby indicating some differences are being removed. Yet, book value for 70 percent of the companies surveyed is lower under IFRS. On average, IFRS returns on equity are much higher. Citigroup stressed that in breakdowns of book value and equity returns, U.K. companies topped the tables of European companies showing the biggest divergences. For example, BSkyB (84.1 percent), GlaxoSmithkline (72.9 percent), Imperial Tobacco (61.5 percent), and National Grid (55.8 percent) had book values significantly lower than the U.S. GAAP equivalent. In terms of the largest differences for return on equity, nine of the top 15 were U.K. based. For example, BSkyB, which headed the list, had a 382 percent increase in return on equity under IFRS.

Citigroup, thus, concludes that the 'differences could well result in investors and/or analysts arriving at different conclusions about the financial position and performance of business depending on the GAAP used.' Citigroup further indicates that it appears that 'if U.S. companies were given the option to use IFRS rather than U.S. GAAP then this would provide a boost to book earnings and returns.'

#2 The 20-F reconciliation includes valuable information that would be lost after its elimination.

In *The Roadmap to Convergence: U.S. GAAP at the Crossroads* S&P's Bukspan and Joas[1] present an alternative view to the Roadmap Roundtable participants' perspective and state that it is premature to drop the reconciliation before U.S. GAAP and IFRS are fully converged. According to these authors, the 20-F reconciliation guides analysts between different accounting conventions and provides a better appreciation of how accounting differences are evident under varying reporting regimes. In the absence of convergence, the reconciliation serves as a 'useful tool for aiding comparisons among global peers, particularly as IFRS is still in its infancy in terms of its application and interpretation.' Without the reconciliation, analysts and other financial statement users would have to rely more on disclosures, thereby calling into question the robustness of current IFRS requirements.

Bukspan and Joas reference an earlier S&P study that highlights 'significant variations in the quality and types of IFRS disclosures' and concludes that many of the disclosures are boilerplate and, thus, lacking in the analytical information needed to gain a full appreciation of the underlying assumptions and risks. This S&P report's conclusion is consistent with reports issued by SEC staff (see www.sec.gov/divisions/ corpfin/ifrs_staffobservations.htm) as well as the U.K. Financial Reporting Review Panel (see http://www.frc.org.uk/images/ uploaded/documents/ IFRS%20Implementation%20-20preliminary.pdf) based on their regulatory reviews of IFRS accounts. According to Bukspan and Joas, the overall SEC staff report emphasizes the need for robust and consistent disclosures that analysts view as 'essential in fostering a transparent, principles-based reporting environment.'

Bukspan and Joas also contend that the SEC review of 100 IFRS reports filed for fiscal year 2005 draws attention to other reasons to improve IFRS disclosure requirements before eliminating the reconciliation. They refer to problems associated with 'scant guidance' on financial statement presentation; different accounting treatments for merger recapitalizations, reorganizations, acquisitions of minority interests, and insurance contracts; auditors signing-off on home country-based IFRS (as opposed to IFRS as issued by the IASB); and SEC requests for additional disclosures related to revenue recognition, intangible assets and goodwill, policies for evaluating impairments, leases, and contingent liabilities.

#3 IFRS are not being faithfully and consistently applied throughout the world.

The SEC request for comment and proposal poses the question of whether there is sufficient comparability among companies using IFRS 'as published by the IASB' to allow investors and others to use and understand financial statements prepared in accordance with IFRS without a reconciliation. This question is somewhat challenging to address in that, as acknowledged by the Commission, for most of the approximately 200 companies filing fiscal year 2005 20-F's 'based on IFRS,' the auditor did not opine on IFRS 'as issued by the IASB.' The studies referred to in the following paragraphs are, accordingly, based on accounts opined on as 'IFRS-based' (i.e. IFRS as endorsed by the EU, etc.) as well as IFRS 'as issued by the IASB.' No distinction was made in the sample selection by the authors.

Reviews of fiscal year 2005 IFRS statements by academics and regulators indicate that the answer to the SEC question may be 'no.' While generally promising, these reviews indicate problems with emerging 'flavors of IFRS,' thereby suggesting that a substantial learning curve exists for many 1st-time IFRS adopters.

Academic research indicates the degree of compliance with IAS/IFRS by early, 'voluntary' adopters was mixed and somewhat selective.[mnop] Street and Bryant find that, for early adopters, the extent of compliance with IAS was greater for companies with U.S. listings than for companies without U.S. listings. Similarly, Street and Gray find greater levels of compliance with IAS-required disclosures for companies with non-regional listings (including most notably U.S. listings), companies referring exclusively to the use of IAS in their accounting policy notes, and companies audited by, what was at the time, a Big 5+2 accounting firm. These early studies support the SEC position that consideration should only be given to dropping the reconciliation for companies using IFRS 'as issued by the IASB.' This position is further endorsed in a comment letter to the SEC prepared by the FASB's Investors Technical Advisory Committee.

It is important to stress that Glaum and Street[q] identified significant non-compliance by companies listed on Germany's now defunct Neuer Market not only for IAS accounts but also for U.S. GAAP accounts. Their study, therefore, indicates the key issue is enforcement of standards and not the quality of the accounting standards used. Companies listed on the Neuer Market were required to prepare either IAS or U.S. GAAP accounts. Thus, the use of internationally recognized standards was mandatory as opposed to voluntary, yet compliance, on average, was problematic.

Following the required adoption of IFRS in the EU and elsewhere in 2005, researchers began to examine larger samples of IFRS accounts. Their findings again reveal implementation problems. For example, Glaum, Street, and Vogel[r] conducted an assessment of the 2005 merger and acquisition disclosures of companies comprising the premium segments of 17 major European exchanges (see www.pwc.de/en/ma-ifrs-survey2005). Their analysis uncovers several areas in need of notable improvement. Thus, these authors conclude that the understandability and information content of IFRS merger and acquisition disclosures needs to improve to enhance transparency and comparability. The findings of Glaum, Street, and Vogel are in line with those of regulatory reviews of 2005 IFRS accounts by, among others, the SEC (see www.sec.gov/divisions/corpfin/ ifrs_staffobservations.htm) and U.K. Financial Reporting

Review Panel (see http://www.frc.org.uk/images/ uploaded/documents/ IFRS%20Implementation%20-20preliminary.pdf.

In a study of 2005 disclosures provided by companies comprising the premier segments of 20 European exchanges, Faßhauer, Glaum, & Street[s] uncover a number of cases where companies omit certain relevant IAS 19 pension disclosures. They also identify a troubling number of boilerplate disclosures and vague, shallow disclosures. Their findings regarding boilerplate and vague disclosures are in line with concerns expressed by the U.K. Financial Reporting Review Panel based on its review of IAS 19 disclosures provided in 2005 accounts by a small sample of U.K. companies (see http://www.frc.co.uk/images/uploaded/documents/010806%20-%20final% 20report.pdf).

The regulatory reviews of IFRS accounts noted above are uncovering examples of non-compliance in addition to raising questions regarding the quality of the disclosures provided. A notable area of concern is whether various banks complied with IAS 39, in determining loan impairment. SEC discussions on this topic are ongoing (see http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm), and CESR has posted information regarding several regulatory rulings regarding the issue on its website (see http://www.cesr-u.org/index.php?page=home_details&id=209).

A review of the accounts of 284 companies by the U.K. Financial Reporting Review Panel resulted in 49 companies being obliged to undertake alterations to financial reporting policies. In February 2007, the U.K. Financial Services Authority issued *Financial Risk Outlook 2007*[t] highlighting potential risks stemming from, among other things, the move to IFRS. Inconsistent national application was noted as a major risk to the continued success of IFRS. Specifically, the U.K. report states:

> With regard to inconsistency, the true benefit of IFRS can only be realised through enabling a better comparison of similar entities across national boundaries, which, in turn, will provide enhanced transparency for markets and a more efficient global capital market. We also acknowledge that, under a principles-based accounting framework, there may be relevant economic and legal differences between countries such that similar transactions might legitimately be reported in different ways. However, should local custom or national interest operate to threaten the consistent application of IFRS, much of this anticipated benefit could be lost.
>
> There is a great deal of work being undertaken internationally to ensure that IFRS is implemented in a way that is both consistent and responsive to local economic differences. However, judging whether or not this balance is being successfully achieved will only be possible after one or two more years have passed.

#4 Removing the reconciliation should be delayed until foreign issuers, audit firms, and other constituents have more experience with preparing IFRS statements.

IFRS implementation problems may be linked to, among other things, an inconsistent and fragmented international auditing environment. Bukspan and Joas state that harmonizing international auditing standards and ensuring consistent compliance with these standards are key to developing confidence in any accounting framework. In the same vein, SEC Director of Corporation Finance, White[u] indicates that 'The auditing point is another very critical one ... that clearly must be considered in any comprehensive conversation about convergence and ending reconciliation.'

Wyatt[v] posits that 'maybe we are not so close to having a single set of accounting standards around the world. And, maybe we are even further from having an acceptable international financial reporting regime that would add credibility to financial statements that investors rely upon for their investment decisions.' He calls for 'patience by all parties to permit the overall environment to become appropriate for a successful transition to the utilization of truly international accounting standards.' Wyatt's five facets to achieving 'effective' convergence include effective accounting standards combined with relevant education and understanding, effective regulatory regimes, a suitable political environment, and as stressed in both the NYC report and by Bukspan and Joas, effective auditing standards.

Wyatt explains that while considerable progress has been made by the International Federation of Accountants (IFAC) in developing International Standards of Auditing (ISA), the application of these standards is affected by cultural and environmental forces that vary across countries. Reconciling these differences will not be easy. The existence of a solid set of generally accepted auditing standards will not, therefore, necessarily result in consistent application of those standards globally. It remains an open question as to how regulators in different countries will address variations in audit practice that have lead to inconsistent application and implementation of IFRS.

#5 U.S. accountants and auditors are not adequately versed in IFRS.

Wyatt explains that, regardless of the quality of IFRS, effective implementation cannot be achieved until accounting practitioners, both in public and private practice, in countries all around the world, achieve a degree of understanding of those principles that enable their application in practice. Since we currently do not have a set of accounting standards on which broad agreement has been reached, we do not have the textbooks necessary to convey those standards to students and other interested parties. In the U.S., Wyatt notes that universities do not have courses devised to assist in this educational process. While the development of the necessary educational materials and course curricula should not require a lengthy time period, the process is highly unlikely to commence until IFRS are further along in their development stage.

Wyatt estimates that the various requirements of the educational process will not get underway globally in any concerted fashion until the IASB determines that it has an effective set of standards and securities regulators around the world deem these standards to be acceptable. At that point, we are probably looking at a three to seven year changeover from current educational processes to the introduction of new curricula. While the large accounting firms and publicly-owned companies may be able to re-educate their employees in a somewhat shorter time period, the process for an international company will require planning and dedication to retraining.

In a bulletin describing the move to IFRS in Canada, the Canadian Accounting Standards Board stresses that such a transition from national GAAP to IFRS requires education, not only for auditors and in the universities, but also for public companies, their investors, lenders, and advisors. The need for a comparable transition period prior to acceptance of IFRS in the U.S. should not be overlooked by the SEC or taken lightly.

#6 Convergence, particularly the work of the IASB and FASB, will most likely be impeded if the reconciliation is dropped prematurely.

Street and Linthicum[w] consider whether it is conceivable that eliminating the reconciliation now would stall convergence efforts of the IASB and FASB, especially since the EU's incentive to achieve convergence and comparability with U.S. GAAP, as well as its support for the continued improvement of IFRS, may disappear with the reconciliation. While stressing the importance of convergence, the SEC is adamant that the IASB and FASB should not focus on eliminating differences between accounting standards needing significant improvement. Instead the Boards should cooperate and develop new requirements in areas where both sets of standards require improvement. SEC Deputy Chief Accountant Erhardt[x] has specified that the Boards should 'tackle the toughest, most intractable and problematic standard setting issues' such as financial instruments, performance reporting, revenue recognition, pensions, leases, and consolidation policy. The IASB and FASB accepted this challenge in the 2006 update of their Memorandum of Understanding by revising their joint work program with the goal of making significant progress in the development of new joint standards to address the areas highlighted by Erhardt.

While the efforts of the IASB and FASB to address the SEC's desire to 'advance the frontiers of accounting' are clearly in the best interest of investors, Street and Linthicum point out that one can question whether the Boards' work program is in favor with the EU. For example, EU Commissioner for the Internal Market and Services McCreevey[y,z] stated that convergence cannot be allowed to destabilize the IFRS platform in Europe and, cautioned that convergence is not an invitation for standard setters to advance the 'theoretical frontiers' of accounting. 'Revolutionary' new standards will not be acceptable as the 'IFRS train' has just 'left the station.' While the SEC has not suggested a timetable for addressing the issues noted by Erhardt, the implication is that IFRS and U.S. GAAP must improve. It is feasible that McCreevey's stable platform may hinder the improvement desired by the SEC as his message to the IASB contradicts the SEC position.

It is important to acknowledge that the IASB responded to concerns expressed by European and other IFRS adopters that the Board was moving too fast in the development of new standards. To assist 'adoption of IFRS and reinforce consultation,' in 2006, the IASB announced that no new standards will be effective until 2009, thereby providing four years of stability in the IFRS platform for companies adopting IFRS in 2005. The IASB stresses that establishment of this approach does not preclude issuance of new standards before that date. IASB Chair Tweedie explains that the policy is directed at assisting those involved with IFRS implementation throughout the world, while concurrently enabling the IASB to make progress on its contribution toward eliminating the need for 20-F reconciliation requirements by 2009. From the perspective of the U.S. investor, a key issue, however, remains. If the reconciliation is dropped, will EU and other non-U.S. registrants adequately implement the new international standards that become effective in 2009? Or, will there again be implementation and compliance issues in line with those identified based on reviews of 2005 accounts?

Another concern pointed out by Larson and Street is the onerous and ever expanding EU endorsement process.[aa] The NYC report states that elimination of the reconciliation without delay would communicate to the global financial services community that the U.S. respects and honors approaches developed outside its borders. However, as discussed by Street and Linthicum, the EU endorsement process suggests a similar view may not be shared in Europe. Even with the reconciliation in place and some U.S. GAAP disclosures required for foreign registrants (including segment reporting requirements), the IASB's decision to adopt U.S. segment reporting requirements in IFRS 8 sparked opposition. In April 2007, the Economic and Monetary Affairs Committee of the European Parliament[bb] proposed a Parliamentary resolution calling on the EC to conduct a thorough assessment of the impact prior to endorsing IFRS 8. Among the concerns expressed was that adoption of IFRS 8 'would import into EU law an alien standard without having conducted any impact assessment.' In response, the EC announced that a vote on IFRS 8 would be delayed.

Another example of the EU endorsement process hindering convergence is IAS 39. Despite a SEC warning that 'watering down' IAS 39 could hinder convergence,[cc] the EU went forward with a 'carve out' of IAS 39. With the EC willing to block convergence efforts by modifying IFRS for use in Europe with the reconciliation in place, how much bolder will the Commission become post-reconciliation?

The EU's endorsement process to determine whether each IASB standard will be approved for use in the EU will likely continue to produce variations between IFRS 'endorsed by the EU' and IFRS 'as issued by the IASB.' While the SEC is adamant that the reconciliation will be dropped only for companies using IFRS 'as issued by the IASB,' careful consideration should be given to the conflicting objectives of the SEC and EU prior to eliminating the reconciliation. As a major IASB constituent, the impact of EU lobbying on the development of IFRS should not be underestimated.

At the Roadmap Roundtable, investors also connected convergence with reconciliation. They generally support removing the reconciliation, except in the case where its elimination would cause convergence to cease. It is, therefore, worthy for one to consider what would be the incentive for convergence once the reconciliation takes place. Given the existence of differing global views, one should also ponder whether the IFRS of the future will be 'principles-based.'

6. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD SUPPORT PERMITTING U.S. COMPANIES TO USE IFRS?

#1 For U.S. companies in certain industries, IFRS would enhance comparability with competitors.

Deloitte's Gannon, Sogoloff, and Madla[dd] state that U.S. companies, if permitted, may consider IFRS if their significant competitors report under IFRS (i.e. companies in the banking, insurance, motor vehicle manufacturing, pharmaceutical, and telecommunications industries). According to these authors, comparability in reporting would level the playing field, thereby providing investors an 'apples-to-apples' perspective when comparing results.

#2 IFRS presents several opportunities to U.S. companies that operate globally.

Gannon, Sogoloff, and Madla further explain that IFRS offers U.S. companies, particularly those operating globally, several potential opportunities, including:

- Standardization of Accounting and Financial Reporting Policies – A consistent set of accounting policies and financial statements in each country where local reporting is required improves comparability of financial information and tax planning.
- Centralization of Processes – By moving toward company-wide IFRS use, a company could reduce reliance on local accounting resources for statutory reporting purposes, develop standardized training programs, and eliminate divergent accounting systems.
- Improved Controls – Standardized reporting would allow companies to assign one worldwide owner for statutory reporting, yielding better control over the quality and issuance of financial statements in other locations.
- Better Cash Management – Dividends that can be paid from subsidiaries may be based on local financial statements. Allowing use of a consistent standard across countries can help improve cash flow planning.

#3 Elimination of the reconciliation should be paired with allowing U.S. registrants to use IFRS. Otherwise, some U.S. companies, particularly those in certain industries, may be at a competitive disadvantage.

According to BDO's Johnson, unless allowed the same option to use IFRS, dropping the reconciliation could put U.S. companies at a competitive disadvantage.[ee] For example, IFRS and U.S. GAAP revenue recognition rules differ for the tech industry. Under IFRS, a company can report revenue growth faster than a U.S. company. This is due to the 'principles-based' nature of IFRS, which provides more flexibility in regard to when companies recognize revenue. This is especially important for emerging tech companies because customers, investors, and analysts view revenue recognition as the easiest way to comprehend such a company's worth. Thus, even though two companies could have the same product and similar financial health, customers may view them differently because of the U.S. GAAP company's delay in revenue recognition. Therefore, given the option, U.S.-based tech companies may consider moving to IFRS to avoid competitive disadvantage.

Following a similar line of thinking, at the Roadmap Roundtable, Phillip Jones, Director of External Reporting and Accounting Policies and Procedures at Dupont, referred to his company's willingness to see the reconciliation end. However, from a competitive point, Jones suggests that U.S. issuers should be afforded the same opportunity to report in IFRS.

The SEC's White[ff] shares that he has heard the same from a number of finance and accounting executives at large, multinational corporations in the U.S. These multinationals are already using IFRS for various reasons, whether at their international subsidiaries or for reporting purposes with various regulators in other jurisdictions. They hold that reporting under IFRS in their SEC filings could improve disclosure and reporting processes overall in terms of transparency and internal consistency.

7. WHAT ARE THE MAIN REASONS THAT SOME PARTIES HAVE CITED AS TO WHY INVESTORS SHOULD BE CONCERNED ABOUT PERMITTING U.S. COMPANIES TO USE IFRS?

#1 Allowing U.S. companies to use IFRS may be followed by elimination of U.S. GAAP. This contradicts with the general sentiment in the U.S. that we should maintain control of establishing accounting standards utilized by U.S. companies.

Bukspan and Joas state that the SEC's willingness to explore giving U.S. companies a choice between IFRS and U.S. GAAP may 'be interpreted as a not-so-gentle nudge toward a looming exit for U.S. GAAP, and could bring a sea of change for the future role of U.S. GAAP and of the FASB.' Indeed at the Roadmap Roundtable, former SEC Chief Accountant Nicolaisen shared his belief that eventually U.S. registrants should be required to report under IFRS.[gg] At the Annual Conference of the International Organization of Securities Commissions, SEC Commissioner Campos[hh] further explored the possibility of not only allowing, but requiring, U.S. companies to use IFRS. Campos stated that over the long-term, it is difficult to argue that one set of accounting standards is anything other than an ultimate target.

In May 2007, a poll was taken at the Financial Services Executives Forum in NYC, which was attended by several hundred CFOs and other finance professionals. The results reveal that a vast majority are willing to accept an IFRS-based standard or a converged set of standards. However, when asked if they are prepared to give up control of establishing accounting standards, 68 percent responded no and another seven percent was unsure. Bukspan and Joas believe the latter likely reflects the U.S. sentiment in general, given the historical strength of the U.S. capital markets relative to global markets. Despite the shortcomings of U.S. GAAP, these authors believe that the U.S. market may not be prepared to embrace a completely new set of standards that are in an evolutionary stage, yet to be tested, and to which the market will have to get accustomed.

Based on responses by 142 members of the American Association of Individual Investors to their survey, McEnroe and Sullivan[ii] report that the attitudes of individual investors are in line with studies highlighting potential negative consequences linked to the elimination of the reconciliation. Their study finds that U.S. individual investors are very much in favor of foreign listings on U.S. exchanges. However, individual investors endorse current rules requiring either the use of U.S. GAAP or the reconciliation. A large majority of the individual investors believe the U.S. should maintain control of accounting standards used for U.S. listings. A smaller majority believe there should be a global set of accounting principles for all stock exchanges.

#2 Requiring U.S. companies to use IFRS will limit the influence of the FASB, SEC, and other U.S. organizations in shaping the accounting standards used by U.S. and other companies accessing the U.S. markets.

Tarca[ii] describes the impact of adoption of IFRS in Australia, which historically has followed a standard setting model similar to the U.S. Her major points provide a preview of what the future would likely hold for the U.S. if IFRS were adopted.

- The Australian Accounting Standards Board no longer develops standards from inception. The Board cannot independently determine the content of standards, but is constrained to ensure that Australian standards are not inconsistent with IFRS. The Board does not have control over its work program, which is aligned with that of the IASB, so that matters under consideration by the IASB are also considered by the Australian Board.
- Lobbying efforts of the corporate sector must be directed more at the IASB than the Australian Board. Australian companies have less influence in international standard setting than they had in national standard setting.
- The Federal Government is more removed from the standard setting process now that Australian standards are based on IFRS. Given the Government's support for

> harmonization with IFRS, it is unlikely to intervene in the standard setting process to allow Australian standards to be incompatible with IFRS.

As noted previously, U.S. investors, in general, apparently are not prepared to give up control of establishing accounting standards as has occurred in Australia.

Tarca's point on lobbying is consistent with Wyatt's view that, upon acceptance of IFRS, lobbying is redirected from the national standard setter to the IASB. According to Wyatt, with lobbying from 'multiple governments with differing priorities and multiple business communities with various interests to protect' pressures on the IASB will eventually exceed those ever faced by any national standard setter and make development of 'principles-based' standards a massive challenge.

#3 IFRS does not provide a comprehensive set of standards suitable for the U.S. market.

Bukspan and Joas describe IFRS as a 'work in progress' that does not cover some areas of accounting (see also Street and Linthicum). When an IFRS standard does not address a matter, IAS 8 requires companies to look to the most recent pronouncements of other standard setters. In a review of 2005 IFRS accounts, the SEC staff identified substantial variation in accounting for insurance contracts and in reporting of extractive industry exploration and evaluation activities in the absence of an extensive IFRS standard for these activities. If the reconciliation is eliminated and, more importantly, if U.S. registrants are allowed to use IFRS, the SEC should clarify what rules to follow in the absence of an IFRS. Otherwise, comparability will likely be greatly impeded.

#4 There is limited experience in preparing IFRS statements in the U.S. market. Thus, important implementation concerns should be addressed prior to allowing U.S. companies to use IFRS.

Most U.S. accountants and auditors are not trained in IFRS. Thus, as explained by Wyatt, a move to IFRS would necessitate substantial continuing professional education for those in practice as well as extensive changes in the curricula of universities. Furthermore, a move to IFRS at a rapid pace would require, among other things, investments in systems, personnel, new reporting formats, and modification to the internal control system over financial reporting.[kk] Significant costs could result from re-negotiating contracts, lending agreements and debt covenants, and compensation agreements tied to U.S. GAAP. Tax advisors, as well as regulators, would need to comprehend the implications of moving to IFRS. Following the like-sized efforts associated with implementation of Sarbanes-Oxley, such a move would likely not be welcome.

As noted by the Canadian Accounting Standards Board, in the short-term, Boards of Directors of public companies would need to ensure that a member of management, or an advisor, is responsible for reporting on a regular basis on the implications of IFRS adoption.[ll] Effort up-front would be necessary to mitigate longer-term costs and impact.

#5 Enhanced lobbying will limit the IASB's ability to maintain IFRS' status as 'principles-based.' Thus, acceptance of IFRS will not represent the desired move from the 'rules-based' approach of U.S. GAAP.

Both the NYC report and Bukspan and Joas highlight the need for convergence towards 'principles-based' as opposed to 'rules-based' accounting standards. Wyatt explains that the FASB's departure from the underlying concepts set forth in the Board's Conceptual Framework has in many instances been the result of political interference, either from disagreement with SEC thinking, or more frequently, effective lobbying by the business community signaling to the FASB that the direction of a FASB proposal would cause harm to the U.S. economy. The result is often issuance of a U.S. standard that departs from the Conceptual Framework and that accordingly is more' rules-based' than 'principles-based.'

According to Wyatt, no one understanding accounting standard setting can possibly think the IASB will be immune from the political forces that have caused the FASB so much anguish and have lead to the issuance of bad U.S. standards. He states that 'multiple governments with differing priorities and multiple business communities with various interests to protect will generate even greater pressures on the IASB than the FASB has faced.' Thus, according to Wyatt, the 'principles-based' versus 'rules-based' issue represents a red herring. Future international standards will likely look more like FASB standards than 'principles-based' standards. While 'principles-based' standards are an admirable goal, the evolution of standards, be they U.S. GAAP or IFRS, will likely continue to be influenced by forces unrelated to accounting concepts. While 'rules-based' standards will continue to be issued, Wyatt is hopeful that they will be issued on a diminished basis.

In line with Wyatt's thinking, a PwC report[mm] states that, the IASB and FASB 'fail to acknowledge other key forces that influence standard setting in the EU – specifically, the ... endorsement process at the European Commission level. Thus, the belief that IFRS are the route to global 'principles-based' standards may be flawed.

[a] SEC (2007). *Acceptance from Foreign Private Issuers of Financial Statements Prepared with International Financial Reporting Standards without Reconciliation to U.S. GAAP*, Proposed Rule. July 3. Available at: http://www.sec.gov/rules/proposed/2007/33-8818fr.pdf.

[b] SEC (2007). *Concept Release On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards* (Corrected). August 7. Available at: http://www.sec.gov/rules/concept/2007/33-8831.pdf.

[c] *Sustaining New York's and the US' Global Financial Service Leadership* (2007). Commissioned by Mayor Michael Bloomberg and Senator Charles Schumer.

[d] White, J. (2007). 'Seeing down the road: IFRS and the U.S. capital markets,' speech at NYSE/Brooklyn Law School Breakfast Roundtable, March 23.

[e] Dzinkowski, R. (2007). 'Likely no more U.S. GAAP reconciliation for foreign companies,' *Strategic Finance*, June, 47-49.

[f] Tweedie, D. (2007). 'Simplifying global accounting,' July, available at http://www.aicpa.org/pubs/jofa/jul2007/tweedie.htm.

[g] Street, D. L., Nichols, N.B, and S. J. Gray. (2000). 'Assessing the acceptability of International Accounting Standards in the U.S: An empirical study of the materiality of U.S. GAAP reconciliations by non-U.S. companies complying with IASC standards'. *The International Journal of Accounting*, 35(1): 27-63.

[h] Blanco, J.L.U., and Osma, B.G. (2004). 'The comparability of international accounting standards and US GAAP: An empirical study of Form 20-F reconciliations'. *International Journal of Accounting, Auditing and Performance Evaluation*, 1(1): 5-36.

[i] Street, D., Gray, S., and Linthicum, C. (2007). 'Global accounting convergence: Do European accounts under IFRS and U.S. GAAP provide comparable net income and shareholders' equity information?' Working Paper, University of Dayton.

[j] Gray, S. and Morris, R. (2007). 'Australia's adoption of International Financial Reporting Standards: The impact on net profits and equity' Working Paper, The University of Sydney.

[k] Jetuah, D. (2007). 'Citigroup lays out IFRS-US GAAP gulf,' *Accountancy Age*, 30 August.

[l] Bukspan, N. and Joas, R. (2007). *Roadmap to Convergence: U.S. GAAP at the Crossroads.* Standard & Poor's Commentary Report, July 16.

[m] Cairns, D. (1999). The FT International Accounting Standards Survey, (London: Financial Times).

[n] Street, D., Gray, S., and Bryant, S. (1999). 'Acceptance and observance of International Accounting Standards: An empirical study of companies claiming to comply with IAS,' *The International Journal of Accounting*, 35(1): 27-63.

[o] Street, D. and Bryant, S. (2000). 'Disclosure level and compliance with IASs: A comparison of companies with and without U.S. listings and filings,' *The International Journal of Accounting*,' 35(3): 305-329.

[p] Street, D. and Gray, S. (2001). *Observance of International Accounting Standards: Factors Explaining Non-compliance by Companies Referring to the Use of IAS*, ACCA Research Monograph.

[q] Glaum, M., Street, D.L. (2003), 'Compliance with disclosure requirements at Germany's New Market: IAS versus US GAAP,' *Journal of International Financial Management and Accounting*, 4:1, 64-100.

[r] Glaum, M., Street, D.L. and Vogel, S. (2007) *Making Acquisitions Transparent: An Evaluation of M&A-Related IFRS Disclosures by European Companies in 2005.* Sponsored by PwC, accessible at www.pwc.com/Extweb/pwcpublications.nsf/docid/1619091BABCFF3428025712D00234186.

[s] Faβhauer, J. Glaum, M. and Street, D.L. (2007). 'Adoption of IAS 19R by Europe's premier listed companies: The corridor approach versus full recognition,' working paper University of Dayton.

[t] UK Financial Services Authority. (2007). *Financial Risk Outlook 2007.*

[u] Ibid d.

[v] Wyatt, A. (2007). Address at AAA International Accounting Section Lunch, Chicago, August.

[w] Ibid i.

[x] Erhardt, J.A. (2005). "Remarks before convergence: The future of international financial reporting worldwide conference U.S. Securities and Exchange Commission," Speech by SEC staff, June 24, London, England, accessible at http://www.sec.gov/news/speech/spch062405jae.htm.
[y]McCreevey, C. (2005). Address to the Global Public Policy Symposium, October, London.
[z] McCreevey, C.(2007). Capital markets and European competitiveness, speech at European Financial Forum, Brussels, May 2.
[aa] Larson, R.K., and D.L. Street. (2006). The 'Roadmap' to global accounting convergence: Europe introduces 'speed bumps', *CPA Journal*, 2006, 36-43.
[bb] Economic and Monetary Affairs Committee of the European Parliament. (2007). Resolution RE\663584EN.doc, accessible at http://www.iasplus.com/europe/0704resolutionifrs8.pdf.
[cc] *Financial Times*. (2004). 'US warns Europe on accounting rules,' February 2.
[dd] Gannon, D.J., Sogoloff, R. and Madla, R. (2007). 'The shift toward IFRSs and its impact on U.S. companies' *Heads Up*, Deloitte newsletter August 17, 14(16):1.
[ee] Johnson, S. (2007). 'Auditor: Convergence could spur revenue wreck, Will U.S. tech companies lose out if foreign issuers can use international accounting standards to report here?' *Today in Finance* at CFO.com, August 30, assessable at http://www.cfo.com/article.cfm/9721751/c_9723616?f=home_todayinfinance.
[ff] Ibid d.
[gg] Ibid d.
[hh] Campos, R.C. (2007). Speech by SEC Commissioner: Remarks before the IOSCO conference. April 12, Mumbai, India, accessible at http://www.sec.gov/news/speech/2007/spch041207rcc.htm.
[ii] McEnroe, J.E. and Sullivan, M. (2006). 'Individual investors' attitudes towards listing requirements for foreign entities on U.S. stock exchanges and the promulgation of international accounting standards,' *Journal of International Accounting, Auditing, and Taxation*, 15 (2006) 215–225.
[jj] Tarca, A. (2005). 'Update on standard setting environment,' *In Accounting Theory Update*, editor Jayne Godfrey, John Wiley & Sons Australia Limited.
[kk] Ibid e.
[ll] AcSB. (2006) 'Accounting Standards in Canada: New Directions,' Accounting Standards Board Strategic Plan.
[mm] PwC. (2007). *Convergence of IFRS and US GAAP*, April.

APPENDIX C

FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

Prepared by

Stephen G. Ryan
Professor of Accounting and Peat Marwick Faculty Fellow
Stern School of Business, New York University

July 2008

COUNCIL OF
INSTITUTIONAL
INVESTORS

FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

prepared by

Stephen G. Ryan
Professor of Accounting and Peat Marwick Faculty Fellow
Stern School of Business, New York University

for the Council of Institutional Investors*

July 2008

---

* This white paper was commissioned by the Council of Institutional Investors for the purpose of educating its members, policy makers and the general public about the important and timely topic of fair value accounting and its potential impact on investors. The views and opinions expressed in the paper are those of Professor Ryan and do not necessarily represent the views or opinions of the Council members, board of directors or staff. Official policy positions of the Council are determined only after an extensive due process that includes approval by a vote of the Council board and membership.

FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

Table of Contents

FAIR VALUE ACCOUNTING: UNDERSTANDING THE ISSUES RAISED BY THE CREDIT CRUNCH

Executive Summary

Fair value accounting is a financial reporting approach in which companies are required or permitted to measure and report on an ongoing basis certain assets and liabilities (generally financial instruments) at estimates of the prices they would receive if they were to sell the assets or would pay if they were to be relieved of the liabilities. Under fair value accounting, companies report losses when the fair values of their assets decrease or liabilities increase. Those losses reduce companies' reported equity and may also reduce companies' reported net income.

Although fair values have played a role in U.S. generally accepted accounting principles (GAAP) for more than 50 years, accounting standards that require or permit fair value accounting have increased considerably in number and significance in recent years. In September 2006, the Financial Accounting Standards Board (FASB) issued an important and controversial new standard, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), which provides significantly more comprehensive guidance to assist companies in estimating fair values. The practical applicability of this guidance has been tested by the extreme market conditions during the ongoing credit crunch.

In response to the credit crunch, some parties (generally financial institutions) have criticized fair value accounting, including FAS 157's measurement guidance. Those criticisms have included:

- Reported losses are misleading because they are temporary and will reverse as markets return to normal
- Fair values are difficult to estimate and thus are unreliable
- Reported losses have adversely affected market prices yielding further losses and increasing the overall risk of the financial system.

While those criticisms have some validity, they also are misplaced or overstated in important respects.

The more relevant question is whether fair value accounting provides more useful information to investors than alternative accounting approaches. The answer to that question is "yes."

Some of the key reasons why fair value accounting benefits investors include:

- It requires or permits companies to report amounts that are more accurate, timely, and comparable than the amounts that would be reported under existing alternative accounting approaches, even during extreme market conditions
- It requires or permits companies to report amounts that are updated on a regular and ongoing basis
- It limits companies' ability to manipulate their net income because gains and losses on assets and liabilities are reported in the period they occur, not when they are realized as the result of a transaction
- Gains and losses resulting from changes in fair value estimates indicate economic events that companies and investors may find worthy of additional disclosures.

I. Introduction

During the ongoing credit crunch,[1] the markets for subprime and some other asset and liability positions have been severely illiquid and disorderly in other respects. This has led various (possibly self-interested) parties to raise three main potential criticisms of fair value accounting. First, unrealized losses recognized under fair value accounting may reverse over time. Second, market illiquidity may render fair values difficult to measure and thus unreliable. Third, firms reporting unrealized losses under fair value accounting may yield adverse feedback effects that cause further deterioration of market prices and increase the overall risk of the financial system ("systemic risk"). While similar criticisms have been made periodically for as long as fair values have been used in GAAP (well over 50 years), the recent volume and political salience[2] of these criticisms is ironic given that in September 2006 the FASB issued FAS 157, *Fair Value Measurements*. This standard contains considerably more comprehensive fair value measurement guidance than previously existed. It almost seems that the credit crunch was sent to serve as FAS 157's trial by fire.

This white paper explains these potential criticisms, indicating where they are correct and where they are misplaced or overstated. It also summarizes the divergent views of parties who believe that fair value accounting benefits investors and of those who believe it hurts investors. Believing in full disclosure, the author acknowledges that he is an advocate of fair value accounting, especially for financial institutions, but not a zealot with respect to fair value measurement issues such as those raised by the credit crunch. Like any other accounting system, fair value accounting has its limitations, both conceptual and practical. The relevant questions to ask are: Does fair value accounting provide more useful information to investors than the alternatives (generally some form of amortized cost accounting)? If so, can the FASB improve FAS 157's guidance regarding fair value measurement to better cope with illiquid or otherwise disorderly markets? In the author's view, the answer to each of these questions is "yes."

Section II provides useful background information about fair value accounting, the limited alternative of amortized cost accounting, and the unsatisfying current mixed-attribute accounting model for financial instruments. This section abstracts from the difficult issues raised by the credit crunch, because investors cannot properly understand these issues and their relative importance without first understanding the more basic issues discussed in this section. Section III summarizes FAS 157's fair value measurement guidance, indicating where that guidance does not address the issues raised by the credit crunch with sufficient specificity. Section IV discusses the aforementioned potential criticisms of fair value accounting during the credit crunch and provides the author's views about these criticisms. Sections V and VI summarize the reasons why some parties believe that fair value accounting benefits investors while others believe it hurts investors.

II. Background Information Abstracting from the Credit Crunch

A. Fair Value Accounting

The goal of fair value measurement is for firms to estimate as best as possible the prices at which the positions they currently hold would change hands in orderly transactions based on current information and conditions. To meet this goal, firms must fully incorporate current information about future cash flows and current risk-adjusted discount rates into their fair value measurements. As discussed in more detail in Section III, when market prices for the same or similar positions are available, FAS 157 generally requires firms to use these prices in estimating fair values. The rationale for this requirement is market prices should reflect all publicly available information about future cash flows, including investors' private information that is revealed through their trading, as well as current risk-adjusted discount rates. When fair values are estimated using unadjusted or adjusted market prices, they are referred to as mark-to-market values. If market prices for the same or similar positions are not available, then firms must estimate fair values using valuation models. FAS 157 generally requires these models to be applied using observable market inputs (such as interest rates and yield curves that are observable at commonly quoted intervals) when they are available and unobservable firm-supplied inputs (such as expected cash flows developed using the firm's own data) otherwise. When fair values are estimated using valuation models, they are referred to as mark-to-model values.

Under fair value accounting, firms report the fair values of the positions they currently hold on their balance sheets. When fair value accounting is applied fully, firms also report the periodic changes in the fair value of the positions they currently hold, referred to as unrealized gains and losses, on their income statements. Unrealized gains and losses result from the arrival of new information about future cash flows and from changes in risk-adjusted discount rates during periods. As discussed in more detail in Section II.C, current GAAP requires fair value accounting to be applied in an incomplete fashion for some positions, with unrealized gains and losses being recorded in accumulated other comprehensive income, a component of owners' equity, not in net income.[3]

The main issue with fair value accounting is whether firms can and do estimate fair values accurately and without discretion. When identical positions trade in liquid markets that provide unadjusted mark-to-market values, fair value generally is the most accurate and least discretionary possible measurement attribute, although even liquid markets get values wrong on occasion. Fair values typically are less accurate and more discretionary when they are either adjusted mark-to-market values or mark-to-model values. In adjusting mark-to-market values, firms may have to make adjustments for market illiquidity or for the dissimilarity of the position being fair valued from the position for which the market price is observed. These adjustments can be large and judgmental in some circumstances. In estimating mark-to-model values, firms typically have choices about which valuation models to use and about which inputs to use in applying the chosen models. All valuation models are limited, and different models capture the value-relevant aspects of positions differently. Firms often must apply valuation models using inputs derived from historical data that predict future cash flows or correspond to risk-adjusted discount rates imperfectly. The periods firms choose to analyze historical data to determine these inputs can have very significant effects on their mark-to-model values.

This issue with fair value accounting is mitigated in practice in two significant ways. First, FAS 157 and the accounting standards governing certain specific positions (e.g., FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which governs retained interests from securitizations) require firms to disclose qualitative information about how they estimate fair values as well as quantitative information about their valuation inputs, the sensitivities of their reported fair values to those inputs, and unrealized gains and losses and other changes in the fair value of their positions. These disclosures allow investors to assess the reliability of reported fair values and to adjust or ignore them as desired. Over time, the FASB can and surely will improve these disclosures and expand them to more positions. Second, most fair value accounting standards require fair values to be re-estimated each quarter, and so past valuation errors can and should be corrected on an ongoing and timely basis.

In principle, fair value accounting should be the best possible measurement attribute for inducing firms' managements to make voluntary disclosures and for making investors aware of the critical questions to ask managements. When firms report unrealized gains and losses, their managements are motivated to explain in the Management Discussion and Analysis sections of financial reports and elsewhere what went right or wrong during the period and the nature of any fair value measurement issues. If a firm's management does not adequately explain their unrealized gains and losses, then investors at least are aware that value-relevant events occurred during the period and can prod management to explain further. Until recently, however, managements have made relatively few voluntary disclosures regarding their fair values. Fortunately, this appears to be changing as a result of the credit crunch and other factors, as illustrated by the Senior Supervisors Group's (2008) survey of recent leading-practice disclosures.

B. The Limited Alternative of Amortized Cost Accounting

The alternative to fair value accounting generally is some form of amortized cost (often referred to over-broadly as "accrual") accounting. In its pure form, amortized cost accounting uses *historical* information about future cash flows and risk-adjusted discount rates from the inception of positions to account for them throughout their lives on firms' balance sheets and income statements. Unlike under fair value accounting, unrealized gains and losses are ignored until they are realized through the disposal, or impairment in value, of positions or the passage of time. When firms dispose of positions, they record the *cumulative* unrealized gains and losses that have developed since the inception or prior impairment of positions on their income statements.

Amortized cost accounting raises three main issues, all of which arise from its use of untimely historical information about future cash flows and risk-adjusted discount rates.

1. Income typically is persistent for as long as firms hold positions, but becomes transitory when positions mature or are disposed of and firms replace them with new positions at current market terms. This can lull investors into believing that income is more persistent than it really is.

2. Positions incepted at different times are accounted for using different historical information and discount rates, yielding inconsistent and untimely accounting for the constituent elements of firms' portfolios. This obscures the net value and risks of firms' portfolios.

3. Firms can manage their income through the selective realization of cumulative unrealized gains and losses on positions, an activity referred to as gains trading.

Issues 2 and 3 are particularly significant for financial institutions. These institutions typically hold portfolios of many positions chosen to have largely but not completely offsetting risks, so that the aggregate risks of the institutions' portfolios are within their risk management guidelines but still allow them to earn above riskless rates of return. Amortized cost accounting effectively treats financial institutions' positions as if they have no unexpected changes in value until institutions realize gains and losses on their positions. Financial institutions can easily engage in gains trading, because their positions are often quite liquid, and because one side of each of their many offsetting positions typically will have a cumulative unrealized gain while the other side will have a cumulative unrealized loss. Financial institutions can selectively dispose of the side of their offsetting positions with cumulative unrealized gains (losses), thereby raising (lowering) their net income. Because these institutions hold many offsetting positions, such gains trading can go on for many periods, possibly in the same direction.

In practice, financial report disclosures mitigate these issues with amortized cost accounting in very limited ways. For example, regarding issues 1 and 2, SEC Industry Guide 3 requires banks to disclose detailed breakdowns of their amortized cost interest revenue and expense by type of interest-earning asset and interest-paying liability. Through careful analysis of these disclosures, investors can attempt to disentangle the persistent and transitory components of amortized cost interest and to undo the inconsistent calculation of interest for different positions. This analysis can be difficult to conduct, however, because it requires investors to estimate from other information sources the average lives of banks' different types of assets and liabilities and thus when these positions likely were incepted and will mature (assuming banks do not dispose of them before maturity). Moreover, these disclosures are not required for non-banks. Regarding issue 3, all firms must disclose their realized and unrealized gains and losses on available-for-sale securities under FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, which clearly reveals gains trading for these securities. However, such disclosures are not required for most other financial assets and liabilities for which gains trading is feasible, although they could be.

Traditional bankers and other advocates of amortized cost accounting often argue that unrealized gains and losses on fixed-rate or imperfectly floating-rate positions that arise due to changes in risk-adjusted discount rates (i.e., both riskless rates and credit risk premia) are irrelevant when firms intend to hold positions to maturity, because firms will eventually receive or pay the promised cash flows on the positions. Absent issues regarding the measurement of unrealized gains and losses, this argument is clearly incorrect. Changes in risk-adjusted discount rates yield economic gains and losses to the current holders of the positions compared to the alternative of acquiring identical positions at current rates. For example, when risk-adjusted discount rates rise old assets yielding interest at lower historical rates are worth less than identical new assets yielding higher current rates. These old and new assets do not have the same values and should not be accounted for as if they do. This is true regardless of whether the firms currently holding the old assets intend to dispose of them before maturity or not.

The incorrectness of this argument is most obvious at the portfolio level, which is the right level to analyze most financial institutions. For example, if interest rates rise, then traditional banks' old assets yielding lower historical rates may have to be financed with new liabilities yielding higher current rates.

Amortized cost accounting usually is not applied in a pure fashion. Assets accounted for at amortized cost typically are subject to impairment write-downs. These write-downs can adjust the asset balance to fair value or to another measurement attribute (typically one that results in an asset balance above fair value). Depending on how impairment write-downs are measured, some or all of the fair value measurement issues discussed in Section II.A also apply to these write-downs. Moreover, additional issues arise for impairment write-downs that are recorded only if judgmental criteria are met, such as the requirement in FAS 115 and some other standards to record impairment write-downs only if the impairments are "other than temporary." Similarly, certain economic liabilities accounted for at amortized cost (e.g., most loan commitments) are subject to judgmental accruals of probable and reasonably estimable losses under FAS 5, *Accounting for Contingencies*.

C. The Unsatisfying Mixed-Attribute Accounting Model for Financial Instruments

GAAP requires various measurement attributes to be used in accounting for financial instruments. This is referred to as the "mixed attribute" accounting model.

1. Most traditional financial instruments (e.g., banks' loans held for investment, deposits, and debt) are reported at amortized cost.

    a. As just discussed, financial assets typically are subject to (other-than-temporary) impairment write-downs. Economic financial liabilities may be subject to accrual of probable and reasonably estimable losses.

2. A few financial instruments—including trading securities under FAS 115, nonhedge and fair value hedge derivatives and fair value hedged items under FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and instruments for which the fair value option is chosen under FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*—are reported at fair value on the balance sheet with unrealized gains and losses included in net income each period.

3. Two distinct hybrids of amortized cost and fair value accounting are required for other financial instruments.

a. Available-for-sale securities under FAS 115 and cash flow hedge derivatives under FAS 133 are recorded at fair value on the balance sheet but unrealized gains and losses are recorded as they occur in accumulated other comprehensive income, a component of owners' equity, not in net income.

b. Loans held-for-sale are recorded at lower of cost or fair value under FAS 65, *Accounting for Certain Mortgage Banking Activities* (mortgages) and SOP 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) that Lend or Finance the Activities of Others* (other loans).

The mixed attribute model often allows firms to choose the measurement attribute they desire for a position through how they classify the position. For example, under FAS 115 a firm may choose to classify a security as any one of trading, available for sale, or held to maturity, and thereby obtain one of three different accounting treatments. Relatedly, the SEC (2005) states "the mixed-attribute model has prompted a significant amount of accounting-motivated transaction structures."

Similar to (and in some respects worse than) amortized cost accounting, the mixed attribute model poorly describes the net value and risks of financial institutions' portfolios of financial instruments. In particular, this model can make effective risk management by these institutions appear to be speculation, and vice-versa. For example, consider a bank that acquires fixed-rate securities that it classifies as trading and that finances those securities with fixed-rate debt with the same duration and other risk characteristics, so that the bank has no interest rate risk. If interest rates rise, then the bank's trading assets will experience an unrealized loss that is recorded in net income, while its debt will experience an unrealized gain that is not immediately recognized for any accounting purpose. Hence, this bank will appear to have been speculating on interest rate movements. Conversely, consider a bank that acquires floating-rate securities and finances those securities with the same fixed-rate debt as before, so that the bank is speculating that interest rates will rise. If interest rates do rise, then the unrealized gain on the bank's debt will not be immediately recognized for any accounting purpose and so the bank will appear to be immune to interest rate risk.

Because of these severe limitations, in the author's view consistent fair value accounting for all of financial institutions' financial instruments is clearly preferable to either the current mixed-attribute accounting model or to a pure amortized cost model.[4] Because amortized costs are useful as a check on fair values and for specific types of investment and other decisions, however, the FASB should require firms to disclose the amortized costs of financial instruments. Fair value accounting with amortized cost disclosures would be essentially the reverse of the current mixed-attribute accounting model with disclosures of the fair values under FAS 107, *Disclosures about Fair Value of Financial Instruments*.

III.FAS 157

FAS 157 contains essentially all of the current GAAP guidance regarding how to measure fair values. FAS 157 does not require fair value accounting for any position; its guidance is relevant only when other accounting standards require or permit positions to be accounted for at fair value. While FAS 157 became effective for fiscal years beginning after November 15, 2007, most large financial institutions early adopted the standard in the first quarter of 2007, and so it has been applicable for these institutions during the entirety of the credit crunch. Not surprisingly, these institutions have reported a large portion of the losses resulting from the credit crunch.

This section describes the critical aspects of FAS 157's definition of fair value and hierarchy of fair value measurement inputs. It also indicates where this guidance does not deal with the issues raised by the credit crunch with sufficient specificity.

A.Definition of Fair Value

FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This definition of fair value reflects an ideal "exit value" notion in which firms exit the positions they currently hold through orderly transactions with market participants at the measurement date, not through fire sales.

"At the measurement date" means that fair value should reflect the conditions that exist at the balance sheet date. For example, if markets are illiquid and credit risk premia are at unusually high levels at that date, then fair values should reflect those conditions. In particular, firms should not incorporate their expectations of market liquidity and credit risk premia returning to normal over some horizon, regardless of what historical experience, statistical models, or expert opinion indicates.

An "orderly transaction" is one that is unforced and unhurried. The firm is expected to conduct usual and customary marketing activities to identify potential purchasers of assets and assumers of liabilities, and these parties are expected to conduct usual and customary due diligence. During the credit crunch, these activities could take considerable amounts of time because of the few and noisy signals about the values of positions being generated by market transactions and because of parties' natural skepticism regarding those values. As a result, a temporal slippage arises between the "at the measurement date" and "orderly transaction" aspects of FAS 157's fair value definition that raises practical problems for preparers of financial reports. This slippage is discussed in more detail in Section III.B.

"Market participants" are knowledgeable, unrelated, and willing and able to transact. Knowledgeable parties are not just generally sophisticated and aware of market conditions; they have conducted the aforementioned due diligence and ascertained as best as possible the fair values of the positions under consideration. FAS 157 presumes that, after conducting these activities, either market participants are as knowledgeable as the firms currently holding the positions or they can price any remaining information asymmetry. The standard does not contemplate the idea that information asymmetry between the current holders of positions and potential purchasers or assumers of positions is so severe that markets break down altogether, as appears to have effectively occurred for some positions during the credit crunch.

B. Hierarchy of Fair Value Measurement Inputs

FAS 157 creates a hierarchy of inputs into fair value measurements, from most to least reliable. Level 1 inputs are unadjusted quoted market prices in active markets for identical items. With a few narrow exceptions, FAS 157 explicitly requires firms to measure fair values using level 1 inputs whenever they are available.

Level 2 inputs are other directly or indirectly observable market data. There are two broad subclasses of these inputs. The first and generally preferable subclass is quoted market prices in active markets for similar items or in inactive markets for identical items. These inputs yield adjusted mark-to-market measurements that are less than ideal but usually still pretty reliable, depending on the nature and magnitude of the required valuation adjustments. The second subclass is other observable market inputs such as yield curves, exchange rates, empirical correlations, et cetera. These inputs yield mark-to-model measurements that are disciplined by market information, but that can only be as reliable as the models and inputs employed. In the author's view, this second subclass usually has less in common with the first subclass than with better quality level 3 measurements described below.

Level 3 inputs are unobservable, firm-supplied estimates, such as forecasts of home price depreciation and the resulting credit loss severity on mortgage-related positions. These inputs should reflect the assumptions that market participants would use, but they yield mark-to-model valuations that are largely undisciplined by market information. Due to the declining price transparency during the credit crunch, many subprime positions that firms previously fair valued using level 2 inputs inevitably had to be fair valued using level 3 inputs.

As discussed in more detail in Section IV.B, while level 2 inputs generally are preferred to level 3 inputs, FAS 157 does not necessarily require firms to use level 2 inputs over level 3 inputs. Firms should use "the assumptions that market participants would use in pricing the asset or liability." When markets are illiquid, firms can make the argument that available level 2 inputs are of such low quality that market participants would use level 3 inputs instead.

If a fair value measurement includes even one significant level 3 input, then it is viewed as a level 3 measurement. FAS 157 sensibly requires considerably expanded disclosures for level 3 fair value measurements.

IV. Potential Criticisms of Fair Value Accounting During the Credit Crunch

This section discusses the three potential criticisms of fair value accounting during the credit crunch previously mentioned in Section I. It also indicates the guidance in FAS 157 that is most relevant to these criticisms and provides some factual observations as well as the author's views about these criticisms and guidance.

A. Unrealized Gains and Losses Reverse[5]

This section discusses two distinct reasons why unrealized gains and losses may reverse with greater than 50% probability. First, the market prices of positions may be bubble prices that deviate from fundamental values. Second, these market prices may not correspond to the future cash flows most likely to be received or paid because the distribution of future cash flows is skewed. For example, the distribution of future cash flows on an asset may include some very low probability but very high loss severity future outcomes that reduce the fair value of the asset.

1. Bubble Prices

The financial economics literature now contains considerable theory and empirical evidence that markets sometimes exhibit "bubble prices" that either are inflated by market optimism and excess liquidity or are depressed by market pessimism and illiquidity compared to fundamental values. Bubble prices can result from rational short-horizon decisions by investors in dynamically efficient markets, not just from investor irrationality or market imperfections.[6] Whether bubble prices have existed for specific types of positions during the credit crunch is debatable, but it certainly is possible.[7]

In FAS 157's hierarchy of fair value measurement inputs, market prices for the same or similar positions are the preferred type of input. If the market prices of positions currently are depressed below their fundamental values as a result of the credit crunch, then firms' unrealized losses on positions would be expected to reverse in part or whole in future periods. Concerned with this possibility, some parties have argued that it would be preferable to allow or even require firms to report amortized costs or level 3 mark-to-model fair values for positions rather than level 2 adjusted mark-to-market fair values that yield larger unrealized losses.[8]

If level 1 inputs are available, then with a few narrow exceptions FAS 157 requires firms to measure fair values at these active market prices for identical positions without any adjustments for bubble pricing. However, if only level 2 inputs are available and firms can demonstrate that these inputs reflect forced sales, then FAS 157 (implicitly) allows firms to make the argument that level 3 mark-to-model based fair values are more faithful to FAS 157's fair value definition.

The author agrees with the FASB's decision in FAS 157 that the possible existence of bubble prices in liquid markets should not affect the measurement of fair value. It is very difficult to know when bubble prices exist and, if so, when the bubbles will burst. Different firms would undoubtedly have very different views about these matters, and they likely would act in inconsistent and perhaps discretionary fashions. To be useful, accounting standards must impose a reasonably high degree of consistency in application.

It should also be noted that amortized costs reflect any bubble prices that existed when positions were incepted. In this regard, the amortized costs of subprime-mortgage-related positions incepted during the euphoria preceding the subprime crisis are far more likely to reflect bubble prices than are the current fair values of those positions.

2. Skewed Distributions of Future Cash Flows

Fair values should reflect the expected future cash flows based on current information as well as current risk-adjusted discount rates for positions. When a position is more likely to experience very unfavorable future cash flows than very favorable future cash flows, or vice-versa—statistically speaking, when it exhibits a skewed distribution of future cash flows—then the expected future cash flows differ from the most likely future cash flows. This implies that over time the fair value of the position will be revised in the direction of the most likely future cash flows with greater than 50% probability, possibly considerably greater. While some parties appear to equate this phenomenon with expected reversals of unrealized gains and losses such as result from bubble prices, it is not the same thing. When distributions of future cash flows are skewed, fair values will tend to be revised by relatively small amounts when they are revised in the direction of the most likely future cash flows but by relatively large amounts when they are revised in the opposite direction. Taking into account the sizes and probabilities of the possible future cash flows, the unexpected change in fair value will be zero on average.

Financial instruments that are options or that contain embedded options exhibit skewed distributions of future cash flows. Many financial instruments have embedded options, and in many cases the credit crunch has accentuated the importance of these embedded options. Super senior CDOs, which have experienced large unrealized losses during the credit crunch, are a good example. At inception, super senior CDOs are structured to be near credit riskless instruments that return their par value with accrued interest in almost all circumstances. Super senior CDOs essentially are riskless debt instruments with embedded written put options on some underlying set of assets. Super senior CDOs return their par value with accrued interest as long as the underlying assets perform above some relatively low threshold (reflecting the riskless debt instruments), but they pay increasingly less than this amount the more the underlying assets perform below that threshold (reflecting the embedded written put options). As a result of the embedded written put options, the fair values of super senior CDOs typically are slightly less than the values implied by the most likely cash flows. During the credit crunch, the underlying assets (often subprime mortgage-backed securities) performed very poorly, increasing the importance of the embedded put option and decreasing the fair value of super senior CDOs further below the value implied by the most likely outcome, which for some super seniors may still be to return the par value with accrued interest.

To illustrate this subtle statistical point, assume that the cash flows for a super senior CDO are driven by home price depreciation, and that the distribution of percentage losses is modestly skewed with relatively small probability of large losses, as indicated in the following table.

home price depreciation	*probability occurs*	*estimated loss on (value of) super senior CDO as a percentage of par value*
<10%	20%	0% (100%)
15%	40%	5% (95%)
20%	25%	20% (80%)
25%	10%	40% (60%)
30%	5%	80% (20%)

In this example, the most likely percentage loss on the super senior is 5%, which occurs 40% of the time. The expected percentage loss is a considerably larger 15%=(40%×5%) + (25%×20%) + (10%×40%) + (5%×80%), because it reflects the relatively small probabilities of large losses. The fair value of the super senior is reduced by the expected percentage loss and so is 85% of face value. Over time, this fair value will be revised upward with 60% probability, to either 95% of face value (with 40% probability) or 100% of face value (with 20% probability). The fair value will be revised downward with only 40% probability, to 80% of face value (with 25% probability) or 60% of face value (with 10% probability) or 20% of face value (with 5% probability). The expected change in fair value is zero, however, because the lower probability but larger possible fair value losses are exactly offset by the higher probability but smaller possible fair value gains. The difference between the most likely and expected change in fair value would be larger if the distribution of cash flows was more skewed.

In the author's view, it is more informative to investors for accounting to be right on average and to incorporate the probability and significance of all possible future cash flows, as fair value accounting does, than for it to be right most of the time but to ignore relatively low probability but highly unfavorable or favorable future cash flows. Relatedly, by updating the distribution of future cash flows each period, fair value accounting provides investors with timelier information about changes in the probabilities of large unfavorable or favorable future cash flows. Such updating is particularly important in periods of high and rapidly evolving uncertainty and information asymmetry, such as the credit crunch.

B. Market Illiquidity

Together, the "orderly transaction" and "at the measurement date" elements of FAS 157's fair value definition reflect the semantics behind the "fair" in "fair value." Fair values are not necessarily the currently realizable values of positions; they are hypothetical values that reflect fair transaction prices even if current conditions do not support such transactions.

When markets are severely illiquid, as they have been during the credit crunch, this notion yields significant practical difficulties for preparers of firms' financial statements. Preparers must imagine hypothetical orderly exit transactions even though actual orderly transactions might not occur until quite distant future dates. Preparers will often want to solicit actual market participants for bids to help determine the fair values of positions, but they cannot do so when the time required exceeds that between the balance sheet and financial report filing dates. Moreover, any bids that market participants might provide would reflect market conditions at the expected transaction date, not the balance sheet date.

When level 2 inputs are driven by forced sales in illiquid markets, FAS 157 (implicitly) allows firms to use level 3 model-based fair values. For firms to be able to do this, however, their auditors and the SEC generally require them to provide convincing evidence that market prices or other market information are driven by forced sales in illiquid markets. It may be difficult for firms to do this, and if they cannot firms can expect to be required to use level 2 fair values that likely will yield larger unrealized losses.

In the author's view, the FASB can and should provide additional guidance to help firms, their auditors, and the SEC individually understand and collectively agree what constitutes convincing evidence that level 2 inputs are driven by forced sales in illiquid markets. The FASB could do this by developing indicators of market illiquidity, including sufficiently large bid-ask spreads or sufficiently low trading volumes or depths. These variables could be measured either in absolute terms or relative to normal levels for the markets involved. When firms are able to show that such indicators are present, the FASB should explicitly allow firms to report level 3 model-based fair values rather than level 2 valuations as long as they can support their level 3 model-based fair values as appropriate in theory and with adequate statistical evidence. Requiring firms to compile indicators of market illiquidity and to provide support for level 3 mark-to-model valuations provides important discipline on the accounting process and cannot be avoided.

Relatedly, the author also believes that the FASB should require firms to disclose their significant level 3 inputs and the sensitivities of the fair values to these inputs for all of their material level 3 model-based fair values. If such disclosures were required, then level 3 model-based fair values likely would be informationally richer than poor quality level 2 fair values.

C.Adverse Feedback Effects and Systemic Risk

By recognizing unrealized gains and losses, fair value accounting moves the recognition of income and loss forward in time compared to amortized cost accounting. In addition, as discussed in Section IV.A.1 unrealized gains and losses may be overstated and thus subsequently reverse if bubble prices exist. If firms make economically suboptimal decisions or investors overreact because of reported unrealized gains and losses, then fair value accounting may yield adverse feedback effects that would not occur if amortized cost accounting were used instead. For example, some parties have argued that financial institutions' write-downs of subprime and other assets have caused further reductions of the market values of those assets and possibly even systemic risk. These parties argue that financial institutions' reporting unrealized losses has caused them to sell the affected assets to raise capital, to remove the taint from their balance sheets, or to comply with internal or regulatory investment policies.[9] These parties also argue that financial institutions' issuance of equity securities to raise capital have crowded out direct investment in the affected assets.

In the author's view, it is possible that fair value accounting-related feedback effects have contributed slightly to market illiquidity, although he is unaware of any convincing empirical evidence that this has been the case. However, it is absolutely clear that the subprime crisis that gave rise to the credit crunch was primarily caused by firms, investors, and households making bad operating, investing, and financing decisions, managing risks poorly, and in some instances committing fraud, not by accounting. The severity and persistence of market illiquidity during the credit crunch and any observed adverse feedback effects are much more plausibly explained by financial institutions' considerable risk overhang[10] of subprime and other positions and their need to raise economic capital, as well as by the continuing high uncertainty and information asymmetry regarding those positions. Financial institutions actually selling affected assets and issuing capital almost certainly has mitigated the overall severity of the credit crunch by allowing these institutions to continue to make loans. Because of its timeliness and informational richness, fair value accounting and associated mandatory and voluntary disclosures should reduce uncertainty and information asymmetry faster over time than amortized cost accounting would, thereby mitigating the duration of the credit crunch.

Moreover, even amortized cost accounting is subject to impairment write-downs of assets under various accounting standards and accrual of loss contingencies under FAS 5. Hence, any accounting-related feedback effects likely would have been similar in the absence of FAS 157 and other fair value accounting standards.

V. Summary of Reasons Why Some Believe that Fair Value Accounting Benefits Investors

In the author's observation, the FASB and IASB, most trading-oriented financial institutions, most investor associations,[11] and most accounting academics[12] believe that overall fair value accounting benefits investors compared to accounting based on alternative measurement attributes, including amortized cost accounting. This section summarizes the benefits of fair value accounting and indicates the prior section of the paper in which these benefits are discussed.

1. Even if markets exhibit bubble prices, fair values are more accurate, timely, and comparable across different firms and positions than are alternative measurement attributes, as discussed in Section II.
    a. Fair values reflect current information about future cash flows and current risk-adjusted discount rates, as discussed in Section II.A.
        i. In contrast, amortized costs can differ dramatically from fundamental values and be very untimely for long-lived positions, as discussed in Section II.B.

   ii. Amortized costs reflect any bubble prices that existed when positions were incepted. In particular, the amortized costs of subprime-mortgage-related positions incepted during the euphoria preceding the subprime crisis are far more likely to reflect bubble prices than are the current fair values of those positions.

b. Fair value accounting self-corrects over time in a timely fashion, as discussed in Section II.A.

   i. This self-correcting quality is particularly important in periods of high and rapidly evolving uncertainty and information asymmetry, such as the credit crunch.

   ii. In contrast, amortized cost accounting does not self-correct until gains and losses are realized, as discussed in Section II.B.

c. The comparability of the fair values of different positions is particularly important in assessing the net value and risks of financial institutions' portfolios of financial instruments, as discussed in Section II.C.

   i. In contrast, amortized costs are inconsistently untimely across positions incepted at different times, as discussed in Section II.B.

2. As discussed in Section III, while the credit crunch raises issues for fair value measurements, under FAS 157 fair values need not reflect fire sale values. When level 2 inputs are driven by fire sales, firms can make the argument that level 3 model-based fair values are allowed under FAS 157. Requiring firms to make this argument provides important discipline on the accounting process.

   a. One should not confuse the need for the FASB to provide additional guidance regarding how to measure fair values in illiquid markets with amortized cost accounting being preferable to fair value accounting. As discussed in Section II.B, amortized cost accounting has severe limitations even in liquid markets. These limitations become more significant in illiquid markets, because it is then that investors most need to be able to assess firms' value and risks accurately and that firms' incentives to manage their owners' equity and net income through gains trading are highest.

3. Fair value accounting does not allow firms to manage their income through gains trading, because gains and losses are recognized when they occur, not when they are realized.

   a. In contrast, amortized cost accounting allows gains trading, especially by financial institutions, as discussed in Section II.B.

4. As discussed in Section IV.A.2, when the distributions of future cash flows are skewed, it is more informative to investors to be right on average and to incorporate the probability and significance of all possible future cash flows, as fair value accounting does, than to be right most of the time but ignore relatively low probability but highly favorable or unfavorable future cash flows. It is also important to update the distribution of future cash flows for new information on a timely basis, as fair value accounting does.

5. Fair value accounting is the best platform for mandatory and voluntary disclosure and for investors to be aware of what questions to ask management, as discussed in Section II.A.

    a. GAAP already mandates some useful disclosures, which the FASB can and surely will improve and extend to more positions over time.

    b. When firms report unrealized gains and losses under fair value accounting, their managements are motivated to explain what went right or wrong during the period and the nature of any fair value measurement issues.

        i. Firms have begun to make useful fair value-related voluntary disclosures, and leading-practices are developing.

    c. If managements do not provide adequate explanations, then investors at least are aware that something value-relevant happened during the period and can prod managements to explain further.

    d. In contrast, amortized cost accounting ignores unrealized gains and losses until they are realized, as discussed in Section II.B. Hence, firms typically are not required or motivated to explain economic gains and losses prior to realization. Investors may not even be aware when valuation relevant events occur during periods.

VI. Summary of Reasons Why Some Believe that Fair Value Accounting Hurts Investors

In the author's observation, virtually all traditional banks[13] and other traditional financial institutions, most bank regulators (although this is changing with Basel II and other recent regulatory decisions),[14] and some investors and accounting academics[15] believe that fair value accounting hurts investors compared to accounting based on amortized cost or other measurement attributes, at least in some circumstances. This section catalogs the potential harms of fair value accounting and indicates the prior sections of the paper in which these potential harms are discussed. Some additional discussion of the author's views is provided regarding points not addressed in prior sections of the paper.

1. When markets are illiquid, fair value is a poorly defined notion involving hypothetical transaction prices that cannot be measured reliably, regardless of how much measurement guidance the FASB provides.

    a. In the author's view, while this point contains considerable truth as discussed in Section IV.B, it is not really a criticism of fair value accounting per se. There are many contexts in accounting where measurements are difficult to make, such as noncash exchanges and bundled sales of goods that are never sold separately as well as impairment write-downs of illiquid real and intangible assets that are otherwise accounted for at amortized cost. In these contexts, accounting measurements often involve hypothetical transactions. Hence, this point essentially boils down to the true statement that some difficult measurement settings necessarily involve hypothetical transactions. In fact, one could argue that fair value accounting for financial instruments is unusual for the opposite reason that the fair values of these instruments often can be based on actual current market transactions, not hypothetical transactions.

2. When fair values are provided by sources other than liquid markets, they are unverifiable and allow firms to engage in discretionary income management and other accounting behaviors.

    a. The comparative advantage of accounting is to provide verifiable and auditable information.

    b. In the author's view, while this point also contains considerable truth as discussed in Section II.A, it ignores the mitigation of the limitations of fair value accounting through disclosure as well as the severe limitations of amortized cost accounting discussed in Section II.B. It also ignores the fact that many amortized cost accounting estimates (e.g., goodwill impairments) are difficult to verify and audit.

3. By recognizing unrealized gains and losses, fair value accounting creates volatility in firms' owners' equity (including financial institutions' regulatory capital) and net income that need not correspond to the cash flows that will ultimately be realized.

    a. If firms are willing and able to hold positions to maturity, unrealized gains and losses resulting from changes in riskless rates and credit risk premia are meaningless because the firms will ultimately receive or pay the promised cash flows.

        i. In the author's view, this point is clearly incorrect, as discussed in Section II.B.

b. Unrealized gains and losses resulting from bubble prices or skewed distributions of future cash flows reverse with more than 50% probability over the positions' lives.

   i. In the author's view, this point is true but not a good reason to use a measurement attribute other than fair value, as discussed in Section IV.A.2.

c. Market participants' reaction to unrealized gains and losses can yield adverse feedback effects and asset prices and even systemic risk.

   i. In the author's view, this point may have some truth but it is overstated, as discussed in Section IV.C.

d. Volatility in financial institutions' regulatory capital yields systemic risk.

   i. In the author's view, this point may have some truth but it is overstated, as discussed in Section IV.C.

4. Fair value accounting mixes normal/permanent components of income, such as interest, with transitory unrealized gains and losses.

   a. In the author's view, to the extent that this issue arises in practice it is properly and easily addressed by the FASB requiring disaggregation of permanent and transitory components of income on firms' income statements. The FASB and IASB currently are addressing this issue in their joint financial statement presentation project.

   b. Moreover, this issue applies in a different and in some respects more significant fashion to amortized cost accounting. Realized gains and losses also are not permanent, and they depend on whether firms have cumulative unrealized gains and losses available to be realized and firms' discretionary choices whether or not to realize those cumulative gains and losses.

NOTES

[1] Ryan (2008) provides a detailed description of the causes and evolution of the subprime crisis, which began in February 2007, and the credit crunch it engendered, which began in July 2007.
[2] For example, U.S. Representative Barney Frank, the chairman of the United States House of Representatives' Financial Services Committee, has asked for fair value accounting rules to be reconsidered.
[3] More subtly, under current GAAP and accounting practices, interest revenue and expense generally are calculated on an amortized cost basis even when fair value accounting is used. As discussed in Ryan (2007, Chapter 6), this has the unfortunate effect of making unrealized gains and losses appear to reverse each period by the difference between fair value interest and amortized cost interest (i.e., the error in the measurement of interest). The FASB can and should remedy this problem by requiring interest to be calculated on a fair value basis.
[4] Whether fair value accounting is desirable for non-financial (e.g., manufacturing and retailing) firms that primarily hold tangible and intangible assets with very different risk characteristics than their primarily financial liabilities is a more complicated question that is beyond the scope of this white paper. Nissim and Penman (2008) argue that amortized cost accounting has a transaction/outcome-oriented focus that better reveals how these firms deliver on their business plans and thereby earn income over time.
[5] This section does not discuss apparent reversals of unrealized gains and losses that result from interest being calculated on an amortized cost basis even when fair value accounting is used. See footnote 3.
[6] Barlevy (2007) is a very readable discussion of asset price bubbles and the related financial economics literature.
[7] In the author's view, there is little or no reason to believe that relatively junior subprime positions have exhibited bubble pricing during the credit crunch. For example, Markit's indices for relatively junior subprime MBS positions generally have declined toward zero with no significant reversals over time, even after market liquidity improved somewhat beginning in March 2008. Moreover, the Bank of England (2008, pp. 7 and 18-20) finds these indices to be fairly close to the model-based values given reasonable loss scenarios. In contrast, there is at least some reason to believe that relatively senior subprime positions may have exhibited bubble pricing during this period. For example, Markit's indices for these positions exhibited sizeable reversals of prior losses during November-December 2007 and again in March-May 2008, although both these reversals can be explained by interventions by policymakers (the first by the Treasury Department's rescue plan for SIVs and the second by various aggressive actions taken by the Federal Reserve in March 2008). Moreover, the Bank of England concludes that these indices are considerably below modeled values even in extremely adverse loss scenarios. This could be explained by the fact the credit derivatives on which Markit's indices are based are themselves subject to illiquidity and counterparty risk.
[8] See Johnson (2008a,b) and Rummell (2008) for discussion of parties holding such views.

[9] For example, the International Monetary Fund (2008) states that "[a]ccounting standard setters will increasingly need to take into account the financial stability implications of their accounting practices and guidance" (p. xiv). Also, while "fair value accounting gives the most comprehensive picture of a firm's financial health...investment decision rules based on fair value accounting outcomes could lead to self-fulfilling forced sales and falling prices when valuations fell below important thresholds (either self-imposed by financial institutions or by regulation)" (p. 127).

[10] Gron and Winton (2001) show that financial institutions' risk overhang (i.e., risk remaining from past business decisions that cannot be eliminated due to market illiquidity) can cause them to reduce or eliminate their trading activity in positions whose risks are correlated with their risk overhang.

[11] See Center for Financial Market Integrity (2005).

[12] See American Accounting Association Financial Accounting Standards Committee (2000).

[13] See the American Banking Associations website (policy positions index, fair value accounting).

[14] See Bies (2008).

[15] See Nissim and Penman (2008).

REFERENCES

American Accounting Association Financial Accounting Standards Committee. 2000. Response to the FASB Preliminary Views: Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value. *Accounting Horizons*, December, pp. 501-508.

American Institute of Certified Public Accountants. 2001. *Accounting by Certain Entities (Including Entities with Trade Receivables) that Lend or Finance the Activities of Others.* Statement of Position 01-6. New York, NY: AICPA.

Bank of England. 2008. Financial Stability Report. Issue No. 23. April.

Barlevy, G. 2007. Economic Theory and Asset Bubbles. *Economic Perspectives*, Third Quarter, 44-59.

Bies, S. 2008. Fair Value Accounting. Speech to the International Association of Credit Portfolio Managers General Meeting, New York, New York, November 18.

CFA Institute. 2005. A Comprehensive Business Reporting Model: Financial Reporting for Investors. Center for Financial Market Integrity. October.

Financial Accounting Standards Board (FASB). 1975. *Accounting for Contingencies.* Statement of Financial Accounting Standards No. 5. Norwalk, CT: FASB.

_____. 1982. *Accounting for Certain Mortgage Banking Activities.* Statement of Financial Accounting Standards No. 65. Norwalk, CT: FASB.

_____. 1991. *Disclosures about Fair Value of Financial Instruments.* Statement of Financial Accounting Standards No. 107. Norwalk, CT: FASB.

_____. 1993. *Accounting for Certain Investments in Debt and Equity Securities.* Statement of Financial Accounting Standards No. 115. Norwalk, CT: FASB.

_____. 1998. *Accounting for Derivative Instruments and Hedging Activities.* Statement of Financial Accounting Standards No. 133. Norwalk, CT: FASB.

_____. 2000. *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* Statement of Financial Accounting Standards No. 140. Norwalk, CT: FASB.

_____. 2007. *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115.* Statement of Financial Accounting Standards No. 159. Norwalk, CT: FASB.

Gron, A., and A. Winton. 2001. Risk Overhang and Market Behavior. *The Journal of Business* 74: 591-612.

International Monetary Fund. 2008. Containing Systemic Risks and Restoring Financial Soundness. April

Johnson, S. 2008a. The fair-value blame game. www.cfo.com. March 19.

_____. 2008b. How far can fair value go? www.cfo.com. May 6.

Nissim, D. and S. Penman. 2008. Principles for the Application of Fair Value Accounting. Center for Excellence in Accounting and Security Analysis, White Paper No. 2. April.

Rummell, N. 2008. Fair-value rules get more blame for crunch. www.financialweek.com, March 24.

Ryan, S. 2007. *Financial Instruments and Institutions: Accounting and Disclosure Rules*. Hoboken, NJ: John Wiley & Sons.

Ryan, S. 2008. Accounting in and for the Subprime Crisis. *The Accounting Review*, forthcoming.

Senior Supervisors Group. 2008. Leading-Practice Disclosures for Selected Exposures. April 11.

United States Securities and Exchange Commission. 2005. *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.* June 15.

Chairman WAXMAN. Mr. Wallison.

STATEMENT OF PETER J. WALLISON

Mr. WALLISON. Thank you, Mr. Chairman and members of this committee. I'm really pleased to have this opportunity to address the question of regulation and its role in the current financial crisis.

There are cases where regulation is necessary and cases where it is harmful. It was necessary in the case of Fannie Mae and Freddie Mac. These two companies were seen in the market as backed by the Federal Government. As a result, investors did not worry about the risks of lending to them since Uncle Sam would bail them out if the companies got into financial trouble. Investors have been proved right. In cases where investors see themselves as bearing no risks lending to a private, shareholder-owned company, strong regulation is essential. That is the only way that government can protect itself against loss. Yet Congress resisted——

Chairman WAXMAN. Mr. Wallison, could you pull the mic a little closer? Some Members are having——

Mr. WALLISON. Oh, I'm sorry.

Yet Congress resisted reforming regulation of Fannie Mae and Freddie Freddie until it was too late. And even then the reform legislation wouldn't have been passed unless it had been attached to a housing bill that Congress wanted to adopt before going home for the August recess.

The failure by Congress had serious consequences. An article in yesterday's New York Times makes clear that reckless buying of junk loans by Fannie Mae and Freddie Mac bears a large part of the responsibility for the financial crisis we are now in. Voters, justifiably angry about the $700 billion rescue plan just adopted by Congress, should recognize who is responsible and act accordingly.

Incidentally, since some issues of compensation have come up, I ought to mention that Fannie was very generous in its own compensation. Franklin Raines, who was its chairman for several years, 4 or 5, made $90 million during the time he was there, and there was little outrage expressed in Congress at that time.

Bad or weak regulation is often worse than no regulation at all. Another article in the New York Times on Friday of last week recounted the SEC's failure to devote sufficient resources to the regulation of the major investment banking firms that have now all collapsed, been taken over, sold themselves to big banks or sought shelter under the Federal Reserve's wings as financial holding companies. According to the article, the SEC assigned a pitifully small staff to regulating these huge investment banks, and as a result they took imprudent financial risks that ultimately led to their losses.

A chart accompanying the article shows that these institutions took increasing risks every year from the time they entered the SEC's supervisory regime. This is important. It demonstrates the effect of regulation in creating moral hazard. Immediately after the SEC took over the supervision of their safety and soundness, the market discipline to which they had previously been subject began to relax. Investors thought the SEC was minding the store, but it wasn't. That is why weak regulation can be worse than none.

Regulation itself is no panacea. Even strong regulation may not be effective. Regulation of commercial banks in the United States is a case of strong regulation failing. Congress imposed a strong regulatory regime on commercial banks when it adopted FDICIA in 1991. Still, even though IndyMac, WAMU, Wachovia and dozens of smaller commercial banks were regulated by one or another agency of the Federal Government under strict FDICIA requirements, they all failed or had to be taken over just like the weakly regulated investment banks.

Calling for more regulation as a solution to the financial crisis is, therefore, somewhat simplistic. Regulation's track record is ambiguous. There is no question that it is the only protection we have when the government is exposed to risks created by companies it backs, like commercial banks, which have deposits insured by the FDIC, and like Fannie Mae and Freddie Mac, which were seen as backed by the Federal Government without any limit.

But the regulation of the investment banks by the SEC was a mistake. They were not seen as backed by the government in any way until the SEC was given authority to supervise their safety and soundness. Then their risk-taking took off. If they had been left free of government oversight, they would not, in my view, have been able to borrow the funds that created their extraordinary leverage.

If our solution to today's crisis is to regulate hedge funds, private equity funds, finance companies, institutional lenders, pension funds, leasing companies and insurance companies and anyone else who participates in the capital markets without any government backing, we will simply be assuring ourselves of many more financial crises in the future.

Many thanks, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Wallison.

[The prepared statement of Mr. Wallison follows:]

Testimony before the House Committee on
Oversight and Government Reform
October 6, 2008

Peter J. Wallison
Arthur F. Burns Fellow in Financial Policy Studies
AEI

Mr. Chairman and members of the committee:

I am pleased to have this opportunity to address the question of regulation and its role in the current financial crisis.

There are cases where regulation is necessary, and cases where it is harmful.

It was necessary in the case of Fannie Mae and Freddie Mac. These two companies were seen in the markets as backed by the federal government. As a result, investors did not worry about the risks of lending to them, since Uncle Sam would bail them out if the companies got into financial trouble. Investors have been proved right.

In cases where investors see themselves as bearing no risks for lending to a private, shareholder-owned company, strong regulation is essential. That is the only way that the government can protect itself against loss.

Yet Congress resisted reforming the regulation of Fannie Mae and Freddie Mac until it was too late, and even then the reform legislation wouldn't have been passed unless it had been attached to a housing bill that Congress wanted to adopt before going home for the August recess.

This failure by Congress had serious consequences. An article in yesterday's *New York Times* makes clear that reckless buying of junk loans by Fannie Mae bears a large part of the responsibility for the financial crisis we are now in. Voters, justifiably angry about the $700 billion rescue plan just adopted by Congress, should recognize who is responsible and act accordingly.

Bad or weak regulation is often worse than no regulation at all. Another article in the *New York Times*—on Friday of last week—recounted the SEC's failure to devote sufficient resources to the regulation of the major investment banking firms that have now all collapsed, been taken over, sold themselves to big banks, or sought shelter under the Federal Reserve's wings as financial holding companies.

According to the article, the SEC assigned a pitifully small staff to regulating these huge investment banks, and as a result they took the imprudent financial risks that ultimately led to their losses.

A chart accompanying the article shows that these institutions took increasing risks every year from the time they entered the SEC supervisory regime. This is important. It demonstrates the effect of regulation in creating moral hazard. Immediately after the SEC took over the supervision of their safety and soundness, the market discipline to which they had previously been subject began to relax. Investors thought the SEC was minding the store. But it wasn't.

That's why weak regulation can be worse than none.

Regulation itself is no panacea. Even strong regulation may not be effective. The regulation of commercial banks in the United States is a case of strong regulation failing. Congress imposed a strong regulatory regime on commercial banks when it adopted FDICIA in 1991.

Still, even though IndyMac, WAMU, Wachovia and dozens of smaller commercial banks were regulated by one or another agency of the federal government under strict FDICIA requirements, they all failed just like the weakly regulated investment banks.

Calling for more regulation as a solution to the financial crisis is simplistic. Regulation's track record is ambiguous.

There is no question that it's the only protection we have when the government is exposed to the risks created by companies it backs—like commercial banks, which have deposits insured by the FDIC; and like Fannie Mae and Freddie Mac, which were seen as backed by the federal government without any limit.

But the regulation of the investment banks by the SEC was a mistake. They were not seen as backed by the government in any way, until the SEC was given authority to supervise their safety and soundness. Then their risk-taking took off.

If they had been left free of government oversight, they would not—in my view--have been able to borrow the funds that created their extraordinary leverage.

If our solution to today's crisis is to regulate hedge funds, private equity funds, finance companies, institutional lenders, pension funds, leasing companies, and insurance companies—and anyone else who participates in the capital markets without any government backing—we will simply be assuring ourselves of many more financial crises in the future.

Many thanks for your attention.

Chairman WAXMAN. I want to thank all of the members of the panel for your presentation. We'll now recognize Members to ask questions for a 5-minute period. We'll start with Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman and Ranking Member Davis and all of the panelists.

We are facing what has been called the most serious financial crisis since the 1930's. And the potential cost to taxpayer is staggering: $29 billion to J.P. Morgan to buy Bear Stearns; $85 billion to AIG; $200 billion to Fannie and Freddie; $700 billion rescue package; $300 billion to the Fed window opening it up to investment banks; $50 billion to stabilize the money market funds. A staggering $1.7 billion potential cost to taxpayers.

Now, Professor Zingales, you seem to believe that this may have been caused by the staggering leverage that was put in these firms, but others see it as the deregulation that has taken place in Congress over the past decade. In 1990, Congress passed the Financial Stabilization Act, which took away the protections of the Glass-Steagall Act that had served and protected our economy for 80 years. This allowed the banking a safety and soundness standard to be able to merge and be lowered, with risky speculative activities. And then during this period, Congress prohibited the regulation of risky derivatives. The SEC loosened rules governing the amount of leverage that investment banks could use, and Federal regulators were defunded and defanged, and they were reluctant to use the authority they had to protect taxpayers and investors.

Some believe that the root cause of the credit cost of this crisis was not only the leverage, but the excessive deregulation. And I would like to ask first, Dr. Wescott, and then others, if you'd like to comment. What do you think were the biggest mistakes or missed opportunities for regulators? And going forward, what do you think we should regulate? Do you think all of this deregulation that I listed was a mistake for protection for our taxpayers and our economy?

Mr. WESCOTT. Regulation is a—as Mr. Wallison said, is an extremely complicated matter, and it is very important that it be handled and that we get the incentives properly lined up here.

There is no question that the regulators did make a decision. The SEC made a decision in 2004, in April 2004, to relax the leverage standards that the large $5 billion-plus investment banks would be allowed to operate under. And in my opinion, this decision did end up making the situation worse. And so I do——

Mrs. MALONEY. What about Glass-Steagall, Dr. Wescott? That is not complicated. It merely says financial institutions, bank safety and soundness should not mingle with risky activities. That is not complicated at all. It is very clear. Was that a mistake to roll that back, do you believe? Or I'd ask any other panelist to talk.

Mr. WESCOTT. I don't have a strong opinion on Glass-Steagall. I do think that there were risks involved in the mortgage-lending business that were greater than were appreciated by regulators and obviously by many of the investment banks themselves. The key thing was that they assumed there was going to be plenty of business, and that they could keep getting additional borrowers, and that they would not suffer credit quality loss as we went further and further down the list of applicants for mortgages.

Mrs. MALONEY. Thank you very much. My time is very limited. I'd just like to go down the line, starting with Dr. Zingales.

Do you think repealing Glass-Steagall, allowing banks to mix with risky investment banks that were leveraged in hedge funds, in some cases 1 to 30, 10 to 60, do you think rolling it back was a mistake, yes or no?

Mr. ZINGALES. No. I don't think it was a mistake.

Mrs. MALONEY. Yes or no. Mr. Wescott, you don't think it was a mistake?

Mr. WESCOTT. No at this point.

Mrs. MALONEY. Ms. Minow.

Ms. MINOW. I do think it was a mistake.

Mrs. MALONEY. You do.

Mr. Smith.

Mr. SMITH. It appears to be from this angle. I'm sorry. It appears to be from this angle.

Mrs. MALONEY. Mr. Wallison.

Mr. WALLISON. Not a mistake.

Mrs. MALONEY. OK. So we're divided on that.

If the Fed and Treasury had not allowed Lehman to fail in default on its obligations, would this have prevented runs on other firms, and especially the money market funds, the run that began on that? Again, down the panel quickly. My time has expired. Quickly now.

Mr. ZINGALES. I think no. The proof is if we look at what happened when Bear Stearns was bailed out, I think that, for example, the price of the credit default swap was—an insurance on default as a measure of how risky borrowers are considered—went up the same amount it went up after the Lehman default. So I don't think that bailing out sort of Lehman would have—would solve the situation.

Mr. WESCOTT. I think that regulators in retrospect would now understand that there was more Lehman paper out there in money market accounts, and they might have made a different decision on that account.

Ms. MINOW. I think it would not have made an enormous difference.

Mr. SMITH. I think it was one piece of a much bigger puzzle.

Mr. WALLISON. It has no significant difference, I think.

Chairman WAXMAN. Thank you, Mrs. Maloney.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you.

This concerns the SEC. Both the chairman and I were instrumental in shepherding through legislation that removed the Civil Service pay ceilings on the SEC employees because they were losing employees like crazy. They lost a third of their senior management because of the pay. We raised that, but we also held hearings on IT and their IT capacity. What were the limitations if SEC had wanted to do something? Were their systems up? Could they have done the appropriate job? Or are there limitations on their IT and personnel that probably limited their abilities? Does anybody have any thoughts on that?

No. OK.

Ms. Minow, let me just ask you. You rated the corporate boards at Lehman. Did you ever rate the board in salaries at Freddie and Fannie?

Ms. MINOW. I'm sorry. Freddie and Fannie? Yes. We did give a high grade to Fannie Mae after they were—in 2002, when we began rating after they were cleared by the SEC and OFHEO. We, however, from the beginning gave poor ratings to Freddie.

Mr. DAVIS OF VIRGINIA. We should have seen this coming; don't you agree? I mean, I don't know if any of you are familiar with the Superior Bank. I just was looking at one—Superior Bank, the inspector general report. This was a Chicago bank owned by—the chief owner was Penny Pritzker, who happens to be, as I think many of us know, Senator Obama's finance chairman. But more importantly, when you look at the inspector general's report, it says that the bank became associated with the subprime lending business in 1992. Beginning in 1993, Superior embarked on a business strategy marked by rapid and aggressive growth into subprime home mortgages. Federal bank regulators warned them in 1993, 1994, 1995, 1997 and 2000 to rein in their risky subprime lending businesses.

According to an independent investigation by the Department of Justice, the bank used improper accounting procedures to cover up their bad debts. Fifteen hundred of the bank customers lost large sums of money. But this was years ago. I mean, didn't—all the warning signs were there that these subprimes were a mess, wasn't there?

Ms. MINOW. Yes, there were. That's why one of my primary concerns is the obstacles to what I would consider the essential market oversight from institutional investors like the Colorado pension fund, if they could have responded as I think they would like to have. If the corporate community hadn't lobbied for so many restrictions on the ability of shareholders to respond to these indicators, then I think we would not need a lot of new regulation.

Mr. DAVIS OF VIRGINIA. Mr. Wallison.

Mr. WALLISON. Well, I would say that this is a very good example of the faith in regulation that is often misplaced. The regulators had the responsibility for looking at the risks that were being taken by these institutions, and they did not effectively do that. And I think that is an important lesson for our Congress to understand, because regulation is not a solution to many of these problems, especially when the regulators have a great deal of difficulty understanding what is happening in these institutions.

The Superior Bank case is a perfect example of something that was starting in 2001 and beginning to build at that point with subprime loans. But I'm afraid that if a congressional committee or a regulator—let's put it this way: If a congressional committee had looked over the shoulder of the regulators and said, will you stop that from happening, I think the regulator would have been reluctant to do it. The institutions were making money from this. And once more, they were afraid of some of the political backlash that would come if they did try to stop this kind of lending.

There is a strong feeling in the United States that many people should have access to housing. And the question is, do you allow the regulators to interfere with a strong housing market, especially involving——

Mr. DAVIS OF VIRGINIA. Lower-income people were getting housing, so nobody wanted to stop that.

Mr. ZINGALES. I think that the problem is not subprime per se, it is a risky lending. But as Mr. Wallison said, it has beneficial effects.

Second, in some situations, a risky—might be profitable. I think that the problem is that the level of securitization this took place was not probably monitored. We have sort of an enormous market that has completely sort of unregulating type of disclosure. I think we should have more disclosure, because today we don't know who owns what. And out of that, a lot of the problems we observe in the credit market is because banks don't know the losses of other banks. If they don't know the losses, it is because they don't know what is in their portfolio. And if they don't know what is in the portfolio—because if you look at the issuances, you cannot trace back easily what is in that package of loans. We don't know whether they are loans from California, we don't know whether they are from Florida. We don't know who has these loans. And this lack of transparency is one of the roots of the problem. It is not subprime, It is the lack of transparency.

Mr. WESCOTT. Just on the question of whether we should have known or did we know, I will just say that in looking at a full range of economic statistics in the summer of 2005, looking at the value of houses divided by median income and by many other measures, we knew that the housing prices were set for a fall. We were beginning to tell our clients in the autumn of 2005 that housing prices were set for a fall and the housing sector was ready for a decline. We were not alone. Many other economists were also giving similar warnings.

Chairman WAXMAN. Thank you, Mr. Davis. Mr. Cummings.

Mr. CUMMINGS. Thank you very much. Ms. Minow, when I went to church yesterday, it is interesting that almost everybody who came up to me afterwards was very upset. And it seemed like the thing they were most upset about was the compensation for these executives. As part of the committee's investigation the committee asked for copies of the e-mails that Mr. Fuld sent and received over the last 6 months. I want to read to you from an e-mail an exchange that involves Mr. Fuld, his executive committee, and senior executives at Neuberger Berman, a money management subsidiary of Lehman Brothers.

The first e-mail is sent in early June of this year. It is sent from Neuberger Berman executives to Mr. Fuld's executive committee. The e-mail begins, "as long-term employees and former partners of Neuberger Berman, we feel compelled to express our views on several matters to members of Lehman's executive committee." In the e-mail, the Neuberger Berman executives write that Lehman had made, "management mistakes," and that, "a substantial portion of the problems at Lehman are structural rather than merely cyclical in nature."

The e-mail then recommended two actions. And let me read from the e-mail. It says top management should forego bonuses this year. This would serve a dual purpose. First, it would represent a significant expense reduction. Second, it would send a strong message to both employees and investors that management is not shirking accountability for recent performance. And then it goes on to say, too, and this is a direct quote, do a partial spinout of NB. A partial spinout could be an attractive source of capital for Lehman at a time when the company needs capital. The officials also suggested that a partial spinout of Neuberger Berman would allow some employees to receive their equity compensation in the new Neuberger Berman shares instead of Lehman shares, which would reassure the Neuberger employees of their funds.

Question: Ms. Minow, what do you think of the recommendations made in this e-mail? And was the recommendations that senior management forego bonuses a sound one?

Ms. MINOW. Yes, it was.

Mr. CUMMINGS. And why is that?

Ms. MINOW. Because in my opinion, management gets paid last. You know, you pay the shareholders, you pay the employees, and then if there is any money left over you take it. But when the company is doing poorly, management should—management compensation should reflect that.

Mr. CUMMINGS. Yeah, because when I talk to the people in my block, they tell me—you said something that was very interesting. You said paying people based on volume as opposed to quality is just the wrong way to go. And the people in my block in Baltimore, if they perform poorly, they get fired.

Ms. MINOW. Yeah.

Mr. CUMMINGS. They certainly don't get a bonus.

Ms. MINOW. That is how it works in my company.

Mr. CUMMINGS. And Mr. Fuld is going to come in here in about an hour, and you know what he is going to say? He is going to say it is everybody's fault but mine, but he was the chief guy, is that right?

Ms. MINOW. He was. He was the captain of the ship. And you are familiar with the expression "the buck stops here." You know, unfortunately it did stop with him. He took all the bucks.

Mr. CUMMINGS. One of the recipients of that e-mail was George W. Walker. Mr. Walker was Lehman's global head of investment management at the time. And if the name sounds familiar, that is because Mr. Walker also happens to be President Bush's cousin. Within 15 minutes, Mr. Walker writes a followup e-mail to the other members of the executive committee. And let me read that to you, because it is extremely interesting. He said sorry, team. I am not sure of what is in the water at 605 Third Avenue today. The compensation issue she raises is hardly worth the EC's—executive committee's that is—time now. I am embarrassed and I apologize. Mr. Fuld also mocked the Neuberger executives. And his response was don't worry. They are only people who think—listen to this—they are only people who think about their own pockets.

Ms. Minow, I see you shaking your head. What do you think of Mr. Fuld's response? I can imagine what you are going to say, because it is clear that he was thinking about his own pockets as he made millions upon millions.

Ms. MINOW. You are exactly right, Congressman. I am horrified by that. I am absolutely horrified. And I am thinking about—I am thinking about what you could possibly say to him when he arrives here to make him understand his responsibility.

Mr. CUMMINGS. I wonder how he sleeps at night. Mr. Smith, do you have a comment on that? I see you shaking your head, too. You talked about all the employees you represent.

Mr. SMITH. Well, it is of interest to me that nowhere in that conversation, nowhere even in their way of thinking does the shareholder have any role whatsoever. And that is who their duty is to.

Mr. CUMMINGS. Thank you very much. I see my time is up.

Chairman WAXMAN. Thank you, Mr. Cummings.

Mr. Mica.

Mr. MICA. First of all, I think it is very important that our committee investigate how we got into this financial mess. I believe Americans want to know who caused this outrage, how it happened, and who will be held accountable. If it is wrongdoing by AIG or Lehman, in fact I saw one of these signs out here with Code Pink, and they said no bail, jail. And which I agree with. In fact, at the conclusion of these hearings I intend to consult with my colleagues to ask for a special counsel to investigate this matter. The announced hearings, however, today and the ones that we have before us selected by the chairman only cover Lehman, AIG, and several regulators. Unfortunately, I think this is a clever sequencing of these hearings, which is obviously organized to deflect attention from government-backed financial institutions, and also deflect from Congress any blame, and put it on Wall Street, or blame it on executive compensation.

Any hearing or real oversight that does not start with Fannie Mae, Franklin Raines, who walked away with over a hundred million dollars in executive compensation and bonuses, and also hearing from his accomplices, any hearing will be a sham. This is like investigating the Great Train Robbery and only talking to the dining car stewards. Instead of a balanced panel today, we will take testimony from academics, and no one from Fannie Mae or Freddie Mac. Rather clever.

The fact is that our Nation's current financial crisis began back in 1992, with the concerted effort to expand government-sponsored enterprises Fannie Mae and Freddie Mac to include loans to marginally qualified borrowers and get into a whole host of speculative investments. Last week Speaker Pelosi incorrectly and partisanly attributed the responsibility to the Bush administration's failed economic policies. Chairman Waxman in his opening statement is trying today to direct focus on Wall Street and regulators. Last time I checked, none of those folks had a vote in Congress.

In fact, it was in 1999, and we heard some reference to this already, I have a copy of the vote here which we will put in the record later, the Congress voted to repeal the Glass-Steagall Act, allowing banks to engage in speculative ventures. And Wall Street followed. In fact, long before Bush took office, the stage was set for the current financial meltdown of the housing and finance industry. In fact, in 1999 the Clinton administration and Fannie Mae Director Raines lowered policy standards and increased subprime loans to new, more dangerous levels.

As quoted in the New York Times that year, Raines said, "Fannie Mae has expanded home ownership for millions of families in the 1990's by reducing down payment requirements, yet there remain too many borrowers whose credit is just a notch below what our underwriting has required who have been regulated to paying significantly higher mortgages in the so-called subprime market. Wall Street followed."

The New York Times article continued, "in moving even tentatively into this new era of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulty during flush economic times, as we saw, but the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan associations."

In fact, in 2004, Raines and Freddie Mac CEO Richard Syron told an ABA meeting, "we push products and opportunities to people who have lesser credit. In fact, testimony before the House Financial Services Committee on Capital Markets and Insurance and Government Sponsored Enterprises on October 6, 2004, Raines termed some of these loans riskless." That is his quote.

In fact, Raines by rule change lowered Fannie Mae's cash reserve requirements from 10 to 2.5 percent. In fact, after fraudulently cooking Fannie Mae's books so Raines and Jamie Gorelick and others could boost earnings to rob millions in bonuses, congressional Democrats chose to ignore the findings. During a House Financial Services hearing on September 10, 2003, the top Democrat at the time, Barney Frank, said the more people in my judgment exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury, which I do not see. I think we see entities that are fundamentally sound and withstand some of the debt disaster scenarios. Representative Maxine Waters demanded to know why if it ain't broke, why anybody would want to fix Fannie Mae. More incredibly——

Chairman WAXMAN. Thank you, Mr. Mica.

Mr. MICA [continuing]. Frank said a few days later, I want to roll the dice a little bit more in this situation.

Chairman WAXMAN. Mr. Mica, you can put the rest of the statement in the record, but your time has expired.

Mr. MICA. Well, since our side is gagged from either giving a statement or——

Chairman WAXMAN. Mr. Kucinich, it is your turn to ask the questions.

Mr. MICA [continuing]. Having the opportunity to not ask questions, I won't get to ask my questions.

Chairman WAXMAN. I thought you asked a lot of brilliant questions here. Mr. Kucinich, your turn to ask questions.

Mr. KUCINICH. I thank the gentleman. Mr. Wallison, in your testimony you said voters are justifiably angry about the $700 billion rescue plan just adopted by Congress. Why?

Mr. WALLISON. Because much of the problem that——

Mr. KUCINICH. You want to speak closely to the mic?

Mr. WALLISON. Because much of the problem that this plan is intended to address was caused by a lack of regulation of Fannie Mae and Freddie Mac.

Mr. KUCINICH. OK. Thank you, sir.

Mr. WALLISON. The bad assets that are now on the books of banks and securities firms all over the world came from a market that they stimulated between 2005 and 2007.

Mr. KUCINICH. Thank you, sir. Thank you for your answer. I am going to go on with the rest of my questions.

I want to say that I agree with you that the American people are angry. I voted against this bailout. And I think that I have to say that, with all due respect to our Chair, who really was given a mandate to hold hearings after the fact, I am sorry that these hearings are taking place after we voted on the bailout. I mean how much better we would have been, how much better informed we would have been if we had had these hearings before the bailout. And I think that it would have—that takes nothing away from Mr. Chairman, who I have the greatest admiration for, but this is a decision that was made by our congressional leaders. We should have had these hearings first and then taken a vote on a bailout later.

Now I want to get into the questions of why didn't Secretary Paulson save Lehman. We all know about the implications of the collapse. That is what we are here to discuss. But you know, my question is why Secretary Paulson decided to bail out AIG and other companies but not Lehman.

Gretchen Morgenson in the New York Times wrote a column about the decision to rescue AIG. She said that Secretary Paulson, a former CEO of Goldman Sachs, made this decision after consulting with Lloyd Blankfein, the current CEO of Goldman Sachs. She also wrote that Goldman Sachs could have been imperiled by the collapse of AIG because Goldman was AIG's largest trading partner. She said Goldman had a $20 billion exposure to AIG.

Now I would like Professor Zingales, when you hear about that, you know, a decision was made to let Lehman go down. Goldman Sachs is still standing for sure. Are you concerned, given these facts, that there is an apparent conflict of interest by the Treasury Secretary in permitting a principal of a firm that he was a CEO with to be involved in these discussions about the survival of Lehman?

Mr. ZINGALES. Yes. I am certainly concerned by that. But I have to say that I think that the reason—and I am not saying it wasn't the right decision—I think the reason to go to the AIG bailout is that AIG was a major player in the credit default swap market. And I think that not only Goldman was very heavily involved with that, J.P. Morgan, to the best of our ability, J.P. Morgan has a notional amount of $7 trillion in the credit default swap market. Most of that is hedged. And since they buy and sell insurance at the same time, so if everybody is holding up, there is no risk. But if AIG went under, all of a sudden J.P. Morgan would have found itself probably on edge for a significant fraction of that sort of a $7.1 trillion. Now——

Mr. KUCINICH. Let me ask you this. You throw Lehman Brothers overboard. Does that help what competitive position may remain with respect to Goldman Sachs?

Mr. ZINGALES. I think it is clear that Goldman Sachs benefits from Lehman Brothers going under, yes.

Mr. KUCINICH. I want to ask Ms. Minow to answer the question that I asked. Is there an apparent conflict of interest here?

Ms. MINOW. Yes, there was.

Mr. KUCINICH. You want to elaborate on that?

Ms. MINOW. You know, that is part of the problem of regulating and deal making and bailing out in the financial sector. You know, we do regressions about the relationships between the various boards of directors. And overwhelmingly, that is the most tightly knit.

Mr. KUCINICH. I want to thank you for that. Because see, what we are confronted with is that bailout legislation gives Secretary Paulson the ability to direct assets over the entire economy, changing forever the idea of a free market and putting him in a direct position where he can benefit the people that he worked with while he was CEO of Goldman Sachs. Does that concern you?

Ms. MINOW. It concerns me greatly, Congressman. And that is why I think it is very important, even though the legislation was already passed, to have these hearings right now, because as you well know, the implementation is going to tell the story here. And even though the legislation is now significantly longer than the original proposal sent over by the administration, there is still a lot of room to make it right or make it wrong. And I think it is going to need a lot of oversight.

Mr. KUCINICH. Thank you very much.

Chairman WAXMAN. Thank you, Mr. Kucinich.

Mr. Turner.

Mr. MICA. Mr. Chairman, I have a unanimous consent request.

Chairman WAXMAN. The gentleman will state his unanimous consent request.

Mr. MICA. I would like to ask unanimous consent to submit for the record the final vote results of roll call 570, which is the Glass-Steagall repeal, which you actually and I voted no on.

I would like unanimous consent to insert in the record H.R. 4071, which Mr. Shays asked me to cosponsor as a cosponsor, to register and regulate the Federal securities laws to include housing-related government-sponsored enterprises in March 20, 2002.

And I would like unanimous consent to submit into the record the legislation entitled Federal Housing Finance Reform Act of 2005, sponsored by Richard Baker, voted for by myself and others—you weren't with me on that one—that would have resolved this. And also the vote of that I think are important to include in the record.

Chairman WAXMAN. Without objection, that will be the order.

Mr. MICA. Thank you.

[The information referred to follows:]

Rep. Mica

I

107TH CONGRESS
2D SESSION

H. R. 4071

To extend the registration and reporting requirements of the Federal securities laws to certain housing-related Government-sponsored enterprises, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 20, 2002

Mr. SHAYS (for himself, Mr. MARKEY, and Mr. RYAN of Wisconsin) introduced the following bill; which was referred to the Committee on Financial Services

---

A BILL

To extend the registration and reporting requirements of the Federal securities laws to certain housing-related Government-sponsored enterprises, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Uniform Securities Disclosure Act".

SEC. 2. REGISTRATION OF SECURITIES.

(a) FANNIE MAE.—

be exempt securities within the meaning of the laws administered by the Securities and Exchange Commission.".

(b) FREDDIE MAC.—Subsection (g) of section 306 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1455(g)) is amended to read as follows:

"(g) Any securities issued or guaranteed by the Corporation shall not be exempt securities within the meaning of the laws administered by the Securities and Exchange Commission.".

SEC. 3. EFFECTIVE DATE.

The amendments under section 2 shall be made upon the expiration of the 180-day period beginning on the date of the enactment of this Act, but shall apply only with respect to fiscal years of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation that begin after the expiration of such 180-day period.

O

Final Conference Report Version – November 4, 1999

FINAL VOTE RESULTS FOR ROLL CALL 570
106th Congress

(Republicans in roman; Democrats in *italic*; Independents underlined)

S 900 YEA-AND-NAY 4-Nov-1999 11:17 PM
QUESTION: On Agreeing to the Conference Report
BILL TITLE: Financial Services Modernization Act

	YEAS	NAYS	PRES	NV
REPUBLICAN	207	5		10
DEMOCRATIC	155	51		5
INDEPENDENT		1		
TOTALS	**362**	**57**		**15**

---- NAYS 57 ---

Baldwin
Barrett (WI)
Barton
Brady (PA)
Campbell
Capuano
Clay
Condit
Conyers
Costello
Coyne
Davis (IL)
DeFazio
DeLauro
Dingell
Dixon
Edwards
Evans
Fattah
Filner
Frank (MA)
Gejdenson
Gutierrez
Hastings (FL)
Hefley
Hinchey
Inslee
Jackson (IL)
Kaptur
Kildee
Kucinich
Lee
Lewis (GA)
Lipinski
Luther
Markey
McDermott
McKinney
Meek (FL)
Mica
Miller, George
Obey
Phelps
Rivers
Rodriguez
Roybal-Allard
Rush
Sanders
Sanford
Schakowsky
Serrano
Taylor (MS)
Thurman
Tierney
Waters
Waxman
Woolsey

---- NOT VOTING 15 ---

Bereuter
Dickey
Kanjorski
Larson
Martinez
McInnis
Mollohan
Ney
Norwood
Paul
Radanovich
Scarborough
Shuster
Stark
Taylor (NC)

H.R.1461 [109th] **Major Actions:** Help House

Title: Federal Housing Finance Reform Act of 2005

Sponsor: Rep Baker, Richard H. [R-LA-6] (introduced 4/5/2005) **Cosponsors:** 19

Committees: House Financial Services; House Judiciary; Senate Banking, Housing, and Urban Affairs

House Reports: 109-171 Part I

Related Bills: H.RES.509

Latest Major Action: 10/31/2005 Referred to Senate committee. Status: Received in the Senate and Read twice and referred to the Committee on Banking, Housing, and Urban Affairs.

MAJOR ACTIONS: [SELECTED] *(dates in italics indicate Senate actions)* For more details, see: Bill Status Display.

4/5/2005	Introduced in House
7/14/2005	Reported (Amended) by the Committee on 109-171, Part I.
9/16/2005	Committee on Judiciary discharged.
10/26/2005	Passed/agreed to in House: On passage Passed by recorded vote: 331 - 90 (Roll no. 547).
10/31/2005	Referred to Senate committee: Received in the Senate and Read twice and referred to the Committee on Banking, Housing, and Urban Affairs.

House bill for Regulation Overhaul of Fannie Mae, Freddie Mac

House Roll Call 547 : Mica voted - Yes

Became Locked in Senate Impasse: S 190

Passed out of Senate Banking on Party Lines: 11 - 9

FINAL VOTE RESULTS FOR ROLL CALL 547

(Republicans in roman; Democrats in *italic*; Independents underlined)

H R 1461 RECORDED VOTE 26-Oct-2005 5:36 PM
QUESTION: On Passage
BILL TITLE: Federal Housing Finance Reform Act

	AYES	NOES	PRES	NV
REPUBLICAN	209	15		6
DEMOCRATIC	122	74		6
INDEPENDENT		1		
TOTALS	331	90		12

Mica voted: Yes

---- AYES 331 ---

Aderholt
Akin
Alexander
Allen
Andrews
Baca
Bachus
Baird
Baker
Baldwin
Barrett (SC)
Barrow
Bartlett (MD)
Barton (TX)
Bass
Bean
Beauprez
Becerra
Berkley
Berman
Berry
Biggert
Bilirakis
Bishop (NY)
Bishop (UT)
Blumenauer
Blunt
Boehlert
Boehner
Bonilla
Bonner
Bono
Boozman
Boren
Boucher
Boustany
Franks (AZ)
Frelinghuysen
Gallegly
Gerlach
Gibbons
Gilchrest
Gillmor
Gingrey
Gohmert
Gonzalez
Goode
Goodlatte
Gordon
Granger
Graves
Green (WI)
Gutknecht
Hall
Harman
Harris
Hart
Hastings (WA)
Hayes
Hayworth
Hefley
Hensarling
Herger
Herseth
Higgins
Hinojosa
Hobson
Hoekstra
Holden
Holt
Hooley
Hostettler
Myrick
Napolitano
Neal (MA)
Neugebauer
Ney
Northup
Norwood
Nunes
Nussle
Obey
Ortiz
Osborne
Oxley
Pallone
Pascrell
Pearce
Pence
Peterson (MN)
Peterson (PA)
Petri
Pickering
Pitts
Poe
Pombo
Pomeroy
Porter
Price (GA)
Pryce (OH)
Putnam
Radanovich
Rahall
Regula
Rehberg
Reichert
Renzi
Reynolds

Boyd	*Hoyer*	Rogers (AL)
Bradley (NH)	Hulshof	Rogers (KY)
Brady (TX)	Hunter	Rogers (MI)
Brown (OH)	Hyde	Rohrabacher
Brown (SC)	Inglis (SC)	Ros-Lehtinen
Brown, Corrine	Issa	*Ross*
Burgess	Istook	*Rothman*
Burton (IN)	*Jackson (IL)*	*Ruppersberger*
Butterfield	*Jefferson*	*Rush*
Buyer	Jenkins	*Ryan (OH)*
Calvert	Jindal	Ryan (WI)
Camp	Johnson (CT)	Ryun (KS)
Cannon	Johnson (IL)	*Salazar*
Cantor	Johnson, Sam	*Sanchez, Loretta*
Capito	Jones (NC)	Saxton
Capps	Keller	*Schiff*
Cardin	Kelly	Schmidt
Cardoza	Kennedy (MN)	*Schwartz (PA)*
Carnahan	*Kildee*	Schwarz (MI)
Carter	*Kind*	Sensenbrenner
Case	King (IA)	Sessions
Castle	King (NY)	Shays
Chabot	Kingston	*Sherman*
Chandler	Kirk	Sherwood
Coble	Kline	Shimkus
Cole (OK)	Knollenberg	Shuster
Conaway	Kolbe	Simmons
Costa	Kuhl (NY)	*Skelton*
Costello	LaHood	*Slaughter*
Cramer	*Langevin*	Smith (NJ)
Crenshaw	*Lantos*	Smith (TX)
Cubin	*Larsen (WA)*	*Smith (WA)*
Cuellar	*Larson (CT)*	*Snyder*
Culberson	Latham	Sodrel
Cummings	LaTourette	Souder
Cunningham	*Levin*	*Spratt*
Davis (AL)	Lewis (CA)	Stearns
Davis (CA)	Lewis (KY)	*Strickland*
Davis (FL)	Linder	*Stupak*
Davis (IL)	*Lipinski*	Sullivan
Davis (KY)	LoBiondo	Sweeney
Davis (TN)	*Lowey*	*Tanner*
Davis, Jo Ann	Lucas	*Tauscher*
Davis, Tom	Lungren, Daniel E.	*Taylor (MS)*
Deal (GA)	*Lynch*	Taylor (NC)
DeFazio	Manzullo	Terry
Delahunt	Marchant	Thomas
DeLauro	*Marshall*	*Thompson (CA)*
DeLay	*Matheson*	*Thompson (MS)*
Dent	*Matsui*	Thornberry
Dicks	*McCarthy*	Tiahrt
Doggett	McCaul (TX)	Tiberi
Doolittle	McCotter	*Tierney*
Drake	McCrery	Turner
Dreier	McHenry	*Udall (CO)*
Duncan	McHugh	*Udall (NM)*
Edwards	*McIntyre*	Upton
Ehlers	McKeon	*Van Hollen*
Emerson	McMorris	Walden (OR)
Engel	*Meehan*	Walsh

English (PA)	*Melancon*	Wamp
Eshoo	*Menendez*	Weldon (FL)
Etheridge	Mica	Weldon (PA)
Evans	*Michaud*	Weller
Everett	Miller (FL)	Westmoreland
Farr	Miller (MI)	Wicker
Feeney	Miller, Gary	Wilson (NM)
Ferguson	*Miller, George*	Wilson (SC)
Filner	*Mollohan*	Wolf
Fitzpatrick (PA)	*Moore (KS)*	*Wu*
Forbes	*Moore (WI)*	*Wynn*
Ford	Moran (KS)	Young (AK)
Fortenberry	*Moran (VA)*	Young (FL)
Fossella	Murphy	
Foxx	*Murtha*	

---- NOES 90 ---

Abercrombie	*Johnson, E. B.*	Paul
Ackerman	*Jones (OH)*	*Payne*
Blackburn	*Kanjorski*	*Pelosi*
Brady (PA)	*Kaptur*	Platts
Capuano	*Kennedy (RI)*	*Price (NC)*
Carson	*Kilpatrick (MI)*	Ramstad
Chocola	*Kucinich*	*Rangel*
Clay	Leach	Royce
Cleaver	*Lee*	*Sabo*
Clyburn	*Lewis (GA)*	*Sánchez, Linda T.*
Conyers	*Lofgren, Zoe*	Sanders
Cooper	Mack	*Schakowsky*
Crowley	*Maloney*	*Scott (GA)*
DeGette	*Markey*	*Scott (VA)*
Dingell	*McCollum (MN)*	*Serrano*
Doyle	*McDermott*	Shadegg
Fattah	*McGovern*	Simpson
Flake	*McKinney*	*Solis*
Frank (MA)	*McNulty*	*Stark*
Garrett (NJ)	*Meek (FL)*	Tancredo
Green, Al	Meeks (NY)	*Towns*
Green, Gene	*Millender-McDonald*	*Velázquez*
Grijalva	*Miller (NC)*	*Visclosky*
Gutierrez	Musgrave	*Wasserman Schultz*
Hastings (FL)	*Nadler*	Waters
Hinchey	*Oberstar*	*Watson*
Honda	*Olver*	*Watt*
Inslee	Otter	Waxman
Israel	*Owens*	*Weiner*
Jackson-Lee (TX)	*Pastor*	*Woolsey*

---- NOT VOTING 12 ---

Bishop (GA)	Diaz-Balart, M.	*Roybal-Allard*
Boswell	*Emanuel*	Shaw
Brown-Waite, Ginny	Foley	*Wexler*
Diaz-Balart, L.	*Reyes*	Whitfield

Chairman WAXMAN. Mr. Turner.

Mr. TURNER. Thank you, Mr. Chairman. I also voted against the bailout package. And I voted against the bailout package because I believe that it did nothing to prohibit the types of practices we are going to discuss today. It provided no real relief to communities or homeowners who are impacted as a result of these practices. And I believe it does no real understanding of what the requirements will be for administering such a program as we look to the underlying mortgages and the number of housing and house units that is there. And I also don't believe that the value is ultimately going to be there when they take a look at the mortgages and the mortgage-backed securities that they are going to be acquiring.

Dr. Wescott, you said that—you gave us about four or five points as to how this happened. Easy credit, housing prices escalating, securitization of mortgages, houses becoming ATMs. And Ms. Minow, you indicated also excessive CEO compensation. Well, I am from Ohio, and we are one of the leaders, unfortunately, in the area of foreclosures. And I want to tell you a little bit about what our experience is. And I would like to get your thoughts on this.

In 2001, I was serving as mayor for my community. And then city commissioner Dean Lovelace, who was a leader in our community of trying to advocate for people who were victims of predatory lending, brought to the attention of the city commission and ultimately legislation, which we passed but were not able to enforce, attempting to prohibit predatory lending practices in our community. We then began working with the Miami Valley Fair Housing Center in our community to work directly with people who were impacted. And our community in the past 2 years has had 5,000 foreclosures on an annual basis in a county of about 500,000 people. The State of Ohio I believe is clipping along at about 80,000-plus foreclosures.

And Dr. Wescott, we are not seeing the housing price escalation as the problem. Ohio is not a State that saw wild fluctuations in housing values. In fact, the Miami Valley Fair Housing Center, Tim McCarthy, the director there, tells me that this is what we experienced. Houses that are probably valued between $75,000, $80,000, people who found the American dream, who got a traditional lending product, were convinced to refinance their house by unscrupulous lenders, predatory lenders, subprime lenders, convinced that the property value was worth a hundred thousand, many times capitalizing the fees, giving the ultimate homeowner a small portion of the cash in the refinancing, the homeowner then facing many times interest rates or payment schedules that they are either not familiar with or not prepared to make; in any event, finding perhaps hard economic times or other circumstances where they realized that the value of the property is below the actual mortgage value. And ultimately, this property going through foreclosure becomes abandoned in my community. Sitting with a leaking roof, broken windows and many times is now worth $20,000, requiring tens of thousands of dollars for it even to be habitable. We are seeing that scourge around our community. And when I see that, I don't see bad loan choices, I don't see people who just were stretching for the American dream but could not afford it. I see someone having stolen the American dream, where there was a homeowner and a family that were sitting there that were convinced to them what they thought was the most regulated transaction in our country, protected by the Federal Government and rules and regulations, caught in a cycle of refinancing.

But there is someone who knew. The person who originated this loan knows that the value of the property isn't there. They know that this homeowner is not going to be able to make it. And ultimately, as we now know, they take that loan, securitize it, and sell it back likely to the bank that had the first mortgage to begin with that wouldn't have given them a loan like that. Again, I believe these people stole. And I believe it was systematic stealing at such an unbelievable and grand scale that it is going to be very difficult for us to unwind this.

In those circumstances, I would like your thoughts on that very process.

Mr. WESCOTT. Mr. Turner, you described very eloquently a second type of housing problem that we are having in this country. We really have two housing problems. We have the credit-oriented problem that is heavily focused in Florida, California, Las Vegas, and so on. And because this part of the economy, because the housing sector of the economy started weakening, we have actually eaten into real disposable income. We have hurt consumer spending across the country. And what that has done is that has lowered demand for automobiles, for industrial goods, and so on. And that is the core part of the problem in the State of Ohio. It is the same in Michigan. These are regions that have lost hundreds of thousands of industrial jobs, as you well know. And so the fundamental problem in Ohio is the loss of jobs and the fact that many people just don't have the income they did 2 years ago or 4 years ago.

Ms. MINOW. Mr. Turner, I want to repeat that one of the most important factors in creating this problem was pay plans that rewarded the executives on the basis of the number of transactions rather than the quality of transactions. And as I said the last time I spoke to this committee, of course we could never pay Congress what you are worth, but if we were paying you based upon the number of laws rather than the quality of the laws, I think you see what the result would be. And when we created these pay packages so that they were benefited by just generating as many transactions as possible, chopping them up, sending them all over the place in a form that could no longer be valued accurately, to me that is one of the key sources of this problem.

Mr. TURNER. As we talk many times about falling housing prices, it is going to be interesting when we actually get into these mortgage-backed securities and look at these mortgage transactions, because I think we will find that many of these loans were given on housing prices where the value wasn't there to begin with.

Ms. MINOW. I agree. And I understand that in some cases even the title searches were not completed.

Mr. TURNER. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Turner.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman. I want to thank all of our panel for testifying today. I know we are going to have this hearing and about four other hearings trying to understand the process that got us into this situation. And today we are focusing on Lehman Brothers. Over the weekend we all got a chance to look at Mr. Fuld's proposed testimony for today. And in looking at that, it appears that he blames just about everyone and everything except himself and the other executives for the downfall of Lehman.

So I wanted to begin by asking this panel for a full diagnosis of just what went on. What were the factors that went into this? Mr. Fuld said it was a litany of destabilizing factors: Rumors, credit agency downgrades, naked short attacks. He says ultimately lack of confidence, and in the end he was overwhelmed. So I want to ask each of you whether or not you agree with that, that Mr. Fuld was a victim of the circumstances or whether or not he and his fellow executives made mistakes, causing the collapse of the company and eventually putting all of us in jeopardy.

Ms. Minow, if I could begin with you. Do you agree with Mr. Fuld's diagnosis?

Ms. MINOW. No. I think it is horrific. I can't believe that he would have the chutzpah to say something like that. I hold him completely responsible. I hold him responsible and his board responsible for the foreseeable consequences of the decisions they made.

Mr. TIERNEY. Professor Zingales, what are your views on that?

Mr. ZINGALES. I think he is definitely responsible for having a too aggressive leverage policy, too much short-term debt that makes the firm sort of at risk of a background that is exactly what happened, and to have not controlled the risk that the firm was taking during this boom period.

All this said, it is also true that we are in exceptional circumstances, and I think that the system is suffering of lack of liquidity. And so it is possible that a lot of banks and firms that in normal times would not be insolvent today find themselves insolvent. The example is suppose that we had no mortgages, what would be the price of your house? And we are in the situation right now. The banks are not lending. And if the banks are not lending, we don't know what the prices of anything is. And at those prices it is very easy that a lot of firms, a lot of banks are insolvent.

Mr. TIERNEY. Thank you. Mr. Smith, you are the only investor on the panel. What are your views?

Mr. SMITH. Well, certainly I hold him responsible, but I think it goes beyond that.

Chairman WAXMAN. Is your mic on?

Mr. SMITH. I am sorry. I certainly hold him responsible. I certainly think they made conscious decisions to take risks that went far beyond the interests of the shareholder. But I also look at the directors, and I look at their responsibility for overseeing management. And I look at the regulatory system that denies investors the opportunity to hold directors accountable. So there are multiple pieces to the puzzle. But I don't believe that he has any safe ground to stand on.

Mr. TIERNEY. Thank you. Professor Zingales and Ms. Minow, if I were to put you or you were to put yourself in Mr. Fuld's position, in 2007 Lehman Brothers paid out nearly $5 billion in bonuses. He himself got a $4 million bonus. But at the same time they did that, they spent over $4 billion buying back shares of stock. They paid out $750 million in dividends. Were those actions, almost $10 billion of capital dissipated in that sense, were those wise decision under the circumstances?

Ms. MINOW. No. I don't think they were. And I will say that I am a real radical on the subject of CEO stock sales. He was also selling a lot of his stock at that time. And I don't believe that CEOs should be allowed to sell stock while they are still with the company.

Mr. TIERNEY. Dr. Zingales.

Mr. ZINGALES. No, it was not a wise decision. He should have increased the equity base, not reduce it at that moment.

Mr. TIERNEY. I noticed that in June 2008 the Lehman Brothers had a $2.8 billion loss on their books, and that sent everything—stunning the markets, sent everything spinning. If they had that $10 billion that had gone to bonuses and to dividends and buybacks, it certainly seems that they might have avoided that situation as well.

Do you know, Dr. Zingales, what the amount of money that Mr. Fuld was seeking from the Korean Development Bank toward the end?

Mr. ZINGALES. No, I don't know the exact amount.

Mr. TIERNEY. Do you, Ms. Minow?

Ms. MINOW. No, I do not.

Mr. TIERNEY. I believe it was probably $6 billion or less. And my point was again, if you take that $10 billion off the books, you lost that opportunity to do something substantial in terms of saving that company and saving our economy on that. But we can explore that further with Mr. Fuld.

But I do want to just cover an e-mail exchange between Mr. Fuld and one of his top executives, David Goldfarb, that was dated May 26, 2008. In that, Mr. Goldfarb reports that a possible deal with the Korean Development Bank would provide several billion dollars worth of new capital to Lehman. Mr. Goldfarb describes what he would like to do with the money, and he writes as follows. It feels like this could become real. If we did raise $5 billion, I like the idea of aggressively going into the market and spending two of the five and buying back lots of stock and hurting Einhorn bad. Now, in the e-mail Mr. Goldfarb was referring apparently to David Einhorn, who at the time was publicly critical of Lehman and was shorting its stock. Mr. Fuld wrote in a short response, I agree with all of it.

So here is how I read this e-mail. Lehman was dangerously low on capital, and possibly found an investor willing to give them billions of dollars. And what they wanted to do with it, however, was buy back stock and punish a short seller. Mr. Smith, what are your views about that e-mail exchange, being an investor?

Mr. SMITH. Well, horrified. When you know that you are low on cash, when you know that you have exposed your company to what I have heard as ranging from 35 to 70 times leverage, and you are giving away your cash with a motive of punishing someone rather than benefiting your shareholders, that is the ultimate breach.

Mr. TIERNEY. Thank you.

Chairman WAXMAN. Thank you, Mr. Tierney.

Ms. Watson.

Ms. WATSON. I really think this is the most important hearing we have had in this particular Congress. I thank the experts for coming out this morning. I just returned from California, the largest State in the Union, 38 million people. It was a turnaround for me. And I tell you, they followed me out of church, they followed me at several dinners, political dinners. Everyone was outraged over the $850 billion of their moneys to bail out people who have shown nothing but corporate greed. And I am hoping that as a result of the six hearings we are going to have that we can come out with a policy that will really curtail this greed out of control.

Now, looking at Lehman Brothers and trying to get to the bottom of what caused this economic crisis that we are in, the makeup of the board may provide some insight with what went wrong. Seven of the 10 board members were retired. Many of them lacked Wall Street experience. And the Lehman board members included the former head of Telemundo, who was a retired Navy Admiral, and a theater producer.

And so I am directing this to Ms. Minow. You are an expert on corporate governance. Do you have concerns about the effectiveness of the Lehman board? And let me just mention one board member, Mr. Roger Berlind, the theater producer. He has been on the board for 20 years, and sits on the audit and the finance and risk committees. What are your concerns about having a board full of people like Mr. Berlind?

Ms. MINOW. Thank you, Ms. Watson. As I said in my testimony, we rank boards based on the decisions they make, and not on their resumes. And I will say in fairness to Mr. Berlind that yes, he is a theatrical producer, he does have a background in finance, and was the co-founder of a Wall Street firm at one time. However, I think it is clear that the members of this board had no clue about the kinds of securities and other issues, the derivative securities and the credit default swaps that we have heard about today. And the fact that the risk committee met only twice 2 years in a row I think tells you everything you need to know.

So I rank this board very, very poorly. They currently get an F from us.

Ms. WATSON. I see one of the biggest problems in corporate governance is how entrenched the board can become. And under current law, there is no effective way for shareholders to challenge an incompetent or negligent board. And in the bailout bill, Chairman Barney Frank tried to address the problem of these entrenched boards. And he said that shareholders should be able to propose their own candidates for the board. The theory behind this reform is that if the board gets too close to management, as the Lehman board did, the shareholders can vote in a new board with more independence and oversight. Unfortunately, Secretary Paulson insisted that this corporate governance reform be dropped from the bill.

So I would like to ask you first, Ms. Minow, was this an important reform? And then Mr. Smith, do you have a view on this? And Mr. Zingales, what you think. In that order, please.

Ms. MINOW. This is a crucial reform. Mr. Smith mentioned it in his testimony. I have it in my written remarks. At this point, you know, I always love bringing this up when I am speaking to the committee because one thing that you all understand very, very well here, very intimately is the concept of an election. And yet we call it an election for a corporate board, and only one person runs, no one runs against them, and management counts the votes. It is a pretty good system. We have to have some way—this is exactly what I am talking about when I say we need to remove the impediments to oversight from investors so that we can remove directors. There are currently more than 20 directors serving on boards today who did not receive a majority vote from their shareholders. Shareholders did everything they could to say we don't want you and they are still serving. So we definitely need to improve that system.

Thank you.

Mr. SMITH. Yes, that certainly is one of the biggest reforms I would like to see. It is the only place I have ever seen where——

Chairman WAXMAN. Is your mic on?

Mr. SMITH. Pardon me?

Chairman WAXMAN. Is your mic on?

Mr. SMITH. Yes, it is. Who are our representatives, the shareholders' representative is not picked by the shareholders and the shareholders have nothing to say about who they are, and they are not accountable to the shareholders. Their presence in the board room is dependent upon management and whether or not management puts them on the slate. That is not a good connection for the shareholders to have their voice heard in a board room, and it has failed us.

Mr. ZINGALES. I completely agree with you. In fact, there are very few things that the United States can learn from Italy, but Italy has a law that allows representatives of institutional investors to be elected on board. And I happen to be one of those. I sit on the board of one of the largest companies in Italy, Telecom Italia, as representative of institutional investors. And I sit on their compensation committee, and I can actually argue about their compensation. And I can tell you that last year I wasn't particularly polite in some of the conversation. And if I was appointed by management, I would not have been renewed. But I was renewed because I am appointed by institutional investors and I represent shareholders on that board.

So I think that would be a very important reform that we could pass.

Chairman WAXMAN. Thank you, Ms. Watson.

Ms. WATSON. Thank you so much.

Chairman WAXMAN. Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chairman. Just a couple of thoughts. Virtually every recession or severe economic downturn originates in excesses in the financial economy. And then they go on to ruin the real economy. I think the recent financial crisis is consistent with that. And I find in my review of the facts four basic abuses: A lack of transparency, excessive leveraging, conflicts of interest, and most egregious, the probability of dishonesty and deceit.

Lehman Brothers didn't just collapse on September 15th. Its financial situation has been getting increasingly dire with each passing quarter. But Lehman's executives kept telling shareholders and public investors that its finances were in great shape. In September 2007, Lehman's chief financial officer told investors, "our liquidity position is stronger than ever." In December 2007, CEO Richard Fuld said, "our global franchise and brand have never been stronger." In March 2008, Lehman fired its chief executive officer and hired a new one. The new chief financial officer told investors, "I think we feel better about our liquidity than we ever have." In June 2008, CEO Richard Fuld told shareholders, "our capital and liquidity positions have never been stronger." And on September 10th, 5 days before Lehman filed for bankruptcy protection, Lehman made upbeat comments to investors and research analysts.

Mr. Smith, you represent a State pension fund. Your fund manages retirement assets of public employees in the State of Colorado. What do you think about these statements by Mr. Fuld and others at Lehman? Were they giving you an honest assessment of what was going on inside the company?

Mr. SMITH. Well, clearly, they were not giving us an honest assessment of it. And unfortunately, neither were the books, neither were the auditors. There was no piece of the puzzle that allowed us—we are big boys and girls. We invest billions of dollars. We understand how to invest. We understand how to do due diligence. But you have to have the tools to do that. And you have to have people who are going to be honest enough to tell you the facts, or at least have you have the ability to go mine the facts yourself. And in today's situation, and for many years now we have been unable, we have been impaired in our ability to do that.

Mr. HIGGINS. Professor Zingales, what is your view? Could Mr. Fuld have been truthful when he said in June 2008 that our capital and liquidity positions have never been stronger?

Mr. ZINGALES. It is hard to imagine that it was never stronger than that. I think that it is clear that was a moment of crisis, and it is clear that he didn't have a good understanding of what the situation was. If it is true, as was said, that he was indicating that they would buy back stocks in order to punish the analysts, I think—I am sorry, the short sellers, this is a typical situation of overconfidence by a CEO that doesn't see the problems as they should be. And he thinks that the responsibility is all on the market that gets it wrong. It is all on the short sellers, the short sellers of stocks, and they don't see the problem coming.

Mr. HIGGINS. Mr. Fuld had a vested interest in painting a rosy picture at Lehman. If he had disclosed its precarious situation it could have put more pressure on the company. That is why I believe the disclosure rules are so important. Investors shouldn't have to rely on the rosy assessment of corporate executives. They should be able to verify those statements in reviewing public filings of the company. Mr. Smith or Dr. Wescott, what are your views about disclosure rules?

Mr. SMITH. Well, I was just mentioning I should have hit transparency a little harder in my answer. I appreciate the loop back, because that is what we believe was lacking with the off balance sheet opportunities, with the loosened accounting rules, with the obfuscation of the leverage that they were actually imposing on the assets of the organization that were in large part undetectable by an investor. Didn't have much of a fair shot at assessing our risk when we got into that.

Mr. WESCOTT. A quick comment. Basically, there are two ways you can go if you are going to regulate an industry. You can have very, very tight regulation. At the limit, you can imagine a regulator basically working full-time in the institution looking at every number every day. And that is one way you could go. The other way is to back off and to allow—to have less day to day, minute to minute regulation. If you are going to go that way, though, you have to—the key building block is disclosure and transparency. And that is—if you don't have this very minute level of regulation, you have to have disclosure and transparency.

Chairman WAXMAN. Thank you, Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chair.

Chairman WAXMAN. Ms. McCollum.

Ms. MCCOLLUM. Thank you, Mr. Chairman. I want to go back to September 10th, because that is 5 days before the bankruptcy filing. It is my understanding that the chief financial officer held a conference call for investors. And that was reported in the Wall Street Journal. And in fact, some of the bankers even advised them not to hold this call because there were going to be too many open questions. And I would like to know from the panel, to your understanding is this accurate?

Ms. MINOW. I don't have any information about that, sorry.

Ms. MCCOLLUM. My understanding is at the time that they were making this call they were trying to raise capital through new investors or by off selling assets. Dr. Wescott, Dr. Zingales, any comment on that?

Mr. WESCOTT. Unfortunately, I don't know the details of what was going on.

Mr. ZINGALES. Neither do I.

Ms. MCCOLLUM. One of the concerns that I had, Dr. Zingales, from your testimony, you talked about how there were three issues kind of involved to Lehman's collapse. One of them that we haven't spoken about very much was the whole idea of the credit market swap that was involved in here. So irrespective of whether or not they were making good investments, and they definitely were not in the home mortgage securities, could you elaborate on Lehman Brothers' role in the credit swap?

Mr. ZINGALES. Actually, the role of Lehman in the credit default swap market is relatively limited. There is a table in my long testimony, I think it is table 5, that reports the best numbers we have regarding sort of the amount of credit default swaps in place. And Lehman is 25th in the list. So they definitely had some sort of play in the market, but not a huge play in that market.

Ms. MCCOLLUM. But when there is lack of confidence in the market, to what degree did these—I mean they were out there hustling for cash, looking for something. They knew that they had problems with the loans that they had accrued. The fact that they got even involved in doing this credit swap, does that bring any—from my research, that does not bring any stability to a company. In fact, it adds to destability.

Mr. ZINGALES. It depends what position they take, because if they were hedging their risk by taking insurance along the way, this should in principal have reduced their risk. Of course if they were selling insurance, that would have been crazy, but I don't think at that time people would have bought the insurance because they were sort of rumored to be in difficulty. So you don't want to buy insurance from an insurance company that you are not sure is going to be around to pay when your house is in trouble, for example.

Ms. MCCOLLUM. Could I ask each one of the panelists, there was great discussion about privatizing Social Security. And as we have heard from the gentleman from Colorado, a lot of pensions had their security assets in fact involved in these types of products. Could you tell me what, in your opinion, privatizing Social Security would have meant for Americans today had that plan gone through?

Mr. SMITH. Well, the beauty in our view as a pension system, and particularly a hybrid defined benefit pension system is that we are able to pool at least some of these market risks for our members. The members in our system who were within a year or so of retiring and faced this crisis probably still have the ability to retire, because we have a long-term ability to provide those benefits. If they were on their own and they were in individual accounts that were under their control and their responsibility, they would be left with only that, and that would be inadequate to provide for them in these times. And this cycle would have caused them to go back to work for years into the future. So it would be devastating to have individuals—in my view, to have individuals and individual accounts out there trying to survive in what is a market that lacks transparency.

Mr. WESCOTT. Just there are many different proposals of how to do a privatization of Social Security. There is carve out, there is add on, and so on. So it is difficult to know exactly which type of plan we would be talking about. The key for insuring safe retirements for Americans is diversification, a blend of income, some coming from Social Security, some coming from company plans, some coming from private 401(k) plans or individual plans. What we really want is to have a blend of money so that you have multiple sources, each of them subject to different risks.

Chairman WAXMAN. Thank you very much. Did anyone else wish to respond to the question? Thank you, Ms. McCollum. Mr. Van Hollen.

Mr. VAN HOLLEN. Thank you, Mr. Chairman. I thank all of the witnesses for being here today. I just want to pick up on a point that Ms. Minow raised in her testimony regarding the link between executive compensation and overall performance. We are looking at Lehman Brothers as a case study today. We have AIG tomorrow. And then we will go on to some of the more systemic issues. But I think what we are seeing today, just looking at Lehman Brothers, is a good case study of the fact that you don't have this alignment between pay and performance. In fact, as my colleague Mr. Cummings was saying, unlike the rest of America, where pay for performance means you get rewarded when you do well, but you actually get—there are disincentives, you get cut in pay when you do poorly, the fact of the matter is on Wall Street you do well when they do well, and you do well when they are doing poorly. And that clearly is a mismatch. And I think it is important to look at this to make the recommendations you have talked about in terms of what we can do legislatively to better align stockholders' interests with those of the executives who are making decisions. And one problem I think is the fact that people are urged to take big risks to maximize short-term pay and bonuses at the expense of longer term well-being of the company and the stockholders. And I think one of the reasons that happens is because people think that when they make bad decisions they are going to still get bailed out.

I want to talk to you briefly about a memo that was written at Lehman Brothers by the compensation committee on September 11th. That is 4 days before Lehman Brothers declared bankruptcy. And it is a recommendation from Lehman Brothers to the compensation committee of the board. It discusses a number of the separation payments, including one of them to Andy Morton. Mr. Morton was the head of Lehman's global head of fixed income. He was the person who was responsible for the leveraged investments that were a good part of what drove Lehman into bankruptcy. Another was Mr. Benoit Savoret, a member of Lehman's executive committee. It says that they both had been involuntarily terminated. They have been fired. And so you would think, you know, when you get fired, bad performance, no pay. But it goes on to recommend giving them cash separation payments combined of $20 million, $16.2 million for Mr. Savoret, and $2 million for Mr. Morton. And it calls—in the memo they describe these as special payments. And they come up with a rationale for providing these kind of last minute bailouts to these guys. Is this part of the mentality of sort of an insatiable, you know, insatiable sense of entitlement on Wall Street that suggests that even when you do badly someone is going to be there to bail you out?

Ms. MINOW. I couldn't possibly have put it as well as you did, Congressman. That was perfect. I had to laugh, though, when you said this was a good case study. I wish it was the only case study. It is just replicated over and over and over and over again. And you are right, they are so completely out of touch, that on the upside they always say I am responsible, it is a market test, I am Michael Jordan, I am A-Rod, I deserve this. But on the downside, it is never their fault. And if we don't have better shareholder oversight, if we don't have better market response to them, then they are never going to get the message.

Mr. VAN HOLLEN. Let me just read to you their description of why these are apparently justified in their view. They say these executives are, "very experienced senior executives with valuable business skills and experience that the corporation may wish to leverage." Again, these are the guys who helped obviously contribute to the downfall. It also says, "the corporation would face significant impacts if the terminating executives should fail to provide appropriate transition assistance, solicit clients, or engage in other behavior that may be detrimental to the corporation."

Now that you have heard the rationale, does that pass the common sense smell test?

Ms. MINOW. Not at all. But this goes back to a point that I made earlier where I said I take a very hard line. I don't believe they should be allowed to sell their stock until after they leave their company. And if that doesn't motivate them adequately, then they are not paying attention. But I think it is hilarious that they use the term "leverage." Because one thing we have learned about this company is they didn't understand leverage at all.

Mr. VAN HOLLEN. Mr. Smith, as somebody who entrusts these individuals with lots of decisions, is that the kind of pay for performance that you would want to see?

Mr. SMITH. Certainly not, and certainly highlights our desire to have say on pay as a shareholder, to be able to be in the board room or have a representative in the board room that actually is looking at those payments and saying how is this going to bring value to my shareholders? And I would contend that there is categorically no way those payments could bring value to the shareholders.

Mr. VAN HOLLEN. Thank you. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Van Hollen.

Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman. I would like to explore the role of excessive leverage in the downfall of Lehman Brothers. Professor Zingales starts his whole testimony by saying the downfall of Lehman Brothers is the result of its very aggressive leveraging policy. Could you help the public understand how leverage magnifies gains or losses?

Mr. ZINGALES. Sure. Let me make sure that you all understand what we are talking about. When you buy a house and you put a 10 percent down, you are basically buying something that is worth 10 times what you put down. So your ratio is 10 to 1. That is the leverage. What Lehman was doing was 30 to 1. So it was much more than what most people do in buying their house. And this exposes you enormously to fluctuations in the value of the underlying assets.

As I said in my testimony, if you have a drop of only 3.3 percent in the value of your assets, your entire value of the equity is wiped out, and so you are insolvent. And this system, as was mentioned by the chairman, is very rewarding on the upside, so that when things go well you have very high sort of earnings, you have very high return on capital, and this allows you to pay very large bonuses. On the downside, this is very dramatic. And so especially given sort of the situation in which we were, the risk on their assets and the risk of a downturn in the housing market, it was not sort of not foreseeable, I think their leverage policies should be much more cautious. But also it is not only the leverage, it is also how much of that leverage is short term. Because when you have a problem, the short term lenders can leave you and create a situation of insolvency, which is exactly where Lehman was. And before the beginning of the crisis, 50 percent of that leverage was made of short-term debt, which is very profitable in the short term because short-term debt, especially in the current environment, is much cheaper than long-term debt but exposes more to a risk of a run, and that is exactly what happened.

Mr. COOPER. So Lehman was levered I think at the start of Dick Fuld's tenure at 27 times, and then it went to 37 times. And now that there are no major investment banks left on Wall Street, even Goldman Sachs and Morgan as I understand are down to about 10 times leverage. So it has been a substantial contraction of the leverage ratios.

Dr. Wallison, could you tell us what you think an appropriate leverage ratio would be for investment banks, assuming we have major investment banks return to America one day?

Mr. WALLISON. I don't think, Congressman, that you can give a number. It depends very much on the risks that they are encountering in the market at a given time. It is obvious, it should have been obvious to the management of Lehman and any other management that when things can't continue, as Herb Stein once said, they will stop. And as a result, a provision should have been made for a downturn. But there isn't a number that is the right number under any circumstances.

Mr. COOPER. But it is sounding today, since no firm, major firm left in the country is leveraged at 30 to 40 to 1, that must be too much, right? Another point about leverage is the fulcrum on which the lever rests, the capital, the equity that Lehman thought it had on its balance sheet. And Professor Zingales, didn't you say in your testimony on the day they went bankrupt it supposedly had $26 billion on its balance sheet?

Mr. ZINGALES. Yes, $26 billion in book value of equity. The problem is the market value of the equity depends crucially on the value of its assets; and the uncertainty that was created in the value of the assets in part by lack of transparency, in part by the liquidity crisis made it impossible to know exactly what it was. And when the market becomes nervous, that is the moment they pull out their money. That is the reason why adding a lot of short-term debt is not wise, because in that situation you can have literally a bank run, and that is what happened.

Mr. COOPER. So a contraction in credit because of excessive leverage crushed $26 billion in capital, which we question the value of anyway, because, apparently, mark-to-market rules didn't necessarily apply quickly enough in this case. And I think that leaves a lot of folks back home wondering whether this is Wall Street or a casino.

Because, as you conclude your testimony, Professor Zingales, you say Lehman did not find itself in this situation by accident. It was the unlucky draw of a consciously made gamble. That doesn't sound like an investment. That sounds like gambling.

Mr. ZINGALES. I think, as I said in my testimony, they were too aggressive in their leverage; and that is the reason why I think they should not have been bought out. My major concern is that if we bail out everybody who took those gambles, we are going to create incentives to have more gambles down the line. And I think that there is a strategy on Wall Street to sort of take a lot of gambles on the outside and then walk away when things don't work out. And if you don't get punished when things don't work out, everybody will play that gamble over and over again. So I think we have to be very careful on what we do now, because I think that what we are doing now will define incentives for a generation to come.

Chairman WAXMAN. Will the gentleman yield? Just for me to point out that the regulation of commercial banks is that the leverage is no more than four to one. So I guess every—all the banks are now commercial banks. But there is a spelling out of it—of a leverage number.

The next person to question would be Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

Of course, we have all alluded to the fact that there is a lot of people who are angry out here in the country. I expect that when we are done with these five hearings they are going to be a lot angrier, because they had deep suspicion about this culture of greed and recklessness on Wall Street. Now they are going to have plenty of proof positive of it once we are done with these hearings.

I don't think there is any surprise to be found in the huge either golden parachute packages or compensation or salaries that these folks got used to thinking they should have. When you look at the amount of money they are playing with—and I use the phrase "play with" rather than "manage" because that's where it seems things seemed to get. So you put it in that context, and they lose all perspective. They are not living really in the same world that everybody else is living when they are dealing with these kinds of dollars under these sorts of conditions.

And I have to go back to what Congressman Higgins was asking about before. Because if you're Richard Fuld, I mean, how do you lose all commonsense? I'm looking at these statements that he made. Late in the game, like right before this thing falls apart, our global franchise and brand name—our brand have never been stronger. In June 2008, still in this year, our capital liquidity positions have never been stronger. This is a no-win statement from him. Because either he has lost all perspective and is completely clueless in a statement like that or he is quite savvy but he is deceiving people affirmatively.

You could pull anybody out of any coffeehouse anywhere in this country who are small businessmen and you could lay out for them the basic metrics of what was happening to this company at that moment in time and they would say, are you kidding me? Are you kidding me that this was a strong position? I mean, anyone would recognize that.

So here is my question. How does this happen? Talk to me a little bit about the culture, the external culture—in other words, if you're Richard Fuld, you've got your company's culture that you're dealing with, and then you have the larger culture. So what happens that makes him lose such perspective? Or, if you want to look at it another way, think he can get away with this kind of public pronouncement. Is it the parties you're going to? Is it the fact that the analyst division of your own company suddenly evaporates and stops doing its job? I mean, what is happening to get you to this point? Anybody. Yes.

Mr. WESCOTT. Let me take the first cut at this.

Think of the—you're having a monthly management meeting of your management team, you have the heads of your profit units there, and you're giving—if you're the CEO, you're giving them their profit targets, let's say, for the quarter. This trading desk, you're expected to have $100 million of profit; that trading desk, $50 million; and so on. In the room, you have the corporate risk officer; and these companies—all of the investment banks have risk officers. Their job is to be looking at the financial developments, at the trends of housing prices, subprime loans and so on. And when you're sitting around the table, the profit managers are explaining what their prospects are for hitting that profit target.

Presumably, the risk officers there are saying, we are getting kind of nervous here, because we're now pushing the envelope in this area. I think maybe we need to cut back the profit target for that—let's say, that trading activity or whatever activity, because it is starting to feel risky.

Ultimately, that is what the CEO is being paid for. He is being paid for that judgment, hearing the debate that is going on. And probably in many of these cases, the risk officers were not speaking up quite loudly enough.

Ms. MINOW. Mr. Sarbanes, I always say when I look at boards of directors, more than being a financial analyst, more than being a lawyer, I'm an anthropologist. Because I think you have to look at kind of the anthropology of the board room. And when you have a CEO who picks his board to make sure that it is a bunch of retirees who barely know what a derivative is and have a risk committee that meets only twice in a year, you have kind of an emperor's new clothes problem. Nobody wants to tell him the truth, and he intentionally surrounds himself with people who are complicit.

If you look at the part of my testimony where I talk about the related party transactions, these are people who were getting side payments from the company. They had no incentive to provide any kind of independent oversight, and that is why it is so important to let shareholders like Mr. Smith throw some of these people out.

Mr. SARBANES. Well, they called Mr. Fuld the gorilla, right? So maybe they should have had Jane Goodall in there doing an analysis from an anthropol—thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Sarbanes.

Mr. Welch.

Mr. WELCH. Thank you. Thank you, Mr. Chairman. I thank the witnesses.

Mr. Wallison, I happen to agree with some of your criticism about Fannie Mae and Freddie Mac and the walk-away bonuses to the folks who ran that company, those public enterprises, into the ground are pretty despicable. And, you know, frankly it is mystifying to me why somebody would get over $100 million for essentially buying and selling mortgages. It is not that complicated.

They, as a public entity, are now prohibited from lobbying. I have a question of you. Do you believe that, in view of the fact that the taxpayers now have $700 billion in the game, that restriction on lobbying should apply to banks or other agencies that choose, choose to participate in the benefit of this taxpayer bailout?

Mr. WALLISON. No. The restriction on Fannie Mae and Freddie Mac from lobbying comes from the fact that they are now controlled by the Federal Government. There isn't any need for them to come to Congress and inform Congress in particular. Lobbying serves a very valuable function, in my view, of informing Congress of what the legislation will actually do.

Mr. WELCH. Let me just clarify it. The distinction between a paid lobbyist and then representatives on the actual payroll of Fannie Mae and Freddie Mac coming in, for which I have no objection.

Mr. WALLISON. I don't see a difference, really, between those two, whether you are salaried by the company or whether you are retained outside. Lobbyists have a valuable function; and Congress should consult with, listen to lobbyists. You have to discount them appropriately, listen to both sides. But it is a very dangerous thing for Congress or anyone else to wall yourself off from the information that the companies themselves can provide about the effect of your legislation.

Mr. WELCH. All right. Let me rephrase the question a little bit. I do agree with you that lobbying is a very valuable activity for people that come in and petition. My question is whether taxpayers should help pay for it.

Mr. WALLISON. Sure. Of course. For individual companies—Mr. Congressman, if I can just finish the question—this is very important for them to make sure that Congress people who are making decisions on legislation that could affect them substantially are well informed and that directly affects the shareholders.

Mr. ZINGALES. I agree with you, Congressman.

Mr. WELCH. And the question—I just want to rephrase it, because I don't want to turn this into lobbying or not. But the question really has to do with the fact that there is $700 billion of taxpayer money in this bailout effort. And should any of that money be allowed to be used for lobbying activities?

Mr. ZINGALES. Yeah. I think that you are right. It should not be used for lobbying. But, most importantly, I think that lobbying does serve a useful purpose, but it is also true that it is an unfair game. Because clearly sort of financial firms have much more power than the public interest. So the public interest always loses out in lobbying.

Mr. WELCH. OK. I mean, we've heard—I'll ask Ms. Minow. You look like you want to weigh in on this.

Ms. MINOW. Thank you very much, Congressman. There is one point that I would like to make.

I would hope that the committee would take a look at Bethany McLean's article in Fortune Magazine about Fannie Mae. Because it wasn't just the lobbying. It was the fact that their foundation had events in all of the congressional districts that—for their Oversight Committee that I think played a very big role in it. So it is more than just lobbying.

Mr. WELCH. All right. Mr. Smith, do you think if we had stronger shareholder representation on the board so that the policies that were then being advocated by the company, if we had those stronger shareholder representatives on the board of governance, that would help address this issue?

Mr. SMITH. Absolutely. I think that is the key to—it is really the solution. Because I think to cutoff lobbying does isolate you. And what we need to have is a balanced opportunity to be heard by the interested parties, and I think that is the piece that is lacking or has been lacking.

Mr. WELCH. OK. Dr. Wescott, do you have anything to add to this?

Mr. WESCOTT. No.

Mr. WELCH. You know, we have been asking a little bit about this corporate pay an awful lot because it is the symbol of outrageous excess and abuse.

Mr. Prince was in here before. He got $38 million when he walked away, lost about $20 billion in two quarters.

Mr. Mozilo of Countrywide, another great American entrepreneur, was given $120 million; and he ran his company into the ground.

Mr. O'Neal from Merrill Lynch got a walk-away package of $161 million. Also, in the last two quarters before he left, they lost about $20 billion for the shareholders.

And all of us think that is a bit odd. Do you believe there should be a right of the taxpayers to have whatever rights would be available to the company to claw back some of that rip-off walk-away money in the event those companies choose to participate in this bailout?

Mr. ZINGALES. Yes.

Mr. WELCH. Mr. Zingales. Mr. Wescott.

Mr. WESCOTT. Yes. If the government is part owner of the firm, it should have the rights of a part owner.

Mr. WELCH. OK. Mr. Wallison, how about you?

Mr. WALLISON. Yeah. If the compensation was, in fact, not properly earned, the shareholders, the company should be able to get it back.

Mr. WELCH. Yeah. And would we all basically agree that these guys got out of dodge before the house of cards collapsed?

Ms. MINOW. Yes.

Mr. WELCH. But it put in place the rot in the beams that led to its falling down.

Ms. MINOW. Congressman, if a private entity were participating in some kind of a transaction of owning distressed securities, they would insist on those rights and the taxpayer should certainly insist on them as well.

Chairman WAXMAN. Thank you, Mr. Welch.

Mr. WELCH. Thank you, Mr. Chairman.

Chairman WAXMAN. Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

I want to apologize. I'm going to make some reference to my statement. I had been hoping that I could do that earlier, because it has context to the questions that I want to ask. I'd like to know your response to what I'm about to say.

At the center of our financial crisis is the collapse of the housing market. So it is surprising to me we are not taking a close look at Fannie Mae and Freddie Mac. But what is also glaringly missing from these hearings is an intense investigation about the role of Congress in this disaster, particularly as it relates to Fannie Mae and Freddie Mac. Together, these two giant financial institutions scrutinize half of our Nation's $12 trillion mortgage market.

Clearly, Wall Street bears significant responsibility for this crisis. The leaders of these financial institutions need to explain how overleveraging, undercapitalization of peak accounting and minimal investor disclosure ever seemed like sound business practices. Every part of the financial market broke down. Wall Street accumulated far too much debt; consumers lived on credit, often refinancing their homes to get it; lenders lured buyers into houses they couldn't afford; investment firms did not disclose the risks associated with their products; the rating agencies seemed oblivious to shaky financial instruments and the companies that bought and sold them; and the Federal Government, including Congress, failed to properly regulate. The regulatory structure was failing, and we in Congress refused to do anything about it.

In the interest of truth, it must be said we are not confronting the 800-pound gorilla in the room. What we're not confronting is the role of Fannie Mae and Freddie Mac in this debacle. Combined, these two companies not only scrutinized half of the Nation's mortgage market but one train alone in subprime loans. Yet they are not required to disclose the risk these mortgages posed to the solvency of their balance sheets.

Why? Because we in Congress have not required the same registration reporting requirements of Fannie and Freddie as we do with all other publicly traded companies.

The efforts of a few of us in Congress to address this situation are a matter of public record. Our efforts can be found in legislation, in hearings and debates and votes in committee and on the floor of the House.

When it came to Fannie and Freddie, lobbyists effectively manipulated both sides of the aisle. Fannie and Freddie hired lobbyists to advocate for their position and kept countless lobbyists on retainer to prevent them from arguing against their position. Congress stood idly by as Fannie and Freddie played with trillions of dollars under a different set of rules with little capital to protect their balance sheets from sudden losses.

There is no way to explain it. The reason—there is no other way to explain it. The reason we haven't scheduled hearings on these two institutions and haven't requested documents from either is because their demise isn't someone else's fault, it is ours; and we don't want to own up to it.

Mr. Chairman, the alarm bells were sounded more than 4 years ago. I requested transcripts of these public discussions. I request that the transcripts of the following committee and House debates be placed in the record for today's hearing:

July 23, 2002, Financial Services Committee hearing, OFHEO Risk-Based Capital Stress Test for Fannie Mae and Freddie Mac.

July 23, 2003, Financial Services Committee markup, H.R. 2420, the Mutual Funds Integrity and Transparency Act.

September 25, 2003, Financial Services Committee hearing, H.R. 2573, the Secondary Mortgage Market Enterprises Regulatory Improvement Act and the Administration's Proposals on GSE Regulation. That was September 25, 2003.

October 6, 2004, Financial Services Subcommittee hearing, the OFHEO Report: Allegations of Accounting and Management Failure At Fannie and Freddie.

April 6, 2005, Financial Services Committee hearing, Additional Fannie Mae Failures.

October 26, 2005, floor debate, consider Mr. Royce amendment to H.R. 4161 to strengthen the OFHEO regulator.

Getting to the bottom of this—that's my motion, that we introduce these into the record.

Chairman WAXMAN. If the gentleman would permit, I would suggest that we make reference to all of those, and people then can link into those, rather than spend taxpayers' money to reproduce all of those records, if that is acceptable.

Mr. SHAYS. That is acceptable.

Chairman WAXMAN. Then, without objection, that will be the order.

Mr. SHAYS. Getting to the bottom of this, whatever that takes, is our obligation but requires us not to just look at CEOs of Lehman or AIG but at ourselves and the wretched manipulation by Fannie Mae and Freddie Mac of the Congress of the United States.

With the limited time I have left, I would like—I have no time left.

Chairman WAXMAN. If the gentleman would permit and yield to me, we have five hearings scheduled on the issues of where we are in the economy and what has happened with Wall Street, and the gentleman raises issues about Freddie Mac and Fannie Mae. Our staff is already looking into some of the documents relating to them, and we may well add additional hearings. We are not restricted to those five hearings, and I appreciate the concern that has been raised.

Mr. SHAYS. Will the gentleman yield?

Chairman WAXMAN. Yes, sir.

Mr. SHAYS. Given that the housing market is what brought down everyone else, why wouldn't we start with Fannie Mae and Freddie Mac, given they were exempted from the 1934 law, the 1933 law and given that we all know that they hired lobbyists to work their will in Congress? Why would we not be looking at Congress? Why are we looking at everyone else but Congress?

Chairman WAXMAN. Well, I have no reason not to look at Congress. We'll be happy to look at Congress. It has been controlled by the Republican party for a 12-year period; and during the 2 years the Democrats have been in control, it has been controlled by a Republican administration. We ought to look at the politics of why we haven't gotten further.

But trying to understand where we have been and where we are now and what the causes were and what reforms are necessary is the objective of this committee. And you can't do everything all at once. We'll start with the first hearing today, and we'll go on to the next one tomorrow, and we'll go on from there.

We have completed all of the members who sought recognition. Mr. Mica——

Mr. MICA. Mr. Chairman, given the importance of this hearing and again asking for fairness for both sides, I would ask unanimous consent that each side be given an additional 10 minutes to be distributed by the Chair and the acting ranking member for additional questions of this panel.

Chairman WAXMAN. The Chair is going to object to that. We have had a very long time with this panel, and we have Mr. Fuld waiting. But the Chair will note that there are many more Democratic Members here than Republican Members, and I will allocate 5 minutes to the Republicans between the two of you to ask any further questions that you wish to pursue of this group. Who should control that time?

Mr. SHAYS. I will control it and yield to my colleague 3 minutes. Thank you, Mr. Chairman.

Chairman WAXMAN. OK.

Mr. MICA. Well, actually, I'm quite disappointed. I was——

Mr. SHAYS. I'd be happy to yield my colleague 5 minutes.

Mr. MICA. I was berated by the Chair in the bipartisan matter in which I conducted my subcommittees. I'm the ranking member of the largest committee in Congress. I chaired the subcommittee— Aviation Subcommittee for 6 years, never once denied a single Democrat or Republican the opportunity to fully participate in offering an opening statement or asking a question. I'm really—I'm really saddened by the way this is being conducted, because this is an important hearing and there are important questions that the people want answered. And if he wonders why people aren't on this side, if you can't participate, why the hell should you be here? But that's another matter.

I have a couple of questions of my remaining time.

So now that we have no major investment banks, Mr. Wallison, what do we do in regulating them?

Mr. WALLISON. Well——

Mr. MICA. That's a rhetorical question.

Mr. WALLISON. Nothing to regulate at the moment—firms, incidentally, all of which could become investment banks over time.

Mr. MICA. Yeah. Well, I think that some of the things that were raised here, transparency, leveraging, would you say that by Fannie Mae reducing its reserves from 10 percent to 2.5 percent, that others in the private sector—people don't understand that we had a government-backed securities operation, which was Fannie Mae, and they were backed by the U.S. Government. Lehman, AIG and the others are private—were private investment activities; is that correct?

Mr. WALLISON. Yes, it is.

Mr. MICA. OK. Not that they should be precluded. But when you have ones reduce their reserves, then what happens? Wall Street follows usually to compete. Isn't that what happened?

Mr. WALLISON. No. Actually, Congressman——

Chairman WAXMAN. Is your mic on?

Mr. WALLISON. Sorry. The capital of Fannie and Freddie were set by statute. That was one of the regulatory problems that are associated with those two enterprises.

Mr. MICA. My point, though, is that, in most of this, Wall Street followed.

Now, of course, Raines only took off with $100 million in compensation, and we have—and that was a government-sponsored activity. That is absolutely outrageous. Mr. Shays tried to bring that under control. He introduced legislation. I was a cosponsor in 2002.

And then people in Congress—and we don't have anyone from Fannie Mae here to start this out. This is ridiculous. Fannie Mae— who was the biggest private mortgage lender in the country? Wasn't it Countrywide, Mr.——

Mr. WALLISON. Countrywide, yes.

Mr. MICA. Countrywide. OK. How is this, Mr. and Ms. America? Franklin Raines received a 5.1 percent loan for 10 years for almost a million dollars in refinancing. Jamie Gerlach received 5 percent for a $960,000 refinancing, both employees. This is a government activity, outrageous. And they walked away with millions of dollars, and we are not looking at that.

Then the guy that writes the bailout package in the Senate gets—he got one of these VIP Countrywide mortgages for himself, and we are just trying to blame Wall Street. Is that fair? I want everyone to——

Mr. WALLISON. There has been greed all around, I would say. Greed all around.

Mr. MICA. OK. Was it greed, Mr. Smith, or just a good deal for the few elected officials and somebody behind a government mortgage company who was ripping folks off?

Mr. SMITH. I would certainly say it is not actions in the best interest of the shareholders.

Mr. MICA. Ms. Minow.

Ms. MINOW. Sorry. I think there are profound conflicts of interests, and I hope that there is oversight of Fannie and Freddie and Congress.

Mr. MICA. Doctor.

Mr. WESCOTT. There is plenty of blame to go around. The truth is that Fannie actually lost market share in some of these mortgage areas in the years in question.

Mr. MICA. To the private sector competing with trying to keep up with what the government was doing.

Mr. WESCOTT. Right.

Mr. MICA. What government-backed activity was doing. Thank you.

Mr. ZINGALES. Conflict of interests are always dangerous, whether they are in Wall Street, in Congress or in a political opposition. It is always dangerous.

Mr. MICA. How again do you bring this under control—and go down the panel—given the cards that we are currently dealt? That is my question.

Mr. WALLISON. Well, there was an excellent bill that came out of the Senate Banking Committee in 2005. That bill would have allowed a regulator to control their capital which would have immediately reduced their risks and controlled their portfolios, which are a major source of their risks. That was a partisan vote. All Republicans voted for it; all the Democrats voted against it.

Mr. MICA. And then who was chairman and—who was chairman and then who blocked it as the ranking member?

Chairman WAXMAN. The gentleman's time has expired.

Mr. MICA. Excellent.

Chairman WAXMAN. The chairman will now take his 5 minutes. And I don't think we ought to use these hearings as an opportunity to be partisan, because Freddie and Fannie had people in charge when Clinton was President that got excessive salaries and bonuses, but so did Mr. Mudd, who was appointed by President Bush.

But what we're starting to look at in these series of hearings of how we got into this mess is what has happened with one of the companies that has actually gone bankrupt and for which many people have told us this started in a direct line to the $700 billion that the Congress has now approved to give to the Treasury to help stabilize our economy. To start off with Lehman I think is perfectly appropriate. To look at Freddie Mac and Fannie Mae is also appropriate. And we should look at all of these issues.

But what struck me from your presentation today—and I thank the panel very much for what you had to tell us—is that there seems to be almost no accountability to the people who own the corporations. They are the ones who own it, and they are the ones who take the loss when the company goes bankrupt. There seems to be no transparency in what is going on.

It appears that the CEO controls the decisions with a board that is hand picked in many circumstances, and it certainly appears to be the case with Lehman Brothers. And the CEO can play with other people's money. And not just play with other people's money, he can borrow a lot of money to leverage the money he has to play with. And if times are good, that leverage can bring in enormous amounts of profit. But if times are bad, then he can lose his footing for his corporation very, very quickly.

It does seem to me that ordinary people play by a different set of rules than they do on Wall Street because ordinary people in this country—many of them have lost their jobs, have lost their homes. Everyone has seen their health care costs go up, if they're lucky enough to have health care insurance. And if they're not, when they go to see a doctor to access the system, they know how expensive it all is, especially if they buy drugs. And if they fail in their jobs, they are held accountable. They don't get the promotions. They don't get the bonuses. And, in fact, they get fired. Even if they have done a good job they get fired if the corporations run into troubles.

But the CEOs seem to always come out on top. They win when the corporation wins, and they win when the corporation tanks. And there is something that is fundamentally troubling about that, because there is no accountability and there is no consequence.

So as we look at how to reform the system, I think we—we need more transparency on Wall Street. We have a vast explosion in new investments, complex financial instruments like credit default swaps, derivatives, collaterized debt obligations. There is no way for an investor to discipline firms that invest in these derivatives because there is so little disclosure. And as I heard you, Mr. Smith, it is hard for you to do anything—as representing a good number of investors to do anything about what a corporation's actions are because the corporation is so closed. Is that an accurate statement?

Mr. SMITH. Yes, it is.

Chairman WAXMAN. So I think as we look at how we got into this situation. We have to recognize that there have been people who have been able to play games with other people's money and never had to face the consequences themselves or failure. There is not enough transparency as to what they are doing, there is not enough control by even their shareholders, and the regulators are toothless either because the laws don't allow them to regulate or they are just not regulating because they are short on their budget or short on their commitment.

So maybe we can say everybody is responsible, everybody is to be blamed. But I know one thing. The $700 billion is now going to be paid for by taxpayers in hopes that we stabilize our financial markets.

There is no guarantee that we are going to return to health right away. We hope we can do that. But what this committee is trying to do is to understand how we got into this situation and give some recommendations. Not that we have the jurisdiction—out of our legislation—but to those committees that do have the jurisdiction, to think through whether there ought to be a limit on the amount of money that they can leverage, there ought to be limits in transparency, there ought to be limits on shareholder—limits on CEO pay, and whether there ought to be a lot more openness to shareholder influence in the companies that they presumably own.

I thank you all very much for your presentation; and we are going to now move onto the second panel, which will be Mr. Fuld. Thank you.

Let's take a few minute recess while this panel leaves, and then we are going to have Mr. Fuld take his place. Let's have a 3-minute break.

[Recess.]

Chairman WAXMAN. The committee will come back to order.

We have Richard S. Fuld, Jr., chairman and CEO of Lehman Brothers. He has been the chairman and CEO of Lehman Brothers since 1993, and we are pleased to have Mr. Fuld here to testify.

Mr. Fuld, it is the practice of this committee that all witnesses that testify do so under oath. So if you would please stand and raise your right hand.

[Witness sworn.]

Chairman WAXMAN. The record will indicate that Mr. Fuld answered in the affirmative.

We are anxious to hear from you. We have your prepared statement. It will be in the record in its entirety, and we will—we'll give you whatever time you want. But be mindful of the fact that your whole statement is already in the record. So go ahead with your oral presentation.

We usually ask witnesses to stay to 5 minutes, but I don't want to limit you to 5 minutes if you feel you need more time. There is a button on the base of the mic. Be sure it is pressed and pull it close to you.

STATEMENT OF RICHARD S. FULD, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, LEHMAN BROTHERS HOLDINGS

Mr. FULD. Chairwoman Waxman, Ranking Member Davis and members of this distinguished committee, today there is unprecedented turmoil in our capital markets. Nobody, including me, anticipated how the problems that started in the mortgage markets would spread to our credit markets and our banking system and now threaten our entire financial system and our country.

Like many other financial institutions, Lehman Brothers got caught in this financial tsunami. But I want to be very clear. I take full responsibility for the decisions that I made and for the actions that I took. Based on the information that we had at the time, I believed that these decisions and actions were both prudent and appropriate.

None of us ever gets the opportunity to turn back the clock. But with the benefit of hindsight, would I have done things differently? Yes, I would have.

As painful as this is for all of the people affected by the bankruptcy of Lehman Brothers, this is not just about Lehman Brothers. These problems are not limited to Wall Street or even Main Street. This is a crisis for the global economy.

We live in a world where large investment—large independent U.S. investment banks are now extinct, where AIG and Fannie Mae and Freddie Mac are under government control and where major institutions are being rescued and where regulators are engaged in a daily struggle to stabilize the financial system. In this environment, it is not surprising that the media coverage of Lehman's demise has been rife with rumors and inaccuracies. I appreciate the opportunity to set the record straight for this committee and to be as helpful as possible in explaining why we ultimately could not prevent a bankruptcy filing. And then I want to respond to your questions.

I'm a Lehman lifer. I joined as an intern in 1966 and got a full-time job as a commercial paper trader while earning my business degree at night. In 1994, when Lehman Brothers was spun out of American Express as a separate company and I became the CEO, we were a small domestic bond firm. By 2007, we had built Lehman into a diversified global firm with 28,000 employees. I feel a deep personal connection to those 28,000 great people, many of whom have dedicated their entire careers to Lehman Brothers. I feel horrible about what has happened to the company and its effects on so many, my colleagues, my shareholders, my creditors and my clients.

As CEO, I was a significant shareholder; and my long-term financial interests were completely aligned with those of all the other shareholders. No one had more incentive to see Lehman Brothers succeed. And because I believed so deeply in the company, I never sold the vast majority of my Lehman Brothers stock and still owned 10 million shares when we filed for bankruptcy.

As I said, following the spin-off of Lehman Brothers from American Express, our business was almost exclusively at a fixed income. We recognized the need for diversification, and over the subsequent 14 years we built and acquired significant equity and asset management businesses. We established a presence in 28 countries. We also continually strengthened our risk management infrastructure.

Lehman Brothers did have a significant presence in the mortgage market. This should not be surprising, though. U.S. residential mortgages are an $11 trillion market, more than twice the size of the U.S. Treasury market and a serious participant in the fixed-income business, had a significant presence in the mortgage market.

As the environment changed, we took numerous actions to reduce our risk. We strengthened our balance sheet, reduced leverage, improved liquidity, closed our mortgage origination businesses and reduced our exposure to troubled assets. We also raised over $10 billion in new capital. We explored converting to a bank holding company. We looked at a wide range of strategic alternatives, including spinning off our commercial real estate assets to our shareholders.

We also considered selling part or all of the company. We approached many potential investors, but in a market paralyzed by a crisis in confidence none of these discussions came to fruition. Indeed, contrary to what you may have read, I never turned down an offer to buy Lehman Brothers.

Throughout 2008, the SEC and the Federal Reserve conducted regular and at times daily oversight of our business and our balance sheet. They saw what we saw in real time as they reviewed our liquidity and our funding, our capital risk management and our mark-to-market process.

As the crisis in confidence spread throughout the capital markets, naked short sellers targeted financial institutions and spread rumors and false information. The impact of this market manipulation became self-fulfilling as short sellers drove down the stock prices of financial firms, the rating agencies lowered their ratings because lower stock prices made it harder to raise capital and reduced financial flexibility. The downgrades in turn caused lenders and counter parties to reduce credit lines and then demand more collateral, which increased liquidity pressures.

At Lehman Brothers, the crisis in confidence that permeated the markets led to an extraordinary run on the bank. In the end, despite all of our efforts, we were overwhelmed.

However, what happened to Lehman Brothers could have happened to any financial institution and almost did happen to others. Bear Stearns, Fannie Mae, Freddie Mac, AIG, Washington Mutual and Merrill Lynch all were trapped in this vicious cycle. Morgan Stanley and Goldman Sachs also came under attack.

Lehman's demise was brought on by many destabilizing factors: the collapse of the real estate market, naked short attacks, false rumors, widening spreads on credit default swaps, rating agency downgrades, a loss of confidence by clients and counter parties and buyers sitting on the sidelines waiting for an assisted deal.

Again, this is not just a Lehman Brothers's story. It is now an all-too-familiar tale. It is too late for Lehman Brothers, but the government has now been forced to dramatically change the rules and provide substantial support to other institutions.

I greatly appreciate the opportunity to speak with you today; and if I can be helpful to this committee in any way to understand how we got here and what our country can do to move forward, I am happy to do so. Thank you, sir.

Chairman WAXMAN. Thank you very much, Mr. Fuld.

[The prepared statement of Mr. Fuld follows:]

STATEMENT OF RICHARD S. FULD, JR.

**BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM**

OCTOBER 6, 2008

Chairman Waxman, Ranking Member Davis, and Distinguished Committee Members,

We are in the midst of unprecedented turmoil in our capital markets. The problems that most believed would be contained to the mortgage markets have spread to our credit markets, our banking system, and every area of our financial system. As incredibly painful as this is for all those connected to or affected by Lehman Brothers – this financial tsunami is much bigger than any one firm or industry. Violent market reactions to a number of factors affected all of the financial system. These problems are not limited to Wall Street or even Main Street. This is a crisis for the entire global economy.

No one realized the extent and magnitude of these problems, nor how the deterioration of mortgage-backed assets would infect other types of assets and threaten our entire system. In April 2006, Chairman Bernanke predicted that the housing market "will most likely experience a gradual cooling rather than a sharp slowdown." In March 2007, he stated "the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained." Similarly, Secretary Paulson said in June 2007 that the crisis in the mortgage markets "will not affect the economy overall," echoing the views of the International Monetary Fund. And at Lehman Brothers' annual shareholder meeting, I too said what I absolutely believed to be true at the time – that the worst of the impact to the financial markets was behind us. With the benefit of hindsight, I can now say that I and many others were wrong.

Far from the credit crisis being contained, we now exist in a world where there are no major independent investment banks; where AIG, Fannie Mae and Freddie Mac are under government control; where we are seeing the largest bank seizures in history; and where we are struggling daily to stabilize the financial system. These events have been as stunning as they have been swift. On September 14, there were four major stand-alone investment banks, and they were considered essential for the flow of capital to and investment in American business. Within a week, there were none. Since July of this year, nine banks across the United States have been taken over by government regulators. Creditors and shareholders have lost money on their investments, employees in the financial industry – from support staff, administrative professionals, and recent college graduates to thirty-year veterans – have already lost jobs. Around our country, workers in industries dependent upon the flow of credit fear they could be next.

I will try my best to be helpful to this Committee, so that what happened to Lehman Brothers does not happen to other companies; so that their shareholders, creditors, clients and employees do not have to feel the enormous pain that our shareholders, creditors, clients and employees are feeling right now. I welcome this opportunity to be helpful to this Committee in its important work, and also to address the issues that Lehman Brothers faced. Some of the media coverage of Lehman Brothers' demise has been sensationalized – based on rumors, speculation, misunderstandings and factual errors. I believe to move forward, we first need to accurately understand how we got here.

By way of background, I am a Lehman lifer. I started 42 years ago as an intern while I was in college at the University of Colorado. I moved to New York and started working full time for Lehman Brothers in 1969, and later began taking night classes at New York University to earn my business degree. I have never left Lehman Brothers.

Founded in 1850 in Montgomery, Alabama by three brothers who ran a dry-goods store, Lehman Brothers has played a significant role in the American economy. Lehman Brothers financed the growth of railroads as Americans pushed west, and funded legendary American businesses, from Sears, Roebuck and Woolworth's to B.F. Goodrich and RCA. In 1984, Lehman Brothers was acquired by American Express and merged with Shearson. In 1994, we became independent again, after American Express spun off Lehman Brothers to its shareholders. At the time, our Firm had only 9,000 employees and $75 million in earnings.

Over the next decade, we restored the once proud Lehman Brothers name. In 1998 we joined the S&P 500 index; by 2000, we had joined the S&P 100 index. In 2002, we executed the largest financial services IPO in history. In 2004, we advised on two of the top five largest worldwide M&A deals. In 2005, we were awarded "Best Investment Bank" by *Euromoney*. In 2006, Barrons ranked us #1 in its annual survey of corporate performance of Fortune 500 firms. In 2007, we were ranked #1 "Most Admired Securities Firm" by *Fortune*. Between 2004 and 2007, we had four consecutive years of record-breaking financial results. Between 1994 and 2007, our market capitalization grew from $2 billion to $45 billion. During this period, our share price went from $5 per share to $86 per share, an average annual return for shareholders of

24.6%. We grew to more than 28,000 employees, with more than 60 offices in over 28 countries. Through a commitment to excellence and innovation, Lehman Brothers created value for its clients and investors in the United States and throughout the world.

On September 15, 2008, Lehman Brothers Holdings was forced to declare bankruptcy as a result of an extraordinary run on the bank. The Honorable James M. Peck, Bankruptcy Judge for the Southern District of New York, after the first several days of intense hearings in the bankruptcy proceedings, observed: "Lehman Brothers became a victim. In effect, the only true icon to fall in the tsunami that has befallen the credit markets. And it saddens me."

Again, I say that in the recent months, many of our nation's financial institutions have disappeared, been acquired or have received massive government assistance to avoid a similar fate. Our economy is suffering, and everyone in America feels the effect of this turmoil. What has happened is an absolute tragedy.

For us, Lehman Brothers was more than a place of employment, it has been a home. Every single day everyone at Lehman Brothers fought for our venerable Firm. Employees were the largest owner of Lehman Brothers, owning around thirty percent of Lehman's equity. This aligned our interests with the interests of our shareholders – we had a stake in the future of our Firm. The past several months have been extraordinarily challenging and frustrating. For the employees whose steadfast determination, dedication and loyalty epitomized the best of Lehman Brothers and its culture, this has been very painful both personally and financially. I cannot say enough about their dedication, commitment and loyalty. I feel horrible about what happened.

We saw the undeniable spirit of Lehman Brothers after the tragic events of September 11, 2001. Lehman employees watched the towers fall around them that morning as they fled for safety. We lost a co-worker that day, and we lost our homes at One World Trade Center and Three World Financial Center. In the hours and days that followed, we were dispersed to makeshift offices in and around New York City. We worked around the clock under incredible stress, with the goal of serving our clients and shareholders in a suddenly uncertain world and returning stability to rattled markets. Over that weekend, we built two complete trading floors in our temporary office in Jersey City. When the markets reopened the morning of September 17, to the surprise of many, Lehman Brothers was there.

We still saw this courageous spirit of Lehman Brothers' employees in these last several weeks. Many employees worked 20 hour days, even after we entered bankruptcy, uncertain of whether another paycheck was coming, but wanting to do everything humanly possible to help their clients and their coworkers salvage what they could.

We believed that we were well-protected to withstand even the most difficult markets. What we have seen recently in the international credit markets has overwhelmed many financial institutions and threatened all financial institutions. We did everything we could to protect the Firm, including: closing down our mortgage origination business; reducing our leveraged loan exposure; reducing our total assets by $188 billion, specifically reducing residential mortgage and commercial real-estate assets by 38%; and dramatically reducing our net leverage so by the end of the third quarter in 2008 it was 10.5 times, one of the best leverage ratios on Wall Street at the time. We raised capital. We made changes to our senior management team and reduced expenses. We sought strategic investors for a sale of all or part of the Firm. We called on regulators to clamp down on abusive short selling practices.

Throughout 2008, the SEC and Fed actively conducted regular, and at times, daily oversight of both our business and balance sheet. Representatives from the SEC and the Fed were in our offices on a regular basis, monitoring our daily activities. They saw what we saw in real time as they reviewed our liquidity, funding, capital, risk management and mark-to-market process. Lehman Brothers had specific, dedicated teams that worked with the SEC and the Fed to take them through our finances and risk management, and answer any and all of their questions and provide them with all the information they requested. These were open conversations with seasoned and dedicated government officials.

Quarter to quarter, month to month, regulators saw how we reduced our commercial real-estate holdings; how we increased our liquidity pool; how we decreased leverage and strengthened our capital levels. They actively reviewed our risk management reports, which included our hedges for each business. They saw our "mark to market" process and how we arrived at our valuations, including our mortgage and commercial real-estate valuations. They held regular price verification reviews. They were privy to everything as it was happening.

Over the summer, we discussed with the Federal Reserve the possibility of converting Lehman Brothers to a bank holding company, and applied for a regulatory exemption that would permit our Utah bank to receive assets from its affiliates, all for the purpose of creating additional liquidity. On the same day Lehman Brothers prepared to file for bankruptcy, the Federal Reserve significantly broadened the types of collateral all banks were able to pledge to the Federal Reserve to create additional liquidity, the life-blood of our system, and the Federal Reserve also adopted, on a temporary basis, the type of exemption that Lehman Brothers had applied for earlier. Had these changes been made sooner, they would have been extraordinarily helpful to Lehman Brothers. A few days later, the Federal Reserve took expedited action to approve applications of Goldman Sachs and Morgan Stanley to become bank holding companies.

After the second quarter, Lehman Brothers developed a series of options to strengthen the Firm, including working with regulators to develop a plan to separate the vast majority of our commercial real estate assets from our core business by spinning off those assets to our shareholders in an independent, publicly-traded entity. We believed this plan would have improved our balance sheet while preserving shareholder value. The spinoff entity would have been able to manage the assets for economic value maximization over a longer time horizon. However, a sharp drop in our share price following leaks to the press about confidential negotiations with Korea Development Bank about a possible investment in Lehman Brothers, and rumors regarding our liquidity and capital, compelled us to pre-announce earnings before we had a chance to complete those plans or any of the alternatives we were pursuing. We then faced the threat of credit downgrades. Counterparties to the numerous transactions we conducted every day started to withdraw business and to demand increased collateral for trades. We had pursued buyers and merger partners to no avail. But by the end of that Sunday, it was obvious that the Federal Reserve had made a decision it would not provide support for a transaction involving Lehman Brothers. Had that decision been different, further dislocations in the markets might have been avoided.

In the end, despite all our efforts, we were overwhelmed, others were overwhelmed, and still other institutions would have been overwhelmed had the government not stepped in to save them. What happened to Lehman Brothers could have happened to any firm on Wall Street, and almost did happen to others. A litany of destabilizing factors: rumors, widening credit default swap spreads, naked short attacks, credit agency downgrades, a loss of confidence by clients and counterparties, and strategic buyers sitting on the sidelines waiting for an assisted deal were not only part of Lehman's story, but an all too familiar tale for many financial institutions. The fallout from these repeated onslaughts is what has caused the government to intervene to dramatically change the rules and provide substantial support to other institutions.

Now is not the time or place for a detailed analysis of everything that has happened to the international economy in the last year. I do not have the perspective or the information necessary to analyze all of the causes and to propose cures for these problems. Nor do I think anyone can do that yet in a comprehensive fashion. However, I want to address some of the factors that led to this, and what we can do moving forward.

First, ultimately what happened to Lehman Brothers was caused by a lack of confidence. This was not a lack of confidence in just Lehman Brothers, but part of what has been called a storm of fear enveloping the entire investment banking field and our financial institutions generally. As evidenced by Congress' efforts to pass an emergency rescue plan, there is a systemic lack of confidence in the system that without emergency intervention could result in an across the board failure.

While all investment banks were prepared for shocks in the market, none of us was prepared for this one. And all of us are now forever changed. Investment banks depend on the confidence and trust of employees, clients, investors and counter-parties. Investment banks, unlike commercial banks, are subject to mark-to-market accounting. The result was we all had to mark our positions to the weakest competitors' fire-sale prices of assets. The commercial banks did not. This put investment banks at a disadvantage. Chairman Bernanke himself recognized there is "good value" over the long-term for these assets being sold at fire-sale prices. These write-downs have been a large contributor to shaking general confidence in investment banks and the banking system. Importantly, the SEC is now addressing this issue.

Lehman Brothers was a casualty of the crisis of confidence that took down one investment bank after another. Bear Stearns collapsed. Merrill Lynch was forced to sell itself to Bank of America. Goldman Sachs and Morgan Stanley received expedited approval to convert themselves to bank holding companies, providing substantial comfort to investors and facilitating their receipt of substantial capital infusions. Again, there are no major stand-alone investment banks left.

The second issue I want to discuss is naked short selling, which I believe contributed to both the collapse of Bear Stearns and Lehman Brothers. Short selling by itself can be employed as a legitimate hedge against risk. Naked short selling, on the other hand, is an invitation to market manipulation. Naked short selling is the practice of selling shares short without first borrowing or arranging to borrow those shares in time to make delivery to the buyer within the settlement period – in essence, selling something you do not own and might not ultimately deliver to the buyer.

Naked short selling, followed by false rumors, dealt a critical, if not fatal blow to Bear Stearns. Many knowledgeable participants in our financial markets are convinced that naked short sellers spread rumors and false information regarding the liquidity of Bear Stearns, and simultaneously pulled business or encouraged others to pull business from Bear Stearns, creating an atmosphere of fear which then led to a self-fulfilling prophecy of a run on the bank. The naked shorts and rumor mongers succeeded in bringing down Bear Stearns. And I believe that unsubstantiated rumors in the marketplace caused significant harm to Lehman Brothers. In our case, false rumors were so rampant for so long that major institutions issued public statements denying the rumors.

Following the Bear Stearns run on the bank, we and many others called on regulators to immediately clamp down on naked short selling. The SEC issued a temporary order that went into effect on July 21 prohibiting "naked" short selling of certain financial firms, including Lehman, Merrill Lynch, Fannie Mae and Freddie Mac. This measure stabilized the share prices of Lehman Brothers and the other firms. However, this restriction was temporary, and on August 13 it expired after 17 trading days. History has already shown how wrong and ill-advised it is to allow naked short selling.

Many of the firms that have recently collapsed or have been forced into emergency mergers, takeovers, or government bailouts – Bear Stearns, Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, AIG – did so during the gaps of time in which there was no meaningful regulation of naked short selling. On September 15, when the market opened after the collapse of Lehman, naked shorts appeared to turn their attention to Morgan Stanley and Goldman Sachs. In the three days between the announcement of Lehman Brothers' bankruptcy and the SEC instituting an emergency ban on short selling, Goldman Sachs' and Morgan Stanley's share prices fell 30% and 39% respectively. None of this was a coincidence.

After seeing this stock price reaction in the week following Lehman Brothers' bankruptcy, the SEC, like the Federal Reserve, took immediate action to stabilize the system. On September 18, following the decision of the Financial Services Authority in the United Kingdom a day earlier, the SEC instituted an emergency ban and other restrictions on short selling financial institutions. In taking these steps, Chairman Cox explained: "Given the importance of confidence in our financial markets as a whole, we have become concerned about the sudden and unexplained declines in the prices of securities. Such price declines can give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence without a fundamental underlying basis. The crisis of confidence can impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences." These new restrictions are set to expire no later than October 17. Permanent regulation of naked short selling is needed to prevent a similar demise for the firms that survived with the government's help.

The final issue I will address is the changed landscape of our financial system and regulatory regime. Many have recently commented that what we have seen with this market is a once-in-a-century event. We should remember that even eighty years after the fact, academics, economists and politicians still debate the causes and cures of the Great Depression. We exist in a regulatory regime created in a vastly different world for vastly different markets. Some have compared the regulatory and risk management systems of our current markets to trying to run a bullet train on ancient track. In 1929, the New York Stock Exchange traded about ten million shares a day. Today, that figure is over five billion shares a day – more shares traded every day than were traded in an entire year when the still current regulations were created and put in place. New types of firms, new types of instruments, electronic trading, and a truly global financial marketplace were not anticipated when these early efforts at regulation were enacted into law.

We now have the opportunity to create a new regulatory system and "best practices" for a functioning and orderly market. These new approaches must encourage rather than impede global investment in our capital markets. Shifting and inconsistent rules create a capital markets system that does not give confidence to investors or participants. We need a single set of transparent rules for all of the participants in order to have a fair and orderly market. We must stick to these rules and enforce them evenly, not selectively, or our great capital markets will not be attractive to investors. A loss of investment in our markets would have far-reaching consequences for this country and the American people.

The various proposals being debated came too late to benefit our Firm, but our system today needs liquidity. The inability of businesses and individuals to have access to credit – credit that builds new plants, creates new jobs, pays for college and graduate school for our children, finances the basic needs of families – is not a crisis only for Wall Street. It is a crisis for everyone.

I thank you for allowing me to speak on these issues, and I am available to answer any questions you may have.

Chairman WAXMAN. Without objection, the Chair and the ranking member will control 10 minutes which they can use or reserve and use at a subsequent time. Hearing no objection, that will be the order.

The Chair will recognize himself.

Mr. Fuld, the committee—our committee requested all the documents relating to your salary, bonuses and stock sales; and the committee staff put together a chart, which I hope will come up on the screen. This chart will show your compensation for the last 8 years. It shows your base salary, your cash bonuses and your stock sales.

In 2000, you received over $52 million. In 2001, that increased to $98 million. It dipped for a few years. And then, in 2005, you took home $89 million. In 2006, you made a huge stock sale; and you received over $100 million in that year alone. Are these figures basically accurate?

Mr. FULD. Sir, if those are the documents that we provided to you, I would assume they are.

Chairman WAXMAN. OK. The bottom line is that, since 2000, you have taken home more than $480 million. That is almost half a billion dollars, And that is difficult to comprehend for a lot of people. Your company is now bankrupt, our economy is in a state of crisis, but you get to keep $480 million. I have a very basic question for you. Is this fair?

Mr. FULD. Mr. Chairman, your first question was about this slide: Are those numbers accurate? They are accurate the way you have put them up on that slide, but—I believe your number of cash and salary bonuses are accurate. The option exercises—the way you have them portrayed here I believe represent the full option without the strike price. And the only reason I exercised those options is because they came due at maturity. If I had not exercised those, I would have lost it. There was that stock sale——

Chairman WAXMAN. Well, I will leave the record open for you to give me any changes in that list.

Mr. FULD. What I would say to you——

Chairman WAXMAN. But, basically, didn't you take home around $400 to $500 million as the head of Lehman Brothers for the last—since 2000 to now?

Mr. FULD. The majority of my stocks, sir, came—excuse me—the majority of my compensation came in stock. The vast majority of the stock that I got I still owned at the point of our filing.

Chairman WAXMAN. The stock is in addition to the numbers that I have indicated. Because those were your salary and your bonuses. Now, you had bonuses; and, in addition to that, you had some stock sales. You have lost some money of the stock that you have received as compensation, which you received as compensation on top of these other figures. So you have been able to pocket close to half a billion dollars. And my question to you is, a lot of people ask, is that fair for the CEO of a company that is now bankrupt to have made that kind of money? It is just unimaginable to so many people.

Mr. FULD. I would say to you that the 500 number is not accurate. I would say to you that, although it is still a large number, I think for the years that you're talking about here, I believe my cash compensation was close to $60 million, which you have indicated here. And I believe the amount that I took out of the company over and above that was, I believe, a little bit less than $250 million. Still a large number, though.

Chairman WAXMAN. Still a large amount of money. You have a 14 million ocean front home in Florida. You have a summer vacation home in Sun Valley, Idaho. Yet you and your wife have an art collection filled with million dollar paintings. Your former President, Joe Gregory, used to travel to work in his own private helicopter.

I guess people wonder if you made all this money by taking risks with other people's money, you could have done other things. You had high leverage, 30 to 1 and higher. You didn't pay out billions of dollars in dividends. And you didn't have to pay out these millions of dollars in dividends and bonuses. You could have saved some of these funds for lean times, but you didn't.

Do you think it is fair and do you have any recommendations on fundamental reforms that would bring a new approach to executive compensation? Because it seems that the system worked for you, but it didn't seem to work for the rest of the country and the taxpayers who now have to pay up to $700 billion to bail out our economy.

We can't continue to have a system where Wall Street executives privatize all the gains and then socialize the losses. Accountability needs to be a two-way street. Do you disagree with that? And do you have any recommendations of what we ought to be doing in this area?

Mr. FULD. Mr. Chairman, we had a compensation committee that spent a tremendous amount of time making sure that the interests of the executives and the employees were aligned with shareholders. My employees owned close to 30 percent of our company; and that was because we wanted them to think, act and behave like shareholders. When the company did well, we did well. When the company did not do well, sir, we did not do well.

Chairman WAXMAN. Well, Mr. Fuld, there seems to be a breakdown. Because you did very well when the company was doing well and you did very well when the company wasn't doing well. And now your shareholders who owned your company have nothing. They have been wiped out.

I'm going to reserve the balance of my time, and we are going to go on to other Members. Mr. Shays.

Mr. SHAYS. If you'd yield me 2 minutes.

Mr. Fuld, I'd like to ask you first, who appoints the compensation committee?

Mr. FULD. The compensation committee is now appointed by the corporate governance committee of the board.

Mr. SHAYS. But did you have a major role in appointing the compensation committee?

Mr. FULD. I believe I had more of a role in the early or mid-'90's. Clearly less of a role these last number of years.

Mr. SHAYS. And then, finally, of the 10 million shares that you had in the company—that is what you have right now, 10 million shares?

Mr. FULD. No. I don't have the exact amount. I think it is closer to 8 million shares, and that does not include the options that expired that are worthless. Well, actually, they haven't expired—that are still there with a longer term vesting but with a much higher strike price than, obviously, where the stock is today.

Mr. SHAYS. Thank you.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Shays.

I want to recognize Mrs. Maloney for 5 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman.

We are in a financial crisis, and we lost four major investment banks in a week, and taxpayers have been called upon to assume a potential $1.7 billion in taxpayer liability to backstop our financial institutions. During this hearing today, we have seen a long list of examples of deregulation and we have heard about the net capital rule, which was eliminated so that Lehman and other investment banks could ramp up their leverage to very dangerous high levels, putting their institutions at risk. And for almost 30 years this rule kept investment banks from taking on debt more than 12 times the value of the banks' investments. Firms were required to stop trading if their debt exceeded that ratio. As a result, most investment banks did not take on excessive debt.

Yet this report in the New York Times—and I'd like permission to have it referenced or put in the record——

Chairman WAXMAN. Without objection.

Mrs. MALONEY [continuing]. Last Friday, called the Agency's 2004 Rule Let Banks Pile Up New Debt. And many people feel that this was a major cause of the crisis, and they reference a meeting in April 2004.

And I'd like to ask you, were you at that meeting? Did you lobby for this change? Why did Lehman want to increase its leverage? And, in hindsight, do you think the SEC rule—that changing this SEC rule was appropriate for protecting safety and soundness, the stability of our markets and taxpayers' money?

Mr. FULD. Congresswoman, I was not at that meeting, I believe, in 2004. And I do not recall if any other of my people were there. I had a chance to—while I was sitting in the waiting room, I saw, I would assume, almost all of the first panel. The information about leverage I think has been grossly misunderstood.

There are two numbers. One is gross leverage, and one is net leverage. Gross leverage includes—excuse me if I get technical. If I get too technical, please stop me. Close to half of our balance sheet, if not more, was what we called the matched book. The matched book was predominantly government securities and agencies that we took on our balance sheet to finance for our clients. We were one of the top U.S. Treasury Government traders and financiers, meaning financing the U.S. Government debt. And we supplied a tremendous amount of liquidity to institutional investors that owned U.S. Government debt and agencies. At times, that was as high as $300 to probably more, $300 billion. I heard some of the earlier remarks about if you lost 3 or 4 percent of that. For the matched book, you do not—those are government securities. So the real number, the effective number is net leverage.

Mrs. MALONEY. So did you lobby for this capital rule change, and do you think it contributed to the financial instability and loss of safety and soundness in financial institutions such as your own that allowed this increased leverage?

Mr. FULD. I myself did not lobby for the increased leverage.

Mrs. MALONEY. Did Lehman Brothers lobby for it?

Mr. FULD. I am not aware of that.

Mrs. MALONEY. I would like to ask you, now that we have the opportunity of looking back, and we want to look forward on what needs to be done, if you had to give government advice on how we could strengthen the safety and soundness of our institutions and the accountability and transparency that all of us want, what would you recommend to change the system?

Mr. FULD. In my written testimony, I spoke about the need for additional regulation and new regulation; because when the original regulations were written, it was a very different environment. I believe there were 10 million shares a day traded, and today there are close to 5 billion shares traded. The electronic connectivity today, not only within this country but country to country; investors today, given that electronic connectivity, have the right to move their money to the highest returning asset, and money moves very quickly and freely. So it is not just about regulation within the United States. I believe it is also about more of a matrix regulation that is more global in nature.

I would focus also on capital requirements, capital requirements meaning more capital for less liquid assets, and a more robust understanding of mark to market, which I believe is one of the pillars of the new plan. Mark to market during periods of stress create one set of numbers and obviously, in a functioning noncredit crisis environment, produce another set of numbers.

Chairman WAXMAN. Thank you.

Your prepared statement, which has these recommendations, are in the record. And we want to move on to other questioners. Did you want to add one last point?

Mr. FULD. Yes, please. And the other is, something I strongly believe in, is the creation of what I call a master netting system, where all capital market counterparties download each night all their transactions to one local spot, first in the United States and then eventually hopefully make that be global. That is about all transactions and trades. It is about positions. It is about capital. It is about leverage. And it would give whatever regulator is then in control of that master netting system a complete view of the financial landscape, the available capital to each and every asset class, flexibility within those asset classes and vulnerability within those asset classes and vulnerability of one institution versus the next. What I am proposing is clearly expensive, costly, but by comparison to the unprecedented regulation this Congress has just passed, it is a fraction and, I believe, money well spent.

Chairman WAXMAN. Thank you.

Mr. Mica for 5 minutes.

Mr. MICA. Thank you, Mr. Chairman.

And looking at, first, your comment on Lehman Brothers primarily dealing in some, for most of its history——

Mr. FULD. Sir, I apologize, I cannot hear you.

Mr. MICA. Can you hear me now?

Mr. FULD. Yes.

Mr. MICA. Again, when you opened your statement, you said that Lehman Brothers, and it was around for what, 150 years, dealt in some pretty hard assets and some secure investments. You have been around a while. What turned the corner for you to get into some of the more speculative ventures like subprime and some of the other, again, riskier investments?

Mr. FULD. As I said in my verbal testimony, our participation in the mortgage-related businesses was clearly a natural for us given our dominance in fixed income. That was something that went back a number of years. And even as I listened, as I say, to the panel before me, they correctly pointed out that this was a goal of the government, to provide funding and mortgages to a number of people that typically would not or could not have received a mortgage.

Mr. MICA. And one of your big—well, one of the big packagers or the competitors so to speak was Fannie Mae, which was deep into this. And you were dealing in some of the paper I think for secondary markets and other securitized mortgage paper to basically package it and make money off it. Is that right?

Mr. FULD. Yes, sir.

Mr. MICA. What was Lehman Brothers' exposure to the debt of Fannie Mae and Freddie Mac, and what role did their collapse play in precipitating some of your financial troubles? If it didn't matter——

Mr. FULD. Our exposure to both Fannie Mae and Freddie Mac was both de minimis, sir.

Mr. MICA. OK. But their collapse, did that help precipitate any problems with your firm?

Mr. FULD. It certainly set the stage for an environment, as I talked about loss of confidence and credit crisis mentality, that permeated our market; clearly set the stage for investors losing confidence, counterparties asking for additional collateral, and clearly an environment that lost liquidity, which is the life blood of a capital market system.

Mr. MICA. I noticed some questions were asked about your political participation. I pulled Lehman Brothers' contributions to Federal candidates for the last 10 years. Fortunately, I didn't find my name there. Not like some of the other Members of Congress. I added some of this up, it is about $300,000 that you gave to influence Members of Congress. I also got your personal, which wasn't much, you probably bet a little bit too much on Hillary, too. But this is pretty much the extent of your financial contributions? To Members of Congress, to lobby.

Mr. FULD. I believe that was a result of Lehman's PAC——

Mr. MICA. Right.

Mr. FULD [continuing]. Which was not corporate moneys.

Mr. MICA. Right. I am just telling you. But wait until you hear this one. And if you haven't discovered your role, you are the villain today. So you have to act like the villain here.

But guess what Fannie Mae did in the same period of time? $175 million in lobbying contracts over 10 years. Does that surprise you? You were outlobbied. It sounds like rather than just some greed on

Wall Street, we had a little greed in Washington. What would you say to that?

Mr. FULD. I think that is more a matter for your committee, sir.

Mr. MICA. I hope we get to it.

Thank you.

Chairman WAXMAN. The gentleman's time has expired.

We now go to Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. Fuld, I really appreciate that you began your testimony by taking full responsibility for the company's downfall, which occurred on your watch.

But there are some concerns that I want to get to. As you know, the American taxpayer, many of them our constituents, we just passed legislation giving $700 billion to rescue Wall Street. One complaint I have heard over and over again from my constituents was that there seems to be a complete lack of accountability. They see Wall Street executives like you walking away with millions of dollars.

And it is very interesting when you were talking about the chart that Mr. Waxman showed you on the board, you said that it was inaccurate. But I am going to discount it for you, and instead of $448 million over 8 years, let's say $350. How about that? $350? Is that OK? Can we discount it a little bit? You said it was not accurate. What would you say is accurate?

Mr. FULD. I would say that is closer, sir.

Mr. CUMMINGS. OK. I want to ask you about one of the e-mails obtained by the committee. On June 9, 2008, a former top Lehman executive—can you hear me OK?

Mr. FULD. Yes, sir.

Mr. CUMMINGS. Benoit D'Angelin sent an e-mail to Hugh McGee, who was the global head of investment banking at Lehman. The e-mail says that many bankers have been calling in the last few days, and the mood has become truly awful. It warns that, "all the hard work we have put in could unravel very quickly."

And it offers the following advice. It says, "some senior managers have to be much less arrogant and internally admit that major mistakes have been made. We can't continue to say we are great, and the market doesn't understand."

Mr. McGee forwarded this e-mail to you on the same day and explained that it was representative of many others. When you read the e-mail, and this is interesting, what was your reaction? I am just curious.

Mr. FULD. I am sorry, sir, what was the date of that? I am sorry.

Mr. CUMMINGS. That would be June 9, 2008. You remember that e-mail?

Mr. FULD. I do not——

Mr. CUMMINGS. Let me try to refresh your recollection a little bit. Let me tell you what you did, since you don't remember the e-mail. Here is what happened. You didn't take any personal responsibility. Instead, 3 days later, Mr. Fuld, on June 12th, you fired Erin Callan, your chief financial officer, and Joseph Gregory, your chief operating officer, but you stayed on and admitted no mistakes. You were CEO. Why didn't you take responsibility?

Like today, you said you took full responsibility, why didn't you take responsibility for Lehman's mistakes? Why did you continue to say, "we are great, and the market doesn't understand?"

In your testimony today, right here, right now, you continue to deflect personal responsibility. You cite what you call a litany of reasons for Lehman's bankruptcy.

Mr. Fuld, I want to ask you about your personal responsibility, since you have taken it. Do you agree that Lehman took on excessive leverage under your leadership? Please answer yes or no.

Mr. FULD. It is not that easy. I will say to you, our leverage at times was higher, but as we entered this more difficult market over this last year, we continued to bring our leverage down so that even at the point, Congressman, on September 10th, when we announced our third quarter results, we had grossly reduced our balance sheet by close to $200 billion, specifically around residential mortgages and commercial real estate and leverage loans.

Mr. CUMMINGS. Mr. Fuld, I have only got about less than a minute. I have to get this question in. I assume your answer is no. I am just giving you the benefit of the doubt.

Mr. FULD. At the end of the day, we worked hard; our leverage was way down. One of the best leverage ratios on the street. And our tier one capital was one of the highest.

Mr. CUMMINGS. So you feel comfortable with what you did. Is that right? That is not one of the things that you said your——

Mr. FULD. Yes, sir.

Mr. CUMMINGS. OK, fine. Do you regret spending $10 billion in Lehman's cash reserves on bonuses, stock dividends, and stock buybacks as your firm faced a liquidity crisis? Do you regret that now?

Mr. FULD. I heard some of that while I was in the other room. I think that is a misunderstanding which I would like to clear up.

Mr. CUMMINGS. Well, let me go back to—you go ahead, I am sorry.

Mr. FULD. Because it is important that this committee understands exactly what that was. When I talked about my employees owning close to 30 percent, what is typical of Wall Street is you take a percentage of your revenues and you pay your people. We asked our employees to take a big percentage of their compensation in stock. And so what that $10 billion was—we had close to $19 billion of revenues—what most of that $10 billion was, was compensation to our employees that they received in stock with a 5-year forward vest. So they didn't get that stock until 5 years, which aligned our interests, "our" being employees, with the interests of shareholders. To avoid dilution, because we took that $10 billion, gave it to the employees in stock, we had to take the $10 billion that they didn't get and go back into the open marketplace and buy back that stock so that we did not dilute our shareholders. And we did it each and every year. From where you sit, it looks like we just spent an extra $10 billion. That is not, sir, what we did.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Chairman WAXMAN. It sounds like, though, and I yield myself time here, that you were trying to not to dilute the payment to those employees while you were in a liquidity crisis. Wouldn't it have made more sense to use that money to pay off the debts that were heavily on your shoulders at that point and you knew that you were in a difficult situation?

Mr. FULD. At that time, at the end of the year, last year, I didn't believe that we had that problem.

Chairman WAXMAN. You didn't believe you had a liquidity problem.

Mr. FULD. And we did not have a liquidity problem at the end of last year. We had just completed a record year, none of which, by the way, came from mortgages. And we paid our people fairly and what we thought was competitive with the rest of the Street.

Chairman WAXMAN. OK. I accept your answer that you didn't think you had a liquidity problem, so you were trying to make sure that your employees were fully compensated.

Mr. FULD. Yes, sir.

Chairman WAXMAN. OK. Thanks.

Mr. Turner.

Mr. TURNER. Thank you, Mr. Chairman.

Mr. Fuld, in looking at your written testimony, you say ultimately what happened to Lehman Brothers was caused by a lack of confidence.

I have a different view, and I have a couple questions for you about what it really comes down to is we are hearing that the subprime crisis, the predatory lending crisis, the mortgage foreclosure crisis. You said you listened to the first panel and their testimony. I am going to summarize it for you briefly.

Mr. FULD. I heard most of it, but yes, sir.

Mr. TURNER. They said there was a period of easy credit; that housing prices were escalating and then declined; that there was securitization of mortgages; that houses became like ATMs where people withdrew their equity; and excessive CEO compensation.

That is not necessarily our experience in Ohio.

Mr. FULD. I am sorry, that is not what?

Mr. TURNER. That is not necessarily our experience in Ohio. In 2001, my community held a series of hearings on then subprime lending, predatory lending at the behest of City Commissioner Dean Lovelace. And we found that, in many instances, what we were seeing in the escalation of foreclosures was a result of inflated property values at the time of loan origination. In fact, we then turned to the Miami Valley Fair Housing Center in our community, an agency that was helping people who were in the foreclosure crisis, and Jim McCarthy from there reports that over 90 percent of the people that they were dealing with were actually refinances and that many of them had issues of the original value of the property at the time of refinancing where the property values were inflated.

Now, clearly, we are in a period now of decline or slow growth in some areas which is compounding the problem, but I think people are getting off too easy when we say that declining property values are the problem. And I want to tell you what my concern here is. I believe that if you issue a loan at origination where the loan value exceeds the property value and that you then issue securities based upon that loan and you don't disclose that gap that existed at loan origination, that you are in fact, I believe, stealing.

I believe that we are in a series of situations where people aren't disclosing that at loan origination, in fact, there was already a gap between value and loan amount, and that the declining house values really just emphasize it and compound it.

So I have two questions for you. The first is, do you believe that if mortgage-backed securities are issued and they do not disclose at origination that the original loan amount exceeds the property value, that it is stealing? And second, would you please describe Lehman Brothers' role in both issuing subprime loans and mortgage-backed securities?

Mr. FULD. I do not believe that any of the original mortgage securitizers knowingly at the point of origination would have taken a mortgage whose value was in excess of the value of the home. I find that very difficult to either understand or believe.

Mr. TURNER. And if it occurred?

Mr. FULD. If it did occur, I would say it was lack of understanding of what the real value was. But I don't think—I can't talk for the world in general, clearly, but highly unlikely that anybody would do that purposely.

Mr. TURNER. Then could you go to the role of your company in actually issuing original loans and then mortgage-backed securities?

Mr. FULD. We actually owned a number of what we called origination platforms. But those were more wholesale, where we went around to individual groups or companies of brokers that did in fact originate loans. When we bought them, we changed management, we changed underwriting standards to make them much more restrictive, to improve the quality of the loans that we did in fact originate so that those loans that we did then put into securitized form would be solid investments for investors.

Mr. TURNER. So then would it be your testimony that none of those original loans that were issued by your company exceeded the property value at origination?

Mr. FULD. Congressman, in all fairness, I did not review each and every loan. I must tell you the truth on that, I did not. And it would be a misstatement for me to say that——

Mr. TURNER. I thought I had heard you say that no one would do that. And I tell you the experience in Ohio is that is exactly what was being done.

Mr. FULD. I would say no one would do it knowingly.

Mr. TURNER. Since you were at the top of the organization, I really wanted to get your perspective of how something like that could be happening. As I go through neighborhoods in Ohio and see abandoned house after abandoned house, where so many times the American dream of having a home have been stolen from people in refinancing where they did not understand the transaction they were in, and where the value at origination was inflated, making them captive to the house, ultimately leading to foreclosure.

Mr. FULD. Let me clarify that if I can. I said nobody would knowingly do that.

Mr. TURNER. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Turner.

Mr. Kucinich.

Mr. KUCINICH. Thank you. I want to associate myself with the remarks and questions of my colleague from Ohio.

Mr. Fuld, I have here a copy of a memo from April 12, 2008, that you sent to—it is an e-mail that you sent to Thomas Russo. It says you just finished the Paulson dinner. This is a memo—did you have dinner with Mr. Paulson back in April?

Mr. FULD. I very easily could have, sir.

Mr. KUCINICH. This memo references it.

Mr. FULD. I don't believe it was just the two of us.

Mr. KUCINICH. But did you meet with him?

Mr. FULD. You are asking me specifically on that date?

Mr. KUCINICH. Did you talk to Mr. Paulson on a regular basis?

Mr. FULD. We had a number of conversations, sir.

Mr. KUCINICH. OK. Now, would you tell me, this memo says, that you sent to your colleagues, that we have a huge brand with Treasury. Speaking of Treasury, loved our capital raise. Do you feel at any time in this process that Mr. Paulson misled you?

Mr. FULD. I am sorry, sir, in response to this——

Mr. KUCINICH. Do you feel at any time in these conversations—we have your telephone logs—that you were misled by the Treasury Secretary?

Mr. FULD. No, sir, I do not.

Mr. KUCINICH. And do you feel then—you know, on September 10th, you had a conference call with your investors. During the conference call, your investors were told no new capital would be needed; that Lehman's real estate investment property—investments were properly valued. Five days later, you filed for bankruptcy. Did you mislead your investors? And I remind you, sir, you are under oath.

Mr. FULD. No, sir. We did not mislead our investors. And to the best of my ability at the time, given the information that I had, we made disclosures that we fully believed were accurate. And I should—and I should——

Mr. KUCINICH. I want to go back to something here. You know, you have a memo here where you say that Secretary Paulson wanted to implement minimum capital standards, leverage standards, and liquidity standards. These seem to be some of the things that got your company in so much trouble. Now, did he ever tell you in all the conversations you had with him that he decided not to implement any of the proposals he discussed with you last April? And does any part of you feel that you were double crossed by the Secretary and he was playing you off against let's say Goldman Sachs?

Mr. FULD. I would sincerely hope that was not the case.

Mr. KUCINICH. And what about these things that he said to you about minimum capital standards, leverage standards, liquidity standards? Did he ever tell you he decided not to implement any of these things? You talked to him on a regular basis. What can you tell this subcommittee to enlighten us about where Secretary Paulson was? And you, as the head of Lehman Brothers, did you rely on anything that he told you that could have put Lehman Brothers down?

Mr. FULD. We instituted ourselves our own plan for reducing leverage, our own plan for increasing liquidity. And I will note that, on September 10th, when we pre- announced our earnings, we had $41 billion of excess liquidity.

Mr. KUCINICH. Let me ask you this, when did you know that J.P. Morgan was going to make a $5 billion collateral call? When did you first know about that?

Mr. FULD. I know that they had had conversations with our Treasury people.

Mr. KUCINICH. When?

Mr. FULD. I am not sure of the date. But it was——

Mr. KUCINICH. Mr. Chairman, if I may—thank you, sir, you are not sure.

Mr. Chairman, this is a central question here, because with J.P. Morgan making a $5 billion collateral call, and on September 10th, they were telling investors they didn't have any more need for capital, that the real estate investments were properly valued, this puts us in a position where one of two things is possible. Either they were lying to their investors or they were misled by Secretary Paulson as to what could be done to help you, because after that $5 billion collateral call, that is what led directly to Lehman Brothers going down. Isn't that correct? Didn't you go down right after you understood that they were not going to remove that collateral call?

Mr. FULD. When you say collateral call, that is not the same thing as a margin call.

Mr. KUCINICH. I am talking about a collateral call.

Mr. FULD. No, I know. But the collateral call was not to meet a deficit in collateral that they were holding to offset risk. The collateral call, I believe, was because, as our clearing bank, they just asked for additional collateral to continue to clear for us.

Mr. KUCINICH. Thank you.

Thank you, Mr. Chairman.

Thank you, Mr. Fuld.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Tierney.

Mr. FULD. Excuse me, I should clarify also, sir, I didn't mean to cut you off there. This is probably a subject for litigation, and it is probably appropriate that I leave it to that. I believe the creditors and J.P. Morgan are having a conversation.

Mr. KUCINICH. Indeed. Indeed.

Chairman WAXMAN. Mr. Tierney.

Mr. TIERNEY. Mr. Fuld, thank you for joining us here this afternoon.

Just before Lehman went into bankruptcy, you were in conversations with the Korean Development Bank, which I believe is a South Korean lender. What amount of money were you looking for them to contribute to Lehman?

Mr. FULD. Congressman, our conversations with KDB, as one of five banks in a consortium, stretched over a number of months.

Mr. TIERNEY. Can you tell me the amount that you were looking for from the consortium?

Mr. FULD. It wasn't so much that we were looking from them. Their original proposal was they wanted to buy in the open market close to 50 percent of our stock. It was not about giving us new capital. They wanted to buy close to 50 percent.

Mr. TIERNEY. And was that type of arrangement something that you were looking for at that time?

Mr. FULD. I would have welcomed that transaction, yes, sir.

Mr. TIERNEY. OK. Now, at about that time, in looking for that kind of transaction, you knew, because you had known for some time that you were already in a precarious situation. And I say that because there were reports that as far back as Christmas of 2006 that you were telling people that you had a cautious outlook for the year ahead. The next month in January, when you were in Davos at the World Economic Forum, you were reportedly telling people that you were really worried about the risks inherent in the property valuations and excess leverage and the rise in oil and commodity prices. Would that be fair to say you were of that mind around January 2007?

Mr. FULD. I was clearly focused on oil, yes, sir.

Mr. TIERNEY. Then I think we go back to the situation where we know you were in that stage in December 2007. At the end of that year, there were payments made out, both cash and stock bonuses to your employees. They totaled about $4.9 billion. So is there any thought given at that point in time to say to your employees, this isn't the time to be handing out $4.9 billion in cash. We have a liquidity issue here. We have been seeing it coming for all year long. And we are going to keep that money in the company liquidity for the benefit of our shareholders, for the benefit of the public with whom we deal, and for the economy.

Mr. FULD. At the end of 2007, I did not believe at the time that we had a liquidity problem. And our most important assets in the firm are clearly our employees. They are the ones that touch the clients every day and do business every day.

Mr. TIERNEY. I understand. I am a little shocked. I mean, a lot of other people thought that you had a very precarious position. At the end of 2007, you thought everything was fine?

Mr. FULD. We had just completed a record year, sir.

Mr. TIERNEY. And if you want to cover that for a second, the record year that you just completed and the reports on that had some, according to one account, had some rather aggressive and bizarre accounting practices on that. They list out four or five things that they thought were strange. You listed a $722 million paper profit on level three equity holdings, stock that doesn't trade publicly; there aren't liquid markets out there. You claimed a 9 percent profit on them. At the same time, Standard and Poor's index on publicly traded stocks fell by 10 percent. That was what made you seemingly have a record year. One of your short sellers, Mr. David Einhorn, said he was told by your chief financial officer that $400 to $600 million came from writing up the value of electric generating plants in India. He thought the value was somewhere around $65 million, not $400 to $600 million. He also said Lehman showed some $600 million of profit because of the decline in the market value of your own debt obligations and sort of assimilated that to the fact that it is permissible accounting surely enough, but it is like the profit that you make when your house is foreclosed for a value that is lower than your mortgage. Last, he said another $176 million was on your books by almost doubling, to some $365 million, the value ascribed to certain mortgage servicing rights; in other words, the value you get paid for servicing mortgage holders' collection of payments and doing their paperwork, which are sort of tricky things to value.

So I know that at the end of the year maybe your books looked like they were good, but if those were the reasons for that, then I think it is questionable why $4.9 billion is going out to the employees in bonuses, cash and stock, and why you are spending another $4 billion buying some of that back. And I think one of your investors here today clearly said he was horrified to find out you were doing that. That is why I raise the question.

Thank you, Mr. Chairman.

Chairman WAXMAN. I would just note, Mr. Fuld, that in January 2008, there was a presentation to your board, on which you serve, by Eric Felder. And he said very few of the top financial insurers have been able to escape damage from the subprime fall out. And a small number of investors, accounting for a large portion of demand liquidity, can disappear quite fast. So I just want that to be on the record.

I would now go to Ms. Watson.

Ms. WATSON. Thank you so much.

And Mr. Fuld, we are so pleased that you are willing to come and sit on the hot seat and admit that you take full responsibility.

We heard from the first panel's view on what caused this financial crisis. And one key factor was deregulation or inadequate regulation of big financial entities like yours, Lehman Brothers. I would like to get your view on this topic, because as a publicly owned broker-dealer investment bank, Lehman was subject to a number of SEC regulations. The company was required to report important financial information to shareholders, and you were required to meet the basic SEC requirements to make sure that you were adequately capitalized. Is that correct?

Mr. FULD. Yes, Congresswoman.

Ms. WATSON. And in your written statement, you explain that the SEC and Fed conducted oversight of your balance sheet. As you stated, they were privy to everything that was happening. Is that correct?

Mr. FULD. Yes, Congresswoman.

Ms. WATSON. But, Mr. Fuld, Lehman Brothers went bankrupt. Your investors and your creditors lost hundreds of billions of dollars. And the failure has had a widespread impact for the rest of the economy. Would you agree that the current regulatory framework and the way they were implemented in your case failed?

Mr. FULD. Are you asking specifically about the SEC?

Ms. WATSON. Yeah. The regulatory framework.

Mr. FULD. Specifically about the SEC?

Ms. WATSON. Yes.

Mr. FULD. Because I had said in my written testimony that I thought the overall regulatory system had to be redone.

Ms. WATSON. You will agree that they failed.

Mr. FULD. But specifically to the SEC, we had extensive dealings with the SEC. They actually had dedicated and knowledgeable people actually in our firm overseeing a number of our daily activities. I went to them, our firm went to them specifically talking about naked short selling. They were constructive and positive. We went to them with an idea of creating something that we call Spinco. Spinco was the—was a new independent entity into which Lehman would place some number of commercial real estate assets, along with a piece of capital, and then spin that, which means give that to our shareholders, which we believed would have created true shareholder value over a longer period of time. This actually was a model that I believe could have been very helpful and instructive.

Ms. WATSON. Yeah, I am watching our timer there. So let me just say that we have learned how Lehman Brothers relied on an unregulated bond rating agency, whose conflict of interest gave him every incentive to rate your company's risky bonds as safe investments. We have heard how housing and banking regulators failed to curb the predatory lending abuses in the subprime market. And we have heard about how the net capital rule was implemented so Lehman and other investment banks could ramp up their leverage to dangerously high levels. And we heard that the SEC is underfunded, understaffed, and led by a chairman who either was unable or unwilling to enforce even the basic laws on the books. Do you think this deregulation and lack of oversight contributed to the melt down on Wall Street?

Mr. FULD. I cannot talk to what——

Ms. WATSON. Do you think it contributed—my time is almost up—to the melt down on Wall Street?

Mr. FULD. I cannot talk to what the SEC did with the other firms.

Ms. WATSON. Do you think it contributed, or are you wholly and solely responsible for the melt down on Wall Street?

Mr. FULD. I actually gave the SEC high marks for trying to be constructive.

Ms. WATSON. No—OK. Here is my bottom line question. If all the things that I just spoke of you think were just fine and worked like they should, the regulations, then it is your total responsibility for the failure of Lehman Brothers in bankruptcy?

Mr. FULD. In retrospect, it is easy to go back——

Ms. WATSON. Yes or no? Yes or no? My time is up.

Mr. FULD. If you are asking me, do I——

Chairman WAXMAN. The gentlelady's time is up, and Mr. Fuld, you will be permitted to answer the question.

Mr. FULD. Thank you, sir. If you are asking me, did the regulatory framework contribute, or the lack of regulatory framework, contribute to where we are today? I would say yes. And that is why I think we need to redo——

Ms. WATSON. Thank you. Thank you. That is the answer I was trying to get to.

Mr. FULD. That is why I think we need to redo the regulatory framework.

Chairman WAXMAN. Thank you, Ms. Watson.

Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chairman.

Mr. Fuld, there appears to be inconsistencies between your public statements and the private information you were receiving internally. Let me read you some of these inconsistencies and ask you to respond. In January of this year, Eric Felder, one of your top executives, made a presentation to you and the board of directors. He talked about the company's finances, and observed that, "very few of the top financial issuers have been able to escape . . ."——

Mr. FULD. I am sorry, I didn't hear that. I am sorry. After Felder, I didn't hear that.

Mr. HIGGINS. Yeah, he talked about the company's finances. He observed that, "very few of the top financial issuers have been able to escape damage from the subprime fall out." He then warned you explicitly that in the current environment, "liquidity can disappear quite fast."

But that is not what you were telling the public. In December 2007, in a press release, you said, "our global franchise and brand have never been stronger."

My question is, why didn't you say publicly what you were being told internally, that you had to be careful because your liquidity could disappear quickly, which was in fact what happened?

Mr. FULD. Mr. Felder's presentation was when, January you said?

Mr. HIGGINS. December 2007, January 2008. This year.

Mr. FULD. We actually listened very carefully to Mr. Felder. And I believe the record book will show that we reduced our balance sheet. We reduced our leverage. We raised capital. We increased liquidity. So we did listen.

Mr. HIGGINS. Let me show you another internal document. This document is a document that your attorneys produced to the committee. It is from June 2008, 6 months later. This is a set of talking points describing what happened over the past year and why your company posted record billion dollar losses. This is an internal document that was never made public. And it seems to admit the truth about what was going on. It asks, this is your internal document, why did we allow ourselves to be so exposed? And then it spells out the reasons. "Conditions clearly not sustainable. Saw warning signs. Did not move early, fast enough. Not enough discipline in our capital allocation."

But that is not what you told the public that month. Here is what you said during an earnings call with investors on June 16th: Let me discuss our current asset valuation on those remaining positions. I am the one who ultimately signs off and am comfortable with our valuations at the end of the second quarter. Because we have always had rigorous internal process, our capital and liquidity positions have never been stronger.

Mr. Fuld, I don't see how you could say that. Your internal documents said that conditions are clearly not sustainable and that you did not move early or fast enough. But you told the public Lehman had never been in a stronger position. How do you reconcile your public statements with the company's internal assessments?

Mr. FULD. Was this my document?

Mr. HIGGINS. These are documents that your attorneys provided the committee.

Mr. FULD. I didn't mean that. Is this my document? Is this a presentation that I gave?

Mr. HIGGINS. These are documents internally that went past your desk in the past 6 months.

Mr. FULD. This document does not look familiar to me. And if it was an internal document, it was—I really can't speak to that, because this document is not familiar to me.

Mr. HIGGINS. Well, these documents were made——

Mr. FULD. But if you tell me it is mine, I believe you.

Mr. HIGGINS. And ultimately, you are responsible. And this inconsistency with public statements made conveying a strong position and internal documents showing a direct contrast to that assertion, I think, is very troubling with respect to the issue of trust and confidence. According to your lawyers——

Mr. FULD. I am looking very carefully at this——

Mr. HIGGINS [continuing]. This is a document that you either wrote or you reviewed.

Mr. FULD. I am looking at this very carefully, sir. It does not look like my document. Nor does it look like a speech that I gave. Nor does it look like anything that I reviewed.

Mr. HIGGINS. These are your documents.

Mr. FULD. Excuse me, sir?

Mr. HIGGINS. These are your documents.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Shays, you wish to yield 2 minutes to Mr. Mica.

Mr. MICA. Let me get down to some of the heart of this. I guess a lot of the collapse occurred on September 9th and 10th. You were trying to find $5 billion to back up your transactions. I recommend to everybody the Wall Street Journal today. They did an excellent job, better than the committee, of going through some of the public and private statements. I wouldn't necessarily pay for it. Maybe you could get it online. It is two bucks.

But it does outline what you were going through. One is J.P. Morgan asked you for the $5 billion. Lehman executives claimed that they had a restructuring plan. And then you had discussions that night. You wanted to go into a conference call. Your counsel said not to go into a conference call. Maybe you could tell us about that.

On the 10th, however, you told investors, we are on the right track to put these last two quarters behind us. Now, people want to know if you defrauded investors—I mean, I am going to be blunt here—by coming out and saying that as opposed to what happened on the 9th, and you knew or were told you weren't going to get the money.

Mr. FULD. As I said before, I am not—I am not really sure when that conversation——

Mr. MICA. Yeah, but you had to know at some point you weren't going to get the $5 billion. I mean the Korea—the attempt to get the money from Korea was——

Mr. FULD. I am sorry, I thought you were talking about J.P. Morgan. I apologize.

Mr. MICA. OK. But you were trying to get the money—well, J.P. Morgan wanted the money, and you were trying to find the $3 billion to $5 billion, right, to keep the ship afloat.

Mr. FULD. Two very different things. Very different things.

Mr. MICA. Well, this is on the 9th.

Mr. FULD. Well, J.P. Morgan, as I said before, in answering one of the other questions——

Mr. MICA. On September 9th, you needed $5 billion to keep the ship afloat. You were told, and your counsel told—also advised you not to go ahead with the conference call to disclose this internally. But you came out on the 10th and said, we are on the right track to put these last two quarters behind us. That is what you said. Again, I am just reporting——

Mr. FULD. Correct. In our September 10th analysts call, I firmly believed that we put the last two quarters behind us. We had done a tremendous amount—I don't want to go through the whole thing all over again—but lowered our leverage, raised capital; you heard it all before. I am not going to go through it again.

Mr. MICA. Were you told the night before you weren't going to get—be able to cook the deal?

Mr. FULD. I don't know what that refers to.

Mr. MICA. Getting the money to keep the Lehman ship afloat.

Mr. FULD. What we said on September 10th was that we had adequate capital. We talked about a plan that involved spinning off those commercial real estate assets and that we were going to have to put capital into that. On the call, people talked about, how are you going to fill that? We talked about the sale, potential sale of IMD, either all or some, which would have created $3 billion of tangible equity. I think if you go back and look at the third quarter announcement, you will see that. Possibly more if we had sold it for a higher price. We had plans at the time to go to some of our preferred holders and convert some of those preferreds to equity. Because we had to prerelease because of the rumors about our company, we didn't obviously have a chance to complete some of those plans. We didn't know how much capital we were going to need to equitize Spinco. We didn't know how much of the commercial real estate assets would be sold. But that was all 3 months out. On that Wednesday, we had $41 billion. We had plenty of capital to operate. All conversations about additional capital were about what we were going to do when we took capital and put it into the new Spinco. That was all 3 months out. And that was obvious to shareholders. That is what we were talking about. And there were a number of questions from analysts at that time about that. So there was disclosure about where we were and, I believe, understanding. And there certainly was no attempt to mislead anyone.

Mr. MICA. Again, again, before the committee, under oath, the night before September 10th, when you made that statement, did you in fact know that you weren't going to get the estimated $3 billion to $5 billion to keep the ship afloat?

Mr. FULD. Congressman, again, I say I am sorry, those are two very different numbers. One is additional collateral for our clearing bank. I know you are looking for an answer here. That is not capital. That is collateral. Two very different things. We believed we were going to raise, "that $5 billion, by either selling all or part of Investment Management or the sheer fact that we were going to spin those assets off, then we didn't need that much capital." The $5 billion was additional collateral that J.P. Morgan was asking for.

Chairman WAXMAN. The gentleman's time has expired.

The Chair now recognizes Ms. McCollum.

Mr. FULD. Did I answer that, though, for you, sir?

Ms. McCOLLUM. Mr. Chair, a point of personal privilege.

Chairman WAXMAN. Yes.

Ms. McCOLLUM. How I would go about yielding to the gentleman from Tennessee so he could make a flight?

Chairman WAXMAN. I didn't hear you.

Ms. McCOLLUM. How I would go about allowing time for the gentleman from Tennessee to go ahead of me so he could catch a plane?

Chairman WAXMAN. Then why don't I just recognize him now?

Mr. COOPER. I thank the Chair.

Mr. Fuld, in your testimony, on page 8, you say what happened to Lehman Brothers could have happened to any firm on Wall Street and almost did happen to others. But it didn't happen to the others. There is a difference. And you cite many factors in your testimony about how it could have been different, you know, if regulators had behaved differently or different things had happened. What could you have done differently personally that might have changed the fate of Lehman Brothers?

Mr. FULD. With the benefit of hindsight, sir, going back a couple of years, I would have made some changes to how we looked at and thought about our mortgage origination businesses, our commercial real estate business, and probably our leveraged loan business. Those were three of the areas that over the second and third quarter created some losses. And I believe in my verbal testimony I said, given the opportunity to look back, I would have done things differently. Should I have closed those businesses down then, I think people would have looked at me and said, that's irrational to have done that. But knowing what I know today, that clearly could have been a smart move. But given the information that I had, that is not the decision I made.

Mr. COOPER. Well, that was a decision you could have made 2 or 3 years ago. Given your book of business in 2007 and 2008, were there decisions you could have made to have changed the destiny of Lehman Brothers just in the immediate past?

Mr. FULD. We did make aggressive decisions to close some of the mortgage origination businesses. We had substantial hedges on our residential mortgage positions. In retrospect, I think we were slower on commercial real estate. I, like a number of other people, thought the mortgage crisis was contained to residential mortgages. There were a number of people, many experts included, that also thought that. And I was wrong. Looking back now at that information, I thought it was contained. We thought it was contained. And experts thought it was contained.

Mr. COOPER. You mentioned being, "slow on commercial real estate." Does that mean correctly valuing the portfolio of commercial real estate properties?

Mr. FULD. No, sir, it does not mean anything about valuation. It means about how quickly we thought about disposing those assets. And I think the record book will show that we went from $50 billion of those assets to $30 billion, keeping the remaining—I shouldn't say keeping, but ending up with $30 billion that would go into—either 30 or less, depending upon how much of the remaining 30 we sold in the fourth quarter, the remaining piece going to Spinco to be spun to our shareholders, which we firmly believed had real value.

Mr. COOPER. You had a committee, the finance and risk management committee, which I believe was chaired by the once legendary Henry Kaufman, a previous panel said that this committee only met twice a year in 2007 and 2006. Were they giving you advice on these long-term strategic directions?

Mr. FULD. Let me just clarify one thing, if I may. I believe they did meet twice in 2007, but they met four times this year so far. Well, it is over now, so it is four times this year.

Mr. COOPER. Were they giving you advice on changing strategic direction for the firm?

Mr. FULD. We talked about assets, and not just at the risk and finance committees, we talked about it at the board. We talked about how we were bringing down our exposures on residential and on commercial and on leveraged loans at almost each and every board meeting. Whether it was the risk committee or finance committee, we talked about it. It was clearly a subject on everybody's mind. Keep in mind that this was a board that did have a lot of financial experience. This was a strong, independent board. I was the only Lehman person on the board. These people—some of these people ran banks, IBM, other companies, Celanese. These were experienced people. And they had never any reservations about giving me advice and having a view about the markets.

Chairman WAXMAN. Thank you, Mr. Cooper. Your time has expired.

Ms. McCollum.

Ms. MCCOLLUM. Thank you, Mr. Chairman. And I thank the committee for allowing Mr. Cooper to move forward.

My constituents in Minnesota understand that you don't have to do something illegal to do something wrong. Imperfect Federal regulation isn't a license for unethical behavior, especially when it puts taxpayers at risk. In our current regulatory framework, there is a gray space between legal activity and illegal activity. And in that space, financial firms can make a choice to either obey the letter of the law but not to honor the spirit of the law. 12 years ago, and you have been with the firm for 42 years according to your testimony, Lehman Brothers Holding, Inc., sent a vice president to California to check out First Alliance Mortgage. Lehman was thinking about tapping into First Alliance Mortgage's lucrative business of making subprime loans. The vice president, Eric Hibbert, wrote in a memo describing First Alliance as a financial sweat shop, specializing in high pressure sales for people who are in a weak state. First Alliance, he said, the employees, "leave their ethics at the door." The big Wall Street investment bank, that was Lehman Brothers, decided First Alliance wasn't breaking any laws, and Lehman went on to be, to lend the mortgage company—they needed about $500 million worth of sells and more than $700 million worth of bonds. In other words, Lehman Brothers is an example of how Wall Street's money and experience could have been used to prevent us being in this subprime mortgage crisis. History: We should learn from it. You, in your statement, on page 5, you said, "we did everything we could to protect the firm." So I go back to this memo that Mr. Bishop had up and ask you if you agree with the spirit of the memo. Why did we allow ourselves to be so exposed? Did you ask those questions? Did you reflect that conditions were clearly not sustainable? Did you see warning signs? Did you move fast enough?

And I ask that because of two things that have come to my attention, that the Federal Bureau of Investigation has launched preliminary inquiries as to whether or not Lehman or its executives committed fraud by misrepresenting the firm's condition to investors. So, sir, I want to ask you some questions. On September 10th, 5 days before your bankruptcy filing, you and your chief financial officer, Ian Lowitt, held a conference call for investors. According to the Wall Street Journal, you were advised by your bankers not to hold this call because there were too many open questions. It is my understanding that at the time you did make the call, and that you were frantically trying to raise capital either through new investors or selling off assets.

So when you and Mr. Lowitt spoke to your investors and said that you did not need more capital, and that Mr. Lowitt said to investors when asked whether Lehman would need to raise $4 billion, I am paraphrasing, "we don't feel that we need to raise that extra amount. Our capital position at the moment is strong."

So, sir, is this accurate? Were you told not to hold the call? Were you trying to raise capital during the week before you filed bankruptcy? Is it an accurate statement that your capital position was strong on September 10th?

Mr. FULD. It is correct that our capital position on September 10th was strong.

Ms. MCCOLLUM. Did anyone tell you, advise you against holding the conference call I referred to? That should be a yes or no, sir.

Mr. FULD. Well, you are asking me did anyone.

Ms. MCCOLLUM. So that's a pretty big call that was made——

Mr. FULD. Yes.

Ms. MCCOLLUM [continuing]. Five days before filing bankruptcy, and your chief financial officer was present on the call.

I ask you, did any of your outside bankers or other advisers warn you against making, holding this call?

Mr. FULD. I had so many conversations, I would never say to you that no one——

Ms. MCCOLLUM. Well, sir, maybe you remember. Were you trying to raise capital during the week before you went bankrupt?

Mr. FULD. The week before, 2 weeks before, 3 weeks before.

Ms. MCCOLLUM. Sir, I asked you a week before. I was just asking you for the week before this.

Mr. FULD. I am saying yes to all.

Ms. MCCOLLUM. You are saying yes to all. When you were raising that capital, no one in your firm——

Mr. FULD. Yes. No, no, let me finish. I would like to finish because there's a different piece to that. What we were looking to do was to raise capital after we completed——

Ms. MCCOLLUM. You were raising capital.

Mr. FULD. Excuse me, please.

—after we completed the spinoff, which would probably have been January. After we had completed the spinoff of the commercial real estate assets.

On September 10th, we had a strong capital position. We were trying to anticipate how much capital we were going to put into Spinco, how much capital we were going to use. We were trying to anticipate how much we would sell the investment management division for.

So there were a number of moving pieces. But on September 10th, given the business that we had, we had sufficient and strong capital and liquidity.

Mr. TIERNEY [presiding]. Thank you, Mr. Fuld. Thank you, Ms. McCollum.

Mr. Van Hollen, you are recognized for 5 minutes.

Mr. VAN HOLLEN. Thank you, Mr. Chairman.

Mr. Fuld, you said earlier in your testimony that at Lehman Brothers when things were going well then people would do well. When things weren't going so well, then people would have cutbacks.

I have to say that I think people looking in have concluded, based on the compensation structure, that when things went well people did really well. When things didn't go well, they still did very well.

I would like to call your attention to a memo that was written on September 11, 2008, just 4 days before Lehman Brothers declared bankruptcy. And I hope someone can provide you with a copy of the memo.

It's a proposal from the compensation committee, you are cc'd on the memo. It talks about compensation for two employees of Lehman Brothers. One was Andy Morton, I assume you recognize that name.

Mr. FULD. I do, sir.

Mr. VAN HOLLEN. He was the previous global head of fixed income. It said, the document here says he was involuntarily terminated. The memo here proposes to give him an additional $2 million cash payment.

The other official mentioned in the memo is Benoit Savoret. I assume you know him as well, is that right?

Mr. FULD. I do indeed, sir.

Mr. VAN HOLLEN. He used to be Lehman's chief operating officer of Europe and the Middle East until he was terminated. He was also, according to this memo, involuntarily terminated. Yet this memo proposes to give him a $16 million cash payment, again, just days before Lehman Brothers declared bankruptcy.

These are two individuals who were involuntarily terminated. I think the normal sort of parlance is fired. Yet they are being given, combined, about $20 million in additional compensation, despite the obvious poor performance at this point, which nobody can deny.

I ask you, is that appropriate? I mean, we are here having this conversation with you and the American people. Is that appropriate that 4 days before Lehman Brothers declares bankruptcy, that two individuals who have certainly been part of the decisionmaking that led to the decline would be given $20 million in additional compensation?

Mr. FULD. There were two pieces to that, clearly, Andy Morton and Benoit Savoret. Andy Morton was given, I think it's $2 million.

Mr. VAN HOLLEN. Yes.

Mr. FULD. We felt that was—or, more importantly, the compensation committee felt that was appropriate for his years of service.

The $16 million, $16.2 million, was not a severance payment. The $16.2 million was a contractual obligation that the firm had made to Mr. Savoret, I forget when it was, but it was earlier in the year.

That contract said that at any time if terminated he was due the items of the contract. So that's what that was. That was not a severance payment, sir.

Mr. VAN HOLLEN. Regardless of his performance, he would be due that amount of money is what you are saying, under the contract?

Mr. FULD. Unless he was fired for——

Mr. VAN HOLLEN. Let me ask you this. You would agree, would you not, that people can make decisions that in the short term maximizes profits and bonuses but are bad decisions for the long term? I mean, there are decisions that can maximize short-term profits, but people would also agree that they might not be the best long-term interests in the company; isn't that right?

Mr. FULD. If you are referring to this gentleman?

Mr. VAN HOLLEN. No, I am just referring as a general proposition. You would agree that there are times when you can maximize short-term profits, but if you looked at over the longer term, people would agree it's not a good, long-term decision. You would agree that there are some decisions that fall into that category?

Mr. FULD. Certainly not by design, but in retrospect, clearly.

Mr. VAN HOLLEN. Let me ask you about clawbacks. I am not talking about anything with respect to Lehman Brothers, but just as a proposition. Wouldn't you agree that it's appropriate that if somebody makes a decision that raises short-term profits and, therefore, bonuses, but then it's later shown that those same decisions resulted in harm to the company, that on behalf of the shareholders and certainly in cases where the public is now involved, that the shareholders or the public should be able to go back in and get a clawback and take those bonuses or additional payments back that are proven, with the benefit of hindsight, to have been bad decisions for a company and the shareholders?

Mr. FULD. That was actually one of the things I spoke about when I said interesting way to go forward is a long-dated compensation system. In our case, that's exactly what we had. We had a long-dated compensation system.

Look, I am not proud of the fact that I lost that much money. But it does show that the system, our compensation system, did work.

I left 10 million shares plus a whole number of options. I say, I am not proud of that. But when the firm did not do well, I was probably the single largest individual shareholder. I don't expect you to feel sorry for me. I don't mean that. That's not my point. My point, though, is that the system worked.

Mr. VAN HOLLEN. Mr. Chairman, if I could, you are now referring to shares that you owned which, obviously, when the company went bankrupt, went down. I am also referring to bonus payments that may have been made in previous years to executives, including yourself, when, now that the company has gone bankrupt, wouldn't it make sense to have provisions to protect shareholders, not just to—clearly, when the shares go down, the value of the company goes down, the share values do.

But wouldn't it make sense to have clawback provisions with respect to bonus payments, cash payments? The shareholders could recover those moneys that were bonuses for what clearly proved to be bad decisions?

Mr. TIERNEY. If you could answer that briefly, Mr. Fuld. Then we will move on.

Mr. FULD. I am sorry, sir.

Mr. TIERNEY. If you want to answer that briefly, you may, but we have to move on.

Mr. FULD. Our compensation system was specifically set up, even for me. In 19—I am sorry, in 2007, 85 percent of my compensation was in stock. I lost that. All stock that I got for the last 5 years, I lost that.

Actually, compensation that I received back from 1997, 1998 and 1999, I went to the compensation committee and said I believe we should extend the vesting on this. I could have gotten it 7 years ago. I went to the compensation committee and said this should be extended to a 10-year vest. I lost all of that.

I would like also for this committee to know that before the end of our second quarter, I went to my board, and I said, I think we are going to have a tough quarter. We were talking about how we were going to pay the troops, as I called it. I said I want you to take me out of it. I believe, given this performance, my recommendation to you, is that I do not get a bonus.

I would like this committee also to know, I got no severance, I got no golden parachute. I had no contract. I never asked for a contract. I never sold my shares. That's why I had 10 million, because I believed in this company.

I believed that this company—and that's why I said, I am glad I got these last two quarters behind us. I believe we are on the right track. I could have sold that stock. I did not, because I firmly believed that we were going to return back to profitability and get back on the road.

Mr. TIERNEY. Thank you, Mr. Fuld. Thank you, Mr. Van Hollen.

Mr. Sarbanes, you are recognized for 5 minutes.

Mr. SARBANES. Thank you, Mr. Chairman.

I believe that you believed in this company, but I also believe that your belief in the company at a certain stage began to cloud your judgment.

Let me ask you this first off. When you say to the public, our capital and liquidity positions have never been stronger, that is intended to convey the overall strength of the firm and the company, is it not? In other words, you can't assert that a company is not strong if you are asserting that its capital and liquidity positions are strong?

Mr. FULD. Our capital position was strong, our liquidity position was strong. We had completed a whole number of things that we did to protect the firm.

Mr. SARBANES. So the firm was strong, is what you were intending to communicate with a statement like that?

Mr. FULD. We had—I will go through it again with you if you would like, sir. We reduced our leverage.

Mr. SARBANES. Was the firm strong, was the firm strong? Was that the intended communication in saying our capital and liquidity positions have never been stronger? It was to convey that the firm was strong, right?

Mr. FULD. My——

Mr. SARBANES. I am going to assume that is what it was intended to convey. I think that the problem that we have had here is that statements of this kind, at the time they were made, were simply implausible. So it then raises a question of whether your perspective on the health of the firm was clouded or whether there was something else going on. I am going to leave that aside, because I want to move to a different question.

You talked about how Lehman got into the originating business, and, I gathered, did business with a number of other originators, First Alliance was one, for example, for some period of time, before you then actually took an equity stake in those businesses; is that correct?

Mr. FULD. We took an equity stake in BNC Mortgage and also Aurora. A group in Europe called Elk, yes, sir, we did.

Mr. SARBANES. But those were firms or companies that you have been doing business with for some period of time before you then took the next step of taking an equity position? I mean, you did some business with them, so you knew how they operated?

Mr. FULD. We did some business with them.

Mr. SARBANES. You then said earlier that at the time you bought them you changed management, changed underwriting standards and took other actions designed to pull back on the very risky nature of the way they were conducting business, which I respect, although there's some evidence that the practice has continued nonetheless. I guess that's an admission by Lehman that the standards that were being used up to that point, in other words, by those companies, when you were doing business with them but had not yet bought into them, were not adequate standards.

Now, your, one of your vice presidents, this was mentioned briefly, went to California to kick the tires on First Alliance and came back with a memo saying these sorts of things. First Alliance is a financial sweat shop specializing in high pressure sales for people who are in a weak state.

Let me just mention, my primary concern with all of this, and Lehman is an example, it's not the only example, it's an example, is that what was happening was the thirst for more originated loans upon which you could build an empire of derivatives and slice and dice up the chain to make more money, the thirst for those got pushed down the chain and encouraged people to look the other way in terms of standard conventional underwriting standards, and so forth, which then created a culture and atmosphere in which predatory lending could flourish. I think that's what ended up happening to the detriment of millions of homeowners across this country.

So sweat shop was one description. You said First Alliance was the "used car salesman" of blemished credit lending. They made loans where the borrower had no real capacity for repayment. At

First Alliance it is a requirement to leave your ethics at the door, and in spite of this Lehman went ahead, invested in the company, and there's other evidence—I may run out of time, because I want you to respond to this—there's other evidence that these sorts of practices and ethics continued even after First Alliance was purchased, or you took some kind of ownership stake in First Alliance.

How could you consort with this kind of an operation, given how lax those standards were?

Mr. FULD. I am not sure if we took an equity stake in First Alliance, but that doesn't answer your question at all. We actually spent some time with First Alliance. I believe that was in the mid-1990's, and I think in the late 1990's we extended financing to them. We worked with them to change underwriting standards.

In the case of the ones that we bought after BNC and Aurora, we acted more as a conduit. That means we went to them and bought their production, and their production of mortgages. In that, we began to understand their business practice, our name became associated with them. We realized the best way to handle that was to buy them. If our name was going to be associated with them, buy them, change the management and change the underwriting standards, and that is what we did, and that is why we did it.

Mr. SARBANES. Thank you. Mr. Chairman, there's some evidence that it didn't change, but I will accept that answer.

Chairman WAXMAN [presiding]. The gentleman's time has expired.

Mr. Welch, before you start your questions, I want to, just for housekeeping purposes, ask unanimous consent that all the documents that have been referred to in this hearing be made part of the record. We will certainly leave the record open for questions for Members and responses.

Without objection, that will be the order.

Mr. Welch.

Mr. WELCH. Thank you. Thank you, Mr. Chairman.

Thank you, Mr. Fuld, for being here today. This is a tragedy unfolding all across America, and we are only beginning to feel the pain.

I know you sit here as the chief executive of a company that has a proud history of 158 years, did some tremendous things, and I have known some employees at your company and they are terrific, and 28,000 employees now don't work at Lehman Brothers. You had accounts, $700 billion, I guess. I am not going to beat you up about your salary here, but I want to ask you a couple of questions.

No. 1, it seems that Wall Street and Lehman, along with others, turned what was a basic, simple transaction that was a step in reaching the American dream, and that is a family buying a house and being able to do that by borrowing money on a mortgage. It was a straight-out transaction oftentimes between a neighbor who was a community banker and a just wide-eyed young couple oftentimes being able to afford the first house.

That got to be turned into a commodity. It got put on steroids with these subprime mortgages. It then got securitized. As long as the real estate values in this country were going up, fueled by low-cost credit, it was a house of cards that would stand until the first whiff of a downturn.

In retrospect, do you believe that this process of securitization, of easy credit, of convincing people who couldn't afford a mortgage, particularly when the rates were retriggered, was a house of cards that was bound to fail in retrospect?

Mr. FULD. Seeing it as I see it now——

Mr. WELCH. Is that a yes?

Mr. FULD. I am not sure I would say it was a house of cards. It was—none of us ever expected housing prices to decline with the depth of violence that it did.

Mr. WELCH. So, I mean, what I understand the problem you had is that you didn't get out fast enough and delever fast enough, and the market went faster than you were able to make the adjustments.

Mr. FULD. You know, actually, Congressman, that was not the case. Residential mortgages were not our problem at the end. We had——

Mr. WELCH. Let me ask you a couple of questions. Thank you. I don't mean to interrupt, but I only have 5 minutes.

I want to ask you a little bit about AIG. I mean, there was a whole series of bailouts. Then Mr. Paulson made the decision that when it came to Lehman there was going to be no governmental assistance. So, in fact, Lehman Brothers was treated differently than some other financial industry giants that were in similar circumstances. Obviously, the Treasury Secretary made a decision for reasons that he can explain.

But let me ask you this, my understanding is that you did have pretty regular contact, telephone contact with Mr. Paulson and probably some individual meetings. I also understand from reports in the New York Times that Goldman Sachs in fact was a major trading partner of AIG, about $20 billion on the other side of contracts.

Did you have any concerns that there may be some arbitrary reasons why Lehman Brothers, facing similar predicaments as AIG, was allowed to fail, whereas AIG was the beneficiary of an $85 billion bailout sponsored by the Treasury Department?

Mr. FULD. Well, I clearly would have loved to have been part of the group that got that.

Mr. WELCH. Well, do you have any views on that or thoughts on that, why you were allowed to fail, you, Lehman Brothers, were allowed to fail and AIG was bailed out?

Mr. FULD. That was a decision that was made that Sunday afternoon.

Mr. WELCH. I know that.

Mr. FULD. And I was not there.

Mr. WELCH. You have to be wondering. You are the head of this company. You want to keep it going. I understand from you everybody knew you were dedicated to the survival of Lehman.

Mr. FULD. Until the day they put me in the ground.

Mr. WELCH. Exactly.

Mr. FULD. I will wonder.

Mr. WELCH. You got an e-mail, as I understand it, from someone in your office, Mr. Humphrey, I think, about the Jarrett Waite situation, telling you that Mr. Waite had stopped by and commented in just a few weeks on the buy side it's very clear that GS, Goldman Sachs, is driving the bus with the hedge fund cabal and greatly influencing downside momentum, Lehman and others; thought it was worth passing on.

What was the meaning of that, as you understood it? This was from a business associate ally of yours; correct? By the way, I don't blame you for asking the question. That's what we are asking.

Mr. FULD. What Mr. Waite was talking about was that, obviously, Goldman Sachs was involved with the hedge fund community.

Mr. WELCH. Well, that's the short selling, right?

Mr. FULD. Greatly influencing the downside momentum of Lehman and others.

Mr. WELCH. And that refers to short selling?

Mr. FULD. I have no proof of that at all.

Mr. WELCH. I will just ask you your opinion. Do you think that there was any justified reason why Lehman was treated one way; namely, allowed to fail, and AIG, just as another example, was given $85 billion in taxpayer assistance to bail it out?

Mr. FULD. I do not know why we were the only one.

Mr. WELCH. Is there any rational business decision why there would be a distinction made between the predicament that Lehman faced and the predicament that AIG faced?

Mr. FULD. I, actually, I must tell you, Sunday night or, more importantly, that weekend, we walked into that weekend. I firmly believed we were going to do a transaction. I don't know this for a fact, but I think that Lehman and Merrill Lynch were in the same position on Friday night, and they did a transaction with Bank of America.

We went down the road with Barclays. That transaction, although I believe we were very close, never got consummated.

Mr. WELCH. Well, I thank you. You know, I feel bad, I know you do, for those folks at Lehman and your investors and your shareholders.

Mr. FULD. Let me just speak to that for a second, because, you know, we talk about what happened at Lehman, and we talk about whose fault, and why wasn't I on it, and my employees, my shareholders, creditors, clients have taken a huge amount of pain. Again, not that anybody on this committee cares about this, but I wake up every single night thinking what could I have done differently. And this has been going on, what could I have done differently. In certain conversations, what could I have said, what should I have done.

I have searched myself every single night. I come back to at the time—and that's why I said this in the beginning—at the time I made those decisions, I made those decisions with the information that I had. Having said all of that, I can look right at you and say this is a pain that will stay with me for the rest of my life, regardless of what comes out of this committee, regardless of what comes out of when the record book gets finally written.

That's all.

Chairman WAXMAN. Thank you, Mr. Welch.

Mr. Shays.

Mr. SHAYS. Thank you very much, Mr. Chairman. Mr. Fuld, I know it's been a long day, but we are coming to a close.

I have a variety of questions. Let's see how well we can get through them.

First off, what we are doing is we are trying to see what happened. We are trying to see who is responsible, and to determine who is responsible, and that includes Congress, ultimately it must, and what being responsible means.

So I am going to end my question, and I will tell you now, by having you tell me the significance of the fact that you take full responsibility. That's going to be my last question.

But I need to know what that means, and I don't want it now, because I want to ask a few other questions.

Then we are going to look at what do we do to change the system. We are the oversight committee. I am also on the Financial Services Committee that will come up with solutions.

Now, we had Enron and WorldCom and every part of the system broke down. The directors didn't direct, the managers didn't manage. The employees didn't speak out. One spoke out privately, didn't speak out publicly.

The law firm was duplicitous and part of the problem. The accounting firm was part of the problem. You had the rating agencies, everybody, every part of the system failed. So we passed Sarbanes-Oxley.

Amazingly, Fannie and Freddie were not under that, because they are not under the 1933 and 1934 act; therefore, they weren't under Sarbanes-Oxley. So two huge organizations were never under the very system we put in place with Sarbanes-Oxley, much less all the other laws that were required. But that's just a footnote.

What I want you to speak to is the highly leveraged. It strikes me that Wall Street was incredibly blase about risk, including yourself, that 30 to 1, you didn't leave yourself enough to deal with the potential run on a bank, and that when you gave these bonuses you just made it less likely that you would have the kind of reserves you needed, which strikes me, obviously in hindsight, as reckless. But people were saying, as we were going through the system, we have too much leveraging.

I kind of responded, well, you know, the hedge fund folks will tell me, you know what? It's the really wealthy people, and they can absorb the risk. They know what the risk is. They know it's huge leveraging. But what we know now is Wall Street can bring down Main Street. Frankly, I am going to tell you, it's a little scary, because we don't even know all the folks that have been impacted by Lehman Brothers going down. I mean, we know stockholders, shareholders, clearly, employees, but all the different folks who had resources held by your company.

So what I want you to do is speak about risk. Why did we get into this position of having such high leverage, and was it just too easy to make money that way, and so we just said the risk be dammed?

Mr. FULD. We certainly did not say risk be damned. I believe Lehman Brothers had a robust risk process. As far as the leverage, and I spoke about it earlier, there's a very big difference between the 30 times and where we were when we finished in the third quarter at 10½. A big piece of what that 30 was, again, was the match book, which was governments and agencies. So that should not be considered as an additional piece of risky leverage.

Again, I will say that on September 10th we finished with the best or one of the best leverage ratios on the street and one of the best tier 1 capital ratios on the street. And, even to your question, that's how I viewed the company, and that's why I viewed it as strong, Mr. Congressman.

Those were the metrics. Those were the metrics that the regulators used. Those were the metrics that all of us in the industry used, and ours were one of the best.

Mr. SHAYS. Let me ask you about the rating agencies. What kind of relationship do you have with the rating agencies? You end up having to pay them to determine your value. Describe to me, do you have any financial relationship with the rating agencies?

Mr. SHAYS. Yes, sir, we do.

Mr. SHAYS. OK. Tell me that relationship.

Mr. FULD. On securitizations, for example, we go to them with the components of a potential securitized deal, the mortgages, valuation, loan to value, geography.

Mr. SHAYS. Right, and you pay them for that?

Mr. FULD. They charge us a fee for a rating.

Mr. SHAYS. How can we feel comfortable that the very people who are paying them are the very people they are evaluating?

Mr. FULD. That was one of the things on my list of things that should be included in, hopefully, tomorrow's reform.

Mr. SHAYS. Let me just quickly go to executive compensation. I mean, this is the largest irritant, frankly, to the general public. When I got my MBA at NYU, I read a book, the 5,000 people that run America are the 1,000—I forgot what it was, but it was the people who run a company are on the board of three other companies or two other companies. So they help decide the compensation of someone else, and someone else helps decide the compensation of them.

Do you really feel comfortable that the compensation committee can objectively evaluate what you and others should get when in fact you have some real say in who they are and—well, I don't need to say more.

Mr. FULD. There was nothing shy about my or the firm's, more importantly, the firm's or the board's compensation committee. They had access to outside experts, and they used it. They had access to other firms' competitive data. They were independent, and I find no—I was not on that board or on that group.

Mr. SHAYS. Let me just end by saying to those of us on the outside, it seems a little screwed up, and it doesn't seem to us subjective, and that's my closing comment.

I appreciate you being here today. Thank you.

Chairman WAXMAN. Thank you, Mr. Shays.

Mr. Sarbanes wanted additional time, and the Chair still has additional time. So I yield you 2 minutes.

Mr. SARBANES. Really, this is just to add something to the record, Mr. Chairman, getting back to the First Alliance issue, because you talked about how once you took an equity stake and the evidence is that you did do that, that you put new management, that the practices ceased and so forth.

But the record is that even after you put hundreds of millions of dollars in there Mr. Hibbert, the same vice president who warned you about these practices before, indicated that First Alliance was still violating the Truth-in-Lending Act.

In 2000, First Alliance went bankrupt. In 2002, the Federal Trade Commission charged First Alliance with systematically cheating elderly homeowners. The next year, more than 7,500 homeowners sued Lehman and First Alliance for these same tactics. Where most lenders were charging fees of 1 or 2 points for a loan, your company was charging 25 points.

The jury delivered a $50 million verdict against First Alliance and specifically found that Lehman Brothers "substantially assisted First Alliance in perpetrating the fraud."

In light of that, it's just difficult to conclude that Lehman didn't know what was going on in terms of this subprime activity. I just wanted to add that to the record, Mr. Chairman. Thank you.

Chairman WAXMAN. The gentleman's statement is part of the record.

Mr. Fuld, we have completed the questioning by the Members, but I want to thank you for being here. I know this wasn't easy for you to be here, and I accept the fact that you are still haunted every night, as you said, by the wondering whether you could have done something different, whether this could have had a different ending.

But I must say that statement you made that the system works because you lost the value of some of your shares really doesn't sound right to me. Because the system that you lived under gave you a very, very generous reward when your company was highly leveraged and everything was going up, and that's the American way. But when the leverage meant that you were taking huge losses, when the values were not holding up, you still got substantial compensation.

I just would say that most Americans don't understand, even if— we thought you made $500 million, you said you only made around $350 million. That just seems to me an incredible amount of money.

We have held hearings on executive compensation, and we found some conflicts of interest with these compensation committees. We are going to hold a hearing on the ratings, the groups that do the ratings for these bonds, because we think that ought to be explored more fully. But if you walked away with even $350 million and your shareholders got nothing, and the taxpayers have a system now where we put up $700 billion, and the American people are looking to see, are they going to come out of this?

This is another day with a deep loss on Wall Street. We are just completely battered by the failure of our economic system as has shown up on the Dow and the ability to get credit. So something is just not right to say that the system worked as it should. That system didn't seem to be the system that makes sense. I still think that we have to look for ways to change it.

Mr. Shays, do you want to make any closing comments?

Mr. SHAYS. Just to say that I look forward to the next four hearings, and I do hope that we do get right in the thick of Fannie Mae and Freddie Mac.

Thank you.

Chairman WAXMAN. What I didn't hear from you, Mr. Fuld, you took responsibility for the decisions you made. In retrospect, you think you should have done some things different, but you don't seem to acknowledge that you did anything wrong. That, I think, is also troubling to me.

Thank you very much for being here.

That concludes our hearing for today, and we stand adjourned.

[Whereupon, at 2:45 p.m., the committee was adjourned.]

○