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PUBLIC POLICY ISSUES RAISED BY THE REPORT OF THE LEHMAN BANKRUPTCY EXAMINER

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

APRIL 20, 2010

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PUBLIC POLICY ISSUES RAISED BY THE REPORT OF THE LEHMAN BANKRUPTCY EXAMINER

Tuesday, April 20, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 11 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Gutierrez, Sherman, Meeks, Moore of Kansas, Lynch, Miller of North Carolina, Green, Wilson, Perlmutter, Donnelly, Foster, Speier, Minnick, Adler, Kilroy, Driehaus; Bachus, Royce, Jones, Biggert, Hensarling, Garrett, McHenry, Jenkins, and Lance.

Also present: Representative Eshoo.

The CHAIRMAN. The hearing will come to order. The photographers will drop out of sight. If you took a couple of journalists with you, nobody would mind.

We will begin with two of our colleagues who represent public jurisdictions that were victims of the Lehman misbehavior, I believe it is fair to characterize, and we have public jurisdictions that have been left uncompensated. That was one of the consequences of the legal situation that the Bush Administration believed it confronted, that they had no choice, they could either fund everybody or nobody, and in the future that will be different.

But we now deal with the situation; and both Representative Perlmutter, who is a member of this committee, and Representative Eshoo, as a strong advocate for the district in California, along with another member of the committee, Representative Speier, have consistently raised this issue. So Representative Speier will make an opening statement, but we will begin with testimony from our two colleagues.

We will start with Ms. Eshoo, because Mr. Perlmutter is stuck here for the day. You can speak and leave, so we will let you go first.

STATEMENT OF THE HONORABLE ANNA ESHOO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Ms. ESHOO. Mr. Chairman and members of the committee, thank you for inviting me to testify today. I particularly want to thank you for your extraordinary leadership in helping to steer our Na-

tion out of the worst financial crisis since the Great Depression. This hearing on the public policy issues raised by the report of the Lehman bankruptcy examiner demonstrates your continued vigilance on behalf of the American people.

Up until days before its declaration of bankruptcy, Lehman Brothers was considered one of the most trusted, reliable, and safest of firms to invest in. The examiner's report clarifies just how risky the practices and lack of transparency that sank Lehman really were. This behavior exemplifies Wall Street's reckless behavior which brought our economy to the brink of ruin. When we look at the case of Lehman, we are really examining the root causes of the crisis.

We learned in the examiner's report on page 732: "Lehman employed off-balance sheet devices known within Lehman as 'Repo 105' and 'Repo 108' transactions to temporarily remove securities inventory from its balance sheet, usually for a period of 7 to 10 days, and to create a materially misleading picture of the firm's financial condition in late 2007 and 2008. Lehman accounted for Repo 105 transactions as sales as opposed to financing transactions. By recharacterizing the Repo 105 transaction as a sale, Lehman removed the inventory from its balance sheet."

On page 733: "Lehman regularly increased its use of Repo 105 transactions in the days prior to the reporting periods to reduce its publicly reported net leverage and balance sheet. Lehman's periodic reports did not disclose the cash borrowing from the Repo 105 transaction; i.e., although Lehman had in effect borrowed tens of billions of dollars in these transactions, Lehman did not disclose the known obligation to repay the debt."

Now, why did Lehman do this? Let me quote the examiner's report again.

Page 735: "Starting in mid-2007, Lehman faced a crisis. Marked observers began demanding that investment banks reduce their leverage. The inability to reduce leverage could lead to a ratings downgrade, which would have had an immediate, tangible monetary impact on Lehman."

On page 738: "By engaging in Repo 105 transactions and using the cash borrowings, Lehman reduced its reported leverage ratios."

On page 739: "In this way, unbeknownst to the investing public, rating agencies, government regulators, and Lehman's board of directors, Lehman reverse engineered the firm's net leverage ratio for public consumption."

Senior executives at Lehman were fully aware of this. The examiner's report further states on pages 742 and 743: "A senior member of Lehman's financial group considered Lehman's Repo 105 program to be balance sheet 'window dressing' that was based on legal technicalities. Other former Lehman employees characterized Repo 105 transactions as an accounting gimmick and a lazy way of managing the balance sheet."

The bottom line is that, despite senior management knowing full well the perilous situation they were getting themselves and their investors into, they kept moving.

The examiner concludes on page 746: "Repo 105 transactions were not used for a business purpose, but instead for an accounting

purpose: to reduce Lehman's publicly reported net leverage and net balance sheet."

On page 853: "In order for this off-balance sheet device to benefit Lehman, the firm had to conceal information regarding its Repo 105 practice from the public."

With Lehman Brothers engaged in such risky behavior, this begs the question: Where were the SEC, the Treasury, and the Federal Reserve? The examiner's report concludes that these 3 agencies were monitoring the situation since early 2007. They were aware that Lehman was in trouble given their highly leveraged balance sheets. The agencies warned the firm about the risk of collapse if they didn't move to more conservative investments. However, the leadership at Lehman Brothers continued to maintain their pattern of deception.

The examiner's report goes on to say, on pages 1,482 and 1483: "At the highest levels, each of these agencies recognized as early as 2007, but certainly by mid-March 2008, after the Bear Stearns near collapse, that Lehman could fail. Treasury Secretary Paulson, Federal Chairman Bernanke, the Federal Reserve Board New York Secretary Geithner, and SEC Chairman Cox all had direct communication with former Lehman CEO Fuld. The day after Bear Stearns Weekend, teams of government monitors from the SEC and the Federal Reserve Board New York were dispatched to and took up residence at Lehman to review and monitor its financial situation."

So we had one of the largest banks in our country teetering on the brink of bankruptcy and the executives of that bank were masking accounting gimmicks that inflated their quarterly earnings. The rest of the story we know all too well.

The CHAIRMAN. We have a very full day, so you are going to have to wrap this up.

Ms. ESHOO. I will just summarize.

In my congressional district, San Mateo County and its public institutions were severe victims and still are of the Lehman bankruptcy. San Mateo County is required by California State law to hold operating funds, reserves, and bond proceeds in an investment pool. Their investment pool, which held funds on behalf of the county, local cities, school district, transit agencies, and the community college district were invested in the most highly rated conservative Lehman securities. When Lehman collapsed, San Mateo County lost $155 million.

I will submit the rest of my testimony for the record, Mr. Chairman, and would also like to request that a Wall Street Journal article that outlined exactly what happened to San Mateo County be put into the record as well.

[The prepared statement of Ms. Eshoo can be found on page 102 of the appendix.]

The CHAIRMAN. That will be put in the record. And all witnesses, I believe there will be no objection, will have the ability to put anything into the record which they wish to supplement.

Ms. ESHOO. I thank you again.

The CHAIRMAN. Mr. Perlmutter?

STATEMENT OF THE HONORABLE ED PERLMUTTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. PERLMUTTER. Thank you, Mr. Chairman, Mr. Bachus, fellow members.

As we recall, the fall of 2008 was full of turmoil in the financial services sector; and the turmoil intensified on September 15, 2008, when Lehman Brothers Holding, Inc., filed the largest bankruptcy proceeding in this country's history. The Chapter 11 filing of Lehman Brothers rocked Wall Street, but it also severely affected small communities like those in Colorado who invested in Lehman Brothers. These were school districts and local governments who made investments that they believed were conservative in Lehman which was portraying its financial condition in a better light than it was in reality. They trusted that Federal regulators were keeping a watchful eye on companies like Lehman Brothers.

In Colorado, a group of over 100 municipalities, school districts, and other local government entities invested in a State-sanctioned investment program for public monies known as the Colorado Surplus Asset Fund trust or CSAFE. CSAFE is a Triple-A rated fund that was adversely affected by Lehman Brothers filing when a money market fund in which CSAFE had invested known as the primary fund or the reserve fund announced that it broke the buck. CSAFE invested in the primary reserve fund for both security and liquidity purposes.

Another group of 63 Colorado governments invested directly in Lehman Brothers commercial paper through the Colorado Diversified Trust pool known as CDT. CDT is a local government investment pool operated under Colorado statutes where the investments are held on behalf of the participants but registered in the name of the trust. After Lehman went under, CDT disbanded, and the $5 million Lehman investment is now held in their names, but we don't know what they are worth.

The local entities that own Lehman Brothers provide core community services such as sewer, water, fire protection, public safety, and education. As many of you are also experiencing, these school districts and small community entities are already facing economic hardships and the losses suffered from Lehman are multiplying the local economic difficulties.

As we consider the public policy implications highlighted in the report of Examiner Valukas, it is clear that many critical components for the House-passed Wall Street Reform bill are critical to ensuring that similar mistakes are not repeated.

The issue begins with the reliance on the credit rating agencies. These Lehman entities and Lehman investments were Triple-A rated investments, yet communities got clobbered.

The importance of increased oversight and transparency in the derivatives market is also evident in the examiner's report. Information sharing and greater coordination between Federal regulators is critical.

And it is clear from the examiner's report, and I just refer the committee to pages 1,488 and 1,489, the SEC, which was supposed to be the primary regulator, was overseeing a number of Lehman's activities. Whether it was valuation of its assets, whether it was

reporting things properly, whether it was liquid or not, whether things were secured, Lehman Brothers at its end was acting like it was pawning its assets.

It is as simple as that. It kept pawning its assets to its lenders on a faster and faster basis and got less and less for what it pawned. So one week, it pawned its gold watch and got $100. The next week, the secured creditor said, that watch is only worth $75; and pretty soon it was just running to keep time.

The regulators saw this happening, especially the SEC, but they didn't share it with the little guys. The communities in Colorado, the communities in California, my guess is everybody in this committee has entities and community governments which have suffered the same kind of fate. So we need to have better information sharing among the various government entities that are regulating this.

There was this thing, as I said, this Repo 105. The repurchase agreement is just, in my—after you read this, is just another way of describing pawning, just trying to get assets today or get money today for your assets so that you can keep in business. This company was in serious shape over the course of 2007–2008, yet that disclosure wasn't made known to local governments like those in Colorado. We think that disclosure element, that reasonable regulation and reasonable disclosure, as we have outlined in our reform package that hopefully we will vote on this spring, needs to be done to avoid the kind of losses that school districts, hospital districts, and the like suffered in Colorado and elsewhere around the Nation.

With that, I yield back.

The CHAIRMAN. I thank the gentleman from Colorado.

Are there questions for either of our two colleagues?

If not, we will proceed to opening statements.

The gentleman from Alabama.

Mr. BACHUS. Mr. Perlmutter, you mentioned central derivatives clearinghouses as one of the things suggested, and I agree with you that there needs to be some information on that. And you mentioned rating agency reforms, and both Republicans and Democrats propose some of those reforms.

But, going past that, better information sharing between the agencies doesn't require legislation. And I totally agree with you that they did not share information among themselves, nor did they share it with the American people. But that is their statutory duty today. You wouldn't need new legislation.

What I guess I am saying is that 95 percent of the failures here; there were regulations on the books which they simply didn't enforce. I am not sure about the call for more regulations and more powers, when they failed to do their job in the first place.

Mr. PERLMUTTER. If I could respond?

Mr. BACHUS. Sure.

Mr. PERLMUTTER. I think one of the things that I see in this report is that the Securities and Exchange Commission back in 2007–2008, maybe before that, may have been watching things but wasn't sharing much with the other regulators. So I agree with you. They ought to be sharing.

There was also a question of, for instance, the SEC, there was a deposit of several billion dollars with Citigroup by Lehman

Brothers. Lehman Brothers treated it as an asset when in fact it was held as collateral by Citigroup. The SEC knew that, but, quote—and this is on page 1,488—"the SEC did not, however, take any action to require Lehman to remove the deposit from the amount it continued to report publicly." So there were—each agency was making mistakes, and I think the SEC was at the heart of it.

But your bigger question, and I think it is within the bill that we propose, is the oversight council, so that really there is a place where they are forced to talk about these major financial institutions. And if there is a systemic risk, and the report also talks about there being a void in dealing with a systemic risk after Gramm-Leach-Bliley, we have to move forward on that.

Mr. BACHUS. Right. In fact, I think both parties, and we proposed an oversight council, too, so I would agree with you on that. I guess what I am saying is the material misrepresentations, the laws are on the books today. They just didn't do their job. Their number one job is to protect investors; and, as you say, they concealed that information. The Federal Reserve—you talked about the SEC. The Federal Reserve was on site.

Mr. PERLMUTTER. Both of them were.

Mr. BACHUS. They were either incompetent or they concealed the facts. I would agree with both of you that the facts were they did not share that information. And I think they knew. A lot of what Lehman was doing went back to 2005. They got away with a little, then they got away with a little more, then they—

But I am just saying that I think we ought to all really—and what you kind of start with is, if you are going to fix something, you have to find out what caused it. And I think 95 percent of the cause is they didn't do their job. That is the regulators. In fact, not only did they not do their job, in cases they actively failed to share with the American people the information they had. So there was not only nonfeasance, I think there was malfeasance.

Mr. PERLMUTTER. And I will just respond. I agree with you. I think the SEC's job is to especially take care of the investors out in Denver, Colorado, and Lakewood, Colorado, those guys who aren't privy to all of the inside information. They are not JPMorgan Chase. They are not Citigroup. And so the SEC, by not really stepping up and saying to my communities, hey, you better watch these investments, they are not looking so good, we have concerns about them, I think that was a failure. And the regulator has to do a better job. We have to have reasonable regulation. Don't overreach, but when you know there is a problem, let people know that so they can make educated investment decisions.

Mr. BACHUS. Exactly. I agree totally with that.

The CHAIRMAN. I will just recognize myself for a minute to say the gentleman from Colorado said to the counties and other local governments, you are not a sophisticated financial institution, and the answer is, don't try to invest like one either. I think a little more prudence going forward in the investment side would also be helpful.

We will excuse our witnesses. We thank our colleagues. I know Mr. Perlmutter will join us. We will continue. I know there is ongoing legislative activity here.

Our colleagues have been very diligent, along with Ms. Speier, in trying to pursue some relief for their constituents, and we will continue to cooperate with them.

We will now begin with opening statements, and we need our witnesses to leave quickly. Thank you.

We will begin with the opening statement of the gentleman from Pennsylvania, Mr. Kanjorski, the chairman of the Capital Markets Subcommittee.

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet, again today, to examine yet another massive corporate failure. We have heard the sad song of corporate greed and regulatory breakdown one too many times in recent years in instances like the accounting misdeeds at Enron, the massive Madoff fraud, and the audacious bets of the American International Group. The events that led to Lehman's collapse add another verse to this troubling refrain in American capitalism.

In the Lehman tune, it deeply troubles me that we must once again explore how reckless Wall Street titans profited at the expense of innocent shareholders on Main Street. I am also deeply disappointed in the performance of auditors and regulators who failed to uncover wrongdoing, mismanagement, and capital shortfalls even as they fiddled in Lehman's offices. The American people, those who invest their hard-earned savings and retirement nest eggs in our markets, deserve not only answers about what happened but also the enactment of real solutions to design—

Mr. BACHUS. Mr. Chairman, should the witnesses not be present for the opening statements?

The CHAIRMAN. If the gentleman wants them to be, that is fine with me. Are the witnesses here?

Mr. BACHUS. We are waiting on Secretary Geithner.

The CHAIRMAN. I would go ahead.

Mr. BACHUS. The statements are actually intended for the witnesses. I don't know how Mr. Kanjorski feels, but that is the regular order.

The CHAIRMAN. I understand. I think they will hear what has been said. We have a large committee and a lot of questions to ask.

Are the witnesses here? Let's get the witnesses who are here out here. Let's ask those two to be here. My guess is the Secretary is represented, and we will go forward. Let's wait until they come out.

Mr. BACHUS. I do hope that Secretary Geithner is here by the time we ask him questions.

The CHAIRMAN. I will say that the Secretary has been very diligent in responding to requests. He has never ducked us. He has given us a great deal of time. And I think he was told that there would be statements from the members first. So no inference should be drawn about Secretary Geithner's willingness to be here. He has been a very cooperative witness.

The gentleman from Pennsylvania will now proceed.

Mr. KANJORSKI. To reiterate, Mr. Chairman, I am deeply disappointed in the performance of auditors and regulators who failed to uncover wrongdoing, mismanagement, and capital shortfalls even as they fiddled in Lehman's offices. The American people who invest their hard earnings and retirement nest eggs in our markets deserve not only answers about what happened but also the enact-

ment of real solutions designed to reform the way Wall Street functions.

The Valukas Report also reveals that Wall Street executives continue to embellish the truth, tell half truths, and hide behind their power in the marketplace. Lehman's former managers claim not to recall transactions or not to have spent meaningful time examining those very transactions important to investors. I find their excuses difficult to believe, especially in the wake of the corporate accounting and attestation reforms mandated by the Sarbanes-Oxley Act.

Moreover, Lehman's unscrupulous practices illustrate exactly why the Senate needs to quickly pass and the Congress needs to swiftly finalize the Wall Street Reform bill. The bill already passed by the House would force major participants in our markets to hold more capital and leverage less.

Additionally, the House-passed legislation and the pending Senate bill would include provisions to end the era of "too-big-to-fail," like my amendment directing regulators to break up financial firms that have become too big, too interconnected, too concentrated, and too risky.

The thoughtful Valukas Report additionally highlights the importance of my whistleblower reforms and tipster bounties contained in the House bill.

Moreover, his report proves the need to fundamentally change the way the U.S. Securities and Exchange Commission operates. Among other things, the House bill doubles the Commission's budget over 5 years and requires comprehensive review and overhaul of the Commission's operations.

In sum, today's hearing builds a case for Wall Street reform. Hopefully, this Lehman hearing will be one of the last arias of this all too gloomy opera about the dark side of American capitalism. The proverbial fat lady must begin to sing. We must now begin our work.

The CHAIRMAN. The gentleman from Alabama is recognized for 4 minutes.

Mr. BACHUS. Thank you, Mr. Chairman.

In response to reading revelations of the accounting manipulations by the Lehman bankruptcy examiner last month, I called on Chairman Frank to hold this hearing. I want to thank him for his prompt response to my request.

One has to ask the question, was Lehman too big or too interconnected to blow the whistle on? The court-appointed bankruptcy examiner, Anton Valukas, has provided us with an exhaustive report on Lehman's actions and the regulator's failures in that critical period between the rescue of Bear Stearns and Lehman's bankruptcy. As we consider how to reform our financial regulatory system his report serves as both a case study and a cautionary tale of what can only be described as a gross regulatory failure. The regulations and powers needed to address the misconduct were in place. They simply were not utilized.

When Mr. Valukas released his report, he unveiled a troubling narrative that many had suspected but did not know to be the case. The report found that Lehman engaged in "materially misleading accounting and balance sheet manipulation." Had there not been a bankruptcy, and had Mr. Valukas not conducted his report as a re-

sult, the acquiescence of the New York Fed and SEC in Lehman's misrepresentations would have been swept under the rug and the American people and investors kept in the dark.

Far more disturbing than the material accounting irregularities of Lehman were the actions or inactions of regulators, the New York Federal Reserve Bank and the SEC, who were on site at Lehman and had every opportunity and responsibility to observe the actions painstakingly described in Mr. Valukas' report. The report shows at best regulators failed to catch an accounting manipulation that permitted Lehman to give a misleading picture of its financial health to investors, creditors, rating agencies, and the financial markets. As a result, what would have been a bad situation, a failure of one of the Nation's large investment banks, was made far, far worse by the Fed's failure to plan and coordinate the response to Lehman's certain collapse.

These regulators failed to share information with each other about Lehman's deteriorating liquidity position, and they failed to force Lehman to disclose that it was far less liquid than it was reporting itself to be.

The New York Fed and the SEC administered three stress tests to Lehman, and Lehman failed them all. This alone is concrete evidence of a complicity of the Federal Reserve and the material misrepresentation of Lehman's financial condition. Regulators did not require Lehman to do anything in response to these failures. And, more importantly, they failed to disclose these failures to the financial markets.

In conclusion, Mr. Chairman, the regulatory proposals that have been offered by this Administration, and are now being considered by Congress, double down on these same failed policies. The same regulators, in some cases the same individuals who failed us 2 years ago and made Lehman's collapse far more damaging than it should have been, are still with us. Lehman is gone, but the failures of the Fed and the SEC are still with us and should not be rewarded with new regulatory powers.

I yield back the balance of my time.

The CHAIRMAN. The gentlewoman from California, Ms. Speier, is recognized for 1 minute and 50 seconds; and she also represents areas affected by the failure. Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

More than 18 months have passed since Lehman Brothers collapsed, but the repercussions of its failed and possibly criminal leadership continue. As was detailed by my colleagues on the first panel, State and local governments across the country who invested taxpayer dollars in supposedly safe Lehman investments have had to cancel important projects, lay off employees, and make other drastic service cuts to make up their losses. They lost, but others profited handsomely from Lehman's reckless actions.

Lehman's CEO, Richard Fuld, is here today. He certainly profited handsomely. He made almost $500 million in salary, bonuses, and stock options since 2000. You note I did not say "earned." He has publicly stated he felt terrible about the failure of Lehman. I say that is not enough. I say give it back. Disgorge yourself of the money. It is time for those whose greed, arrogance, and fraud caused this crisis to be held responsible.

The bankruptcy examiner makes a compelling case that fraud took place and that Mr. Fuld is lying about his role in it. I guess that is to be expected, since he is trying to avoid liability.

It is funny. Repo 105 is more like criminal procedure 101. The executives of Enron were held criminally and civilly liable for their responsibilities relative to fraud. Their accountants were held liable. We must demand the same here, not just for Lehman but for all those on Wall Street who have bought into the culture of greed and profit for themselves, no matter what the cost is to others.

The executives are not the only ones responsible. Government regulators bear a large share of the responsibility. Mr. Fuld argues that Lehman could have survived had it been one of the clubs favored by the Fed and Treasury and provided a bailout just like Merrill and Bear Stearns and AIG. Instead, the government chose to let Lehman fail.

I will submit the rest of my testimony for the record.

The CHAIRMAN. Let me ask at this point if we can get unanimous consent for our colleague, Ms. Eshoo, who has been a leader in the effort to deal with the fallout here, to sit with the committee. Is there any objection?

Hearing none, Ms. Eshoo will be welcome to sit with us.

And the gentleman from California, Mr. Royce, is recognized for, I guess, 2 minutes and 10 seconds. The gentleman from Alabama gave back 20 seconds.

Mr. ROYCE. Thank you, Mr. Chairman.

As the Fed's Donald Kohn pointed out months prior to the bankruptcy, the question was not whether Lehman Brothers would fail, but the question was when it would fail and how it would fail. And since the crisis we have heard from advocates of the Dodd-Frank regulatory reform package that the regulators only had two options: bailout or bust. Hence, the need for resolution authority. This is a false choice.

As the Lehman bankruptcy examiner puts it, what is clear is that the government—had it acted sooner, the government could have handled this. What is clear is that the markets might have been spared the turmoil of Lehman's abrupt failure. The regulators were not fully engaged, he said. They did not direct Lehman to alter the conduct we know in retrospect led Lehman to ruin. The government did not act soon enough. The regulators were not fully engaged. While regulatory consolidation and updating is necessary, the evidence from the Lehman collapse shows the regulators had the sufficient tools, they just failed to act to mitigate the impact of this failure.

We are now on the brink of doubling down on this flawed approach with the Dodd-Frank regulatory reform, and we are on the verge of authorizing bailouts of the future which is going to create more moral hazard. Instead of moving away from a government-provided safety net under our financial system, the Dodd-Frank approach expands the size and scope of that safety net, thereby compounding the moral hazard problem that frankly not only contributed to the collapse but contributed to the collapse of a lot of other institutions.

Instead of a strong commitment from the Federal Government to never again shield creditors and counterparties of failed institu-

tions from losses, this approach in this legislation does just the opposite. It authorizes bailouts, and that will inevitably lead to the erosion of market discipline as the cornerstone of the well-functioning market.

The CHAIRMAN. The gentlewoman from Ohio, Ms. Kilroy, who was the first to ask for a hearing on this subject, wrote to us and asked for a hearing, and I will—

Mr. BACHUS. Mr. Chairman?

The CHAIRMAN. Yes?

Mr. BACHUS. My letter preceded her letter by one day.

The CHAIRMAN. Oh, I am sorry. I hurt the gentleman. She was the first one who came to my attention. I apologize to the gentleman.

While I am at it, I do want to say, because I want to give the gentleman's feelings full vent, Secretary Geithner, in your absence, there were 1⅔ opening statements. I hope you will read them, because members should not have been making opening statements that you didn't read. So you will not be tested on them, but we do ask you to read them.

I trust I have taken care of everybody's feelings, and the gentlewoman from Ohio is now recognized for 1 minute and 50 seconds.

Ms. KILROY. Thank you, Mr. Chairman. I am more than happy to share credit for writing letters and calling for this hearing with Mr. Bachus.

Today, we are looking at the practices of Lehman Brothers and the policy implications following the report of Anton Valukas, the court-appointed examiner of the Lehman bankruptcy. The report describes how Lehman frequently ignored the warnings of their own risk management system to pursue even greater risk and disguise their position by using an accounting practice known as Repo 105 to bolster their balance sheet and quarterly reports. Representative Perlmutter described that as pawning. I describe it as compulsive gambling, taking ever riskier bets and then disguising those losses through Repo 105.

The subsequent fallout and its effect on Main Street were simply extraordinary. We heard from Colorado and California.

Likewise, I asked the State treasurer of Ohio for public records regarding Ohio State pension funds, which had sophisticated advisors, about their investments with Lehman. I wanted to understand the impact on hard-working Ohioans whose pensions often represent their life savings. While the long-term nature of these investments and the ongoing bankruptcy proceedings make it difficult to calculate the exact amount of economic damage incurred by Ohio's pension funds attributable to Lehman's bankruptcy, the information provided makes it clear that the losses are substantial. For the last quarter of 2007 to September 2008, Ohio's public pension funds holding with Lehman declined in value a staggering $480 million.

That is just Ohio. There are millions of hard-working Americans nationwide who watched their savings eroded by the reckless bets of Wall Street. If they were regulated the way that Ohio's community banks are regulated, I doubt this would happen.

Thank you, Mr. Chairman, for your consideration and your strong leadership. I yield back.

The CHAIRMAN. The gentleman from New Jersey is recognized for 2 minutes and 10 seconds. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you to all the witnesses as well.

I had a chance to read the summaries of the Lehman bankruptcy report, and reading the testimony of some of the witnesses today and thinking back on some of the exchanges that we have had in this committee as well it seems as though a pattern does seem to be emerging here, and that same pattern basically emerges throughout other case studies that led to the current financial crisis. And the pattern that I speak of is where regulators who are basically put in place to protect the investors, the depositors, and the financial system itself basically have repeatedly been shown to be unable or unwilling to do the job that they are appointed to do.

While during the current debate over the regulatory forum you hear a lot of calls for transparency of the institutions that they oversee, many times regulators seem to be having trouble living up to those same standards when it comes to their efforts. Now, in the case of point in Lehman bankruptcy, the Fed knew that Lehman would fail sooner or later. And I think the SEC probably knew all along that the number of employees that they had dedicated to the entire consolidated regulation of the major investment banks, only 24, was really completely inadequate to do the job. Likewise, with the Fed, which I think has disclaimed any responsibility for the only two folks that they had over there. Yet in both of these cases, the regulators led the public to believe that they were on the job and protecting investors, while in fact they were not being transparent about the true state of play at the time.

Another angle on failed regulation that cries out for closer scrutiny, and one I hope that we get to today, is the regulated structure of the New York Fed. One is basically rife with conflict of interest where the institutions being regulated choose their own regulator.

Now, over in the Senate, you have the Dodd bill, which is currently under consideration, would significantly increase the authorities of these same regulators. Like a lot of Americans, I don't have a lot of confidence in the regulatory regime we have; and, given their track record, giving these regulators more power will provide the market with a false sense of security while hampering the free markets.

More people, for instance, should have been listening to the David Einhorns of the world, a hedge fund investor who actually figured out what Lehman was doing at the time and put less faith I think in the regulators that are supposedly watching out for investors on Main Street.

Now, that is a lesson that I think, unfortunately, keeps coming through over and over again as we have these hearings and as we have studied events leading up to this financial crisis.

The CHAIRMAN. I will recognize myself for, I believe I have 1 minute remaining.

Before I do that, before the minute starts, I want to ask unanimous consent to insert into the record testimony of former SEC Chairman and member of this committee Chris Cox, who is out of the country, and former Secretary of the Treasury Henry Paulson—two men who obviously had a major role in dealing with this—and

a letter from the Financial Accounting Standards Board, since we want to get that involved.

I will now recognize myself a minute to say I am disappointed at the partisan tone.

First, I have to say the gentleman from California stated a view of myself and Senator Dodd which has less relation to reality than the norm. We never said that there was only a choice throughout this between bankruptcy and a bailout. What we have said, and we have quoted Secretary Treasury Paulson on this, is that once the failure comes, you have to pay all or nothing. The notion that you do nothing to avert failure is, of course, the opposite of what we believe.

As to the notion about the regulators having enough power, two President Bush appointees, Christopher Cox of the SEC and Henry Paulson as the Secretary of the Treasury, both said, no, we did not have enough authority.

Now, I want to address briefly the false dichotomy between did they have enough authority to do it and, if they did, should we give them any more? Yes, if everybody had worked perfectly, they could have avoided it, but people don't work perfectly. And having more authority to make sure that you deal with potential failures is part of our job.

We will now begin with Secretary Geithner and the testimony.

STATEMENT OF THE HONORABLE TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee.

On September 15, 2008, Lehman Brothers became the largest bankruptcy in American history. In the days that followed, it helped push our financial system to the brink of collapse.

Lehman's failures illustrate many of the fundamental flaws in our financial system. These problems are exposed with great care and force in the Valukas Report. The report tells a story of the ways in which our system allowed large institutions to take on excessive risks without effective constraints. In particular, this system allowed the emergence of a parallel financial system, what many have called the shadow banking system. This system operated alongside and grew to be almost as big as the regulated banking system, but it lacked the basic protections and constraints necessary to protect the economy from classic financial failures.

Imagine building a national highway system with two sets of drivers. The first group has to abide by the speed limit, wear seatbelts, buy cars with anti-lock brakes. The second group can drive as fast as they choose with no safety features and without any fear of getting pulled over by the police. Imagine both groups are driving on the same roads. That system would inevitably cause serious collisions, and drivers following the rules of the game would inevitably get hit by drivers who weren't.

A system like that makes no sense. We would never allow it on the roads, so why do we allow it in our economy?

Our financial system allowed risk to move toward areas where regulations were most lenient. And, as you would expect, when there is a lot of money to be made by avoiding regulation, there is

going to be a lot of activity and risk moving to where the constraints are weak.

In the lead-up to the crisis, we saw a breakdown in the basic, most fundamental, most important checks and balances in the system. Credit rating agencies failed to do an adequate job of assessing the risks in structured credit products and disclosing their ratings methodologies, boards of directors failed to exercise critical judgment and address critical weaknesses in risk management, accounting and disclosure regimes did not adequately inform investors of material risks in a timely fashion, and executive compensation practices were rewarded short-term gains with little attention to the risk of long-term loss. The derivatives market, operating largely in the dark without oversight, grew to enormous scale, with firms able to write hundreds of billions of dollars of commitments without the capital to meet those commitments.

And, tragically, when we saw firms manage themselves to the edge of failure, the government had exceptionally limited authority to step in and to protect the economy from those failures. We did not have any ability, as we have had with banks for more than 3 decades, to step in, and in an orderly and safe way wind down major investment banks like Lehman or major insurance companies like AIG.

Failure is inevitable in financial systems. The challenge for government is to design a system in which the failures of private firms cannot cause catastrophic damage to the economy.

In our system, the Federal Reserve was the fire station, a fire station with important if limited tools to put foam on the runway, to provide liquidity to markets in extremis. However, the Federal Reserve, under the laws of this land, was not given any legal authority to set or enforce limits on risk-taking by large financial institutions like the independent investment banks, insurance companies like AIG, Fannie Mae and Freddie Mac, or the hundreds of nonbank financial firms that operated outside the constraints of the banking system.

The sweeping financial reforms that this committee has passed, that the House has passed and that the full Senate is now about to consider are designed to deal with the vulnerabilities in this system, this financial system exposed by the crisis and illustrated by the Lehman example.

First, with financial reform, investment banks like Lehman will not be able to escape consolidated supervision because of their corporate form. Large firms like Lehman would be subject to tougher prudential requirements such as higher capital, higher liquidity requirements, and more exacting oversight than other firms because of the greater risk they pose to the system.

With financial reform, we will bring derivatives markets out of the dark. We will establish transparency so that regulators can more effectively monitor the risks of derivatives players and financial institutions; and we will bring the standardized derivatives products into central clearinghouses and trading facilities, reducing the risk these markets can pose to the system.

With financial reform, if a firm like Lehman is able to manage itself to the edge of failure, the government will have the ability to wind it down with no exposure to the taxpayer. This is bank-

ruptcy for banks. It is essential to deal with moral hazard, the risk that investors and executives will take risks in the future in the expectation the government will step in to bail them out.

And, finally, with financial reform, we will establish stronger protections for investors and for consumers, with clear rules enforced across the financial marketplace. We need a system in which regulators can act preemptively to protect, not be left to simply come in after the fact to clean up the mess.

The failures in our system, of course, were devastating. When a conservative Republican President, a President with an abiding faith in markets, is forced by a financial crisis to put Fannie Mae and Freddie Mac into conservatorship, to ask Congress for $700 billion in authority to stabilize a financial system, and to invest taxpayers' money into banks that accounted for 75 percent of our financial system, to lend billions of dollars to two of our largest automakers—when a President, a conservative Republican President is forced to do all that, and he was right to do it, it is undeniable that the system is broken.

The question we face is not whether to fix it but how best to fix the system. Any strategy that relies on market discipline to compensate for weak regulation and then leaves it to the government to clean up the mess is a strategy for disaster.

The best strategy is to force the financial system to operate with more transparency, with clear rules that set unambiguous limits on leverage and risk so that taxpayers never have to come in and protect the economy by saving firms from their mistakes. This is the strategy behind the reforms proposed last June by the President, the reforms passed in December by the House, and the reforms currently under debate in the Senate.

Thank you very much.

[The prepared statement of Secretary Geithner can be found on page 166 of the appendix.]

The CHAIRMAN. Chairman Bernanke?

STATEMENT OF THE HONORABLE BEN. S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you.

Chairman Frank, Ranking Member Bachus, and other members of the committee, I appreciate the opportunity to testify about the failure of Lehman Brothers and the lessons of that failure. In these opening remarks, I will address several key issues relating to that episode.

The Federal Reserve was not Lehman's supervisor. Lehman was exempt from supervision by the Federal Reserve because the company did not own a commercial bank and because it was allowed by Federal law to own a federally insured savings association without becoming subject to Federal Reserve supervision.

The core subsidies of Lehman were securities broker-dealers under the supervisory jurisdiction of the SEC, which also supervised the Lehman parent company under the SEC's Consolidated Supervised Entity, or CSE, program. Importantly, the CSE program was voluntary, established by the SEC in agreement with the supervised firms without the benefits of statutory authorization.

Although the Federal Reserve had no supervisory responsibilities or authorities with respect to Lehman, it began monitoring the financial condition of Lehman and the other primary dealers during the period of financial stress that led to the sale of Bear Stearns to JPMorgan Chase. In March 2008, responding to the escalating pressures on primary dealers, the Federal Reserve used its statutory emergency lending powers to establish the primary dealer credit facility and the term securities lending facility as sources of backstop liquidity for those firms. To monitor the ability of borrowing firms to repay the Federal Reserve in its role as creditor required all participants in these programs, including Lehman, to provide financial information about their companies on an ongoing basis.

Two Federal Reserve employees were placed onsite at Lehman to monitor the firm's liquidity position and its financial condition generally. Beyond gathering information, however, these employees had no authority to regulate Lehman's disclosures, capital, risk management, or other business activities.

During this period, Federal Reserve employees were in regular contact with their counterparts at the SEC; and in July 2008, then-Chairman Cox and I negotiated an agreement and formalized procedures for information sharing between our agencies. Cooperation between the Federal Reserve and the SEC was generally quite good, especially considering the stress and turmoil of the period.

In particular, the Federal Reserve, with the SEC's participation, developed and conducted several stress tests of the liquidity position of Lehman and the other major primary dealers during the spring and summer of 2008. The results of these stress tests were presented jointly by the Federal Reserve and the SEC to the management of Lehman and the other firms. Lehman's result showed significant deficiencies in available liquidity, which management was strongly urged to correct. The Federal Reserve was not aware that Lehman was using so-called Repo 105 transactions to manage its balance sheet. Indeed, according to the bankruptcy examiner, Lehman staff did not report these transactions even to the company's board.

However, knowledge of Lehman's accounting for these transactions would not have materially altered the Federal Reserve's view of the condition of the firm. The information we did obtain suggested that the capital and liquidity of the firm were seriously deficient, a view that we conveyed to the company and I believe was shared by the SEC and the Treasury Department.

Lehman did succeed at raising about $6 billion in capital in June 2008, took steps to improve its liquidity position in July, and was attempting to raise additional capital in the weeks leading up to its failure. However, its efforts proved inadequate.

During August and early September 2008, increasingly panicky conditions in markets put Lehman and other financial firms under severe pressure. In an attempt to devise a private-sector solution for Lehman's plight, the Federal Reserve, Treasury, and the SEC brought together leaders of the major financial firms in a series of meetings at the Federal Reserve Bank of New York during the weekend of December 13th through 15th. Despite the best efforts of all involved, a solution could not be crafted. Nor could an acqui-

sition by another company be arranged. With no other option available, Lehman declared bankruptcy.

The Federal Reserve fully understood that the failure of Lehman would shake the financial system and the economy. However, the only tool available to the Federal Reserve to address the situation was its ability to provide short-term liquidity against adequate collateral. And, as I noted, Lehman already had access to our emergency credit facilities.

It was clear, though, that Lehman needed both substantial capital and an open-ended guarantee of its obligations to open for business on Monday, September 15th. At that time, neither the Federal Reserve nor any other agency had the authority to provide capital or an unsecured guarantee; and, thus, no means of preventing Lehman's failure existed.

The Lehman failure provides at least two important lessons. First, we must eliminate the gaps in our financial regulatory framework that allow large, complex, interconnected firms like Lehman to operate without robust, consolidated supervision. In September 2008, no government agency had sufficient authority to compel Lehman to operate in a safe and sound manner and in a way that did not pose dangers to the broader financial system.

Second, to avoid having to choose in the future between bailing out a failing, systemically critical firm or allowing a disorderly bankruptcy, we need a new resolution regime analogous to that already established for failing banks. Such a regime would both protect our economy and improve market discipline by ensuring that the failing firm's shareholders and creditors take losses and its management is replaced.

Thank you, and I would be glad to respond to your questions.

[The prepared statement of Chairman Bernanke can be found on page 118 of the appendix.]

Mr. KANJORSKI. [presiding] Chairman Schapiro?

STATEMENT OF THE HONORABLE MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Thank you, Congressman Kanjorski, Ranking Member Bachus, and members of the committee. I appreciate the opportunity to testify regarding the Lehman Brothers examiner's report, and I want to thank Mr. Valukas for his thorough and invaluable work.

The SEC supervised Lehman through a consolidated supervised entity program which was designed to fill a gap in the regulatory structure that was left when the Gramm-Leach-Bliley Act failed to require investment bank holding companies to be regulated at the holding company level. This program, while staffed with dedicated and hard-working professionals, was flawed in its design and never adequately resourced to meet the challenges of prudential supervision of some of the world's largest financial institutions. It reflected a profoundly different approach to oversight and supervision for the Commission, a move away from our traditional rules-based oversight of broker deals and securities products to a prudential model of consolidated supervision involving a vastly expanded array of entities and financial products. Participation in the CSE program by firms was voluntary. The program was seriously

underresourced, understaffed, and undermanaged, and in some ways lacked a clear vision regarding its scope and mandate. The CSE program was discontinued in September of 2008 by former Chairman Christopher Cox.

The examiner's report raises serious questions about the oversight of Lehman's liquidity pool, asset valuation, and its risk-related internal controls. Although firms are fully responsible for providing accurate information to their regulators, in certain instances it appears there was insufficient follow-up on issues that should have raised concern. In addition, the examiner's report identifies Lehman's use of Repo 105 transactions as a means for it to reduce its leverage.

Though the report concludes that the regulators, credit rating agencies, investors, and the Lehman board were unaware of these transactions, it nonetheless raises critical questions about the use of these transactions to manage Lehman's balance sheet at the close of financial reporting periods and also raises questions as to how widespread this practice may be.

We have requested detailed information from multiple large financial institutions about their use of repurchase agreements or similar transactions and related accounting and disclosures and will take appropriate action when necessary.

While the CSE program no longer exists, the SEC is taking steps to significantly bolster our oversight of larger broker/dealers through improvements to broker/dealer reporting and monitoring, establishment of cross-divisional teams with dedicated responsibility for oversight of key financial firms, enhancements to our broker/dealer examination program, changes to the capital rules to reduce reliance on value at risk models, and consideration of increased capital requirements and explicit leverage requirements.

The failure of Lehman also demonstrates the need for important legislative changes in supervisory resolution structures for large financial entities that can have a systemic impact. The bills passed in the House and being considered in the Senate, although different in many details, are designed to address key issues raised by the financial crisis and illustrated by Lehman's failure. The move toward central clearing and transparency of OTC derivatives can have a substantial impact on the soundness of our financial system. The creation of a systemic risk council, properly empowered, can be a force to improve standards across the industry. And the establishment of a credible resolution regime is vital to ending the problem of "too-big-to-fail."

In light of the Lehman failure and the examiner's report, the SEC is determined to become a more effective regulator focused on capital adequacy and liquidity risk, committed to its core strengths in the areas of disclosure and enforcement and embracing meaningful functional regulation, active enforcement, and transparent markets.

It is not clear that any action by the SEC could have saved Lehman Brothers, but we are determined to use the lessons of that experience to be more effective. More vigorous oversight and a new approach are essential, and I look forward to continuing to work with you as you consider ways to strengthen our financial system.

Thank you for the opportunity to testify today, and I look forward to answering your questions.

[The prepared statement of Chairman Schapiro can be found on page 179 of the appendix.]

Mr. KANJORSKI. Thank you very much, Madam Chairman.

I am going to take my 5 minutes while the chairman is out of the room.

I want to publicly announce that George Orwell lives. I have listened to my colleagues on the Republican side, and I really cannot believe—there are two conclusions I can come to. Either you all failed to read the bill that we passed here in this committee and in the House, or you are purposefully attempting to mislead the American people as to the real content of that bill.

When you say that we do not have protections in there that never existed before, you are just dead wrong. And I call your attention to the amendment that I offered, the "too-big-to-fail" amendment that passed this committee and is part of the House bill, that will prevent this in the future and give authority to these regulators and others the ability to stop institutions from growing so large that they will systemically challenge the American system. That is the first time in history.

Still, everyone on this side of the aisle seems—and particularly not only the members present at this committee, but I listened over to the weekend to these talking heads. I listened this morning to some of the Senators. Now, we have to get everybody together here to accept the basic facts or we are in trouble.

Along with that, I will direct my questions. Mr. Secretary, we need a system, we really need a system. I have listened to your testimony very closely. I listened to Mr. Bernanke very closely and Ms. Schapiro very closely, and I did not hear you mentioning the "too-big-to-fail" amendment where we have authorized the appropriate regulators to move in, take control, and order large banks and institutions that challenge the risk to our system—either force them to break up, add capital, or take other actions that would reduce their risk. Is there a reason I am not hearing you mention that in this testimony?

Secretary GEITHNER. Mr. Chairman, you are exactly right. Critical to any effective reform and at the center to the bill this committee passed are a set of authorities to limit risk taking across the financial system, and as part of that you proposed and the committee embraced a provision to give explicit authority to the Federal Reserve, to limit risks ahead of the crisis.

I completely agree the best way to deal with "too-big-to-fail," the necessary part of reforms to deal with that, is to make sure there are people equipped with authority to put effective constraints on risk taking ahead of the crisis.

Mr. KANJORSKI. The question on that is—and it was raised by Mr. Volcker—have we been too nice to just say the regulators have that authority, or should we mandate the use of that authority?

Secretary GEITHNER. Mr. Chairman, as you know, in the bill that Senator Dodd has proposed in the Senate, he takes an approach building on the model you laid out, which does impose actual limits and does require the Federal Reserve—would require the Federal Reserve, if passed, to design regulations that would apply those

limits. So it includes your broad grant of authority, but accompanies that with an explicit requirement that clear limits be put in place.

Mr. KANJORSKI. I appreciate that. Mr. Bernanke, Mr. Chairman, I did not hear in your testimony any discussion of the "too-big-to-fail" amendment as proposed by this committee and passed into law in the House at least, and now part of the Senate bill in modification.

Is there a reason why important elements of this Administration and the regulatory leadership of this company are not taking a public position on this issue?

Mr. BERNANKE. No, sir. I am very much in favor of addressing "too-big-to-fail." I think it is a major concern, and the two lessons I drew on consolidated supervision and resolution are two big parts of the strategy.

Mr. KANJORSKI. I agree. They are. I did not hear your comment on the amendment that I offered in this committee as part of the House bill, and now part of the Senate bill, giving the authority to the regulators to intercede, require plans, require additional capital, break down organizations that are "too-big-to-fail." Is there a reason why you failed to address that?

Mr. BERNANKE. We were discussing Lehman, which was near the end. Prior to the crisis, you want to take actions necessary to limit risks, and I am very sympathetic to the view that through capital, through restrictions on activities, through liquidity requirements, through executive compensation, through a whole variety of mechanisms, it is important that we limit excessive risk taking, particularly when the losses are effectively borne by the taxpayer.

Mr. KANJORSKI. Mr. Chairman, you dance well.

Mr. BERNANKE. Thank you.

Mr. KANJORSKI. Are you going to answer my question? Are you or are you not in favor of the law as passed by the House and incorporated in the Senate bill authorizing the regulators with greater authority to break up organizations, if necessary, that are deemed to be "too-big-to-fail?"

Mr. BERNANKE. I think it is something that would be on the whole constructive, and I am certainly, as a regulator, willing to work within its dictates.

Mr. KANJORSKI. Madam Chairman?

Ms. SCHAPIRO. Thank you. I would agree that having that authority for regulators is actually quite critical. I would point to the example of the CSE program to illustrate that, because that was a program that lacked a statutory basis and despite its many other flaws, which I am sure we will talk about further this morning, there was no authority on the part of the regulators based in statute to take dramatic or substantive action with respect to imposing requirements upon the investment bank holding companies. I think that was a huge flaw in the program.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you.

Let me state, before I turn to questions, is where we disagree is injecting capital into those companies. The House passed $150 billion, what we continue to call a bailout fund. It is $50 billion in

the Senate. I know Secretary Geithner has now called that it be removed, and I think that is an important step.

But we disagree that in a failing business like Lehman it is appropriate to put additional capital, particular by our governmental entities. That is where there is serious disagreement. Not that you don't need more resolution authority as they go into bankruptcy or a bankruptcy-like proceeding. There is no disagreement there, so I think we are getting closer together.

Let me ask you this, Secretary Geithner. The examiner's report is replete with examples of the New York Federal Reserve and the SEC missing red flags that would have prevented Lehman's implosion from being as devastating to the markets and the economy as it ultimately was, and I am going to quote the examiner:

"Had the government acted sooner on what it did or should have known, there would have been more opportunities for a soft landing. The markets might have been spared the turmoil of Lehman's abrupt failure."

Now, as harsh as that criticism is, for me it raises another question, and that is, why didn't the government act? Why didn't the regulators require Lehman to correct its misstatement and do something to prevent, as the examiner put it, billions of dollars of additional investments into Lehman by investors based on misinformation?

I am wondering if the answer might be hinted at in your explanation to the examiner, that you feared the markets would figure out that Lehman had "air in its marks," in other words, that Lehman was carrying assets on its books at inflated values, much-inflated values. I would ask you to respond to that.

Secretary GEITHNER. Thank you.

Mr. Chairman, could I just begin with your first point, though, and then I will answer your question directly. The bill that this House passed and the Senate is considering would not give the Executive Branch of the United States the ability to go put capital into failed institutions. This is a very important point. You may be right that we may agree on the core provisions of this stuff, but it does not do that.

What it does say is if a firm manages itself to the edge of the abyss, it can't survive without the government coming in, the only thing the government could do would be to step in and, in effect, put it into receivership so it could be broken up, sold off, unwound, without causing catastrophic risk to the economy as a whole and without the taxpayer being exposed to any risk of loss.

Mr. BACHUS. Mr. Kanjorski mentioned putting capital into the firm, and I know, Mr. Bernanke, you said you didn't have the right with Lehman to add capital. You wished you had that right. I think that is where we disagree, Chairman.

Mr. KANJORSKI. Will the gentleman yield? I just want the record to be correct. I never mentioned putting capital in, no.

Mr. BACHUS. You never mentioned capital?

Mr. KANJORSKI. Putting capital in, no.

Mr. BACHUS. All right. We will review the record. I thought you said, Mr. Chairman, that you didn't have the right to put additional capital into Lehman, not that you would have.

Mr. BERNANKE. In that context, we just had no tools. That might have been one possibility. But I am not advocating—

Mr. BACHUS. What I am saying is, you did say you didn't have the tools to put capital in, which to me would be an indication that you at least would like to put capital in. Maybe I misread that.

Mr. BERNANKE. No, sir, I do not.

Mr. BACHUS. You would agree with us that putting capital in is not appropriate?

Mr. BERNANKE. I would want the firm to die, but I would want to be able to break it up and sell off pieces and so on, very much like we do with a bank today.

Mr. BACHUS. Sure. Absolutely. And I don't know—we have proposed an enhanced bankruptcy for that, and I think giving you additional powers is appropriate, in that regard alone.

Go ahead. Would you respond to the charge by the examiner that you could have avoided some of the harshness, that we could have had a softer landing had you acted sooner?

Secretary GEITHNER. Mr. Bachus—

Mr. BACHUS. You were at the New York Fed.

Secretary GEITHNER. I was president of the New York Fed at that time, and this is what I believe. At that point, beginning in March of 2008, two things were clear: One is we were on the edge of the verge of a financial crisis of enormous force, something that we hadn't seen in decades, and there were a series of institutions that had gotten themselves to the point where they were uniquely exposed to those risks. They were going to be terribly vulnerable to that gathering storm.

Now, after Bear Sterns got itself into that mess, as you know we moved very quickly, the Federal Reserve, the Secretary of the Treasury, and the SEC moved very quickly to put in place a set of arrangements. It was a patchwork of arrangements, not an optimal set of arrangements, to try to encourage those large independent investment banks that remained to take actions to make themselves also stronger in the months that followed Bear Sterns. And we worked very closely together—

Mr. BACHUS. Let me—

The CHAIRMAN. The gentleman's time has expired. We are 30 seconds over already.

Mr. BACHUS. He did not—let me ask a yes or no question.

The CHAIRMAN. No, the gentleman may make a concluding statement. We have a lot of members here.

Mr. BACHUS. I am going to point to the examiner's report, page 1510, "The Federal Reserve Bank of New York was aware that Lehman was overstating its liquidity." Is that a true statement?

Secretary GEITHNER. I don't know if that is a fair statement. What I would say, and I will echo what the Chairman said, is that there is nothing in that experience that did anything but confirm our judgment, Mr. Bachus, that Lehman was vulnerable to this gathering storm, both in terms of how much leverage it had and in terms of how it was funding itself. We were deeply concerned about that.

Mr. BACHUS. The Federal Reserve Bank was aware that Lehman was overstating its liquidity.

The CHAIRMAN. I don't understand the gentleman from Alabama's approach here. He had plenty of time. He raised some other issues. It is my responsibility to try to give every member a chance. I asked one of my colleagues on the Democratic side to stop in a very important statement. We can't run the committee with people just talking whenever they want without regard to the time.

Now, I will recognize myself for 5 minutes to add to my procedural dismay, frankly, some substantive dismay. I am disappointed at the partisan tone here.

First of all, let's be very clear. The primary responsibility here is within the Securities and Exchange Commission, that is what Mr. Valukas says, despite Chairman Cox's statement, we believe it is clear that the SEC was Lehman's primary regulator. Page 6 of Mr. Valukas' testimony: "Mr. Cox was a Republican member of this committee appointed by President Bush to head the SEC partly because he thought his predecessor, whom he had also appointed, was too interventionist, Mr. Donaldson."

This effort to put it all on the Fed and diminish the role of the SEC is a fairly transparent partisan effort. It doesn't solve our purpose. We are here to try to make sure this doesn't happen again. That is our major role.

Now, the other thing I have to respond to is this blatant mischaracterization that we are trying to put capital into these companies. The gentleman from Alabama began by saying he disagrees with us, I think he meant the Democrats, because we want to put capital into the company. He incorrectly imputed that statement to the gentleman from Pennsylvania, who made it clear he never said it.

He then said, well, the Chairman said that was a tool they might have had back then. The Chairman is a very nice fellow. He doesn't speak for the Democrats, nor we for him.

The bill that we have, as the Secretary made clear, is very explicit: No money can be spent in these cases until the institution is out of business. The notion that we inject capital into institutions is flatly wrong, flatly contradicted by the text of the bill.

The point is that we put money in at the suggestion of the head of the FDIC, Ms. Bair, another Republican appointee whom I admire greatly, who says her experience is that when you are putting an institution out of business, as she does with banks, you need some money to do that in a way that does not cause greater systemic problems, and in fact, can minimize the cost to the government.

That is what the money is there for. Whether it is there or after doesn't seem to me to be terribly important. What is important is none of that money can be spent to help the institution. So the suggestion, not the suggestion, the statement that there is an effort to inject capital into these institutions is simply flatly and clearly wrong.

Now, the other point I want to make is this, to Ms. Schapiro, because we have been told, well, they had all the authority, etc. But I believe that there were a couple of decisions made by the SEC under Chairman Cox, whose statement we have put in the record. Chairman Cox and Secretary Paulson, by the way, both contradict my Republican colleagues. Those two appointees of President Bush

said no, they didn't have all the authority they should have had, and they wanted to have more authority and they support efforts to give more authority here.

But let me ask Chairwoman Schapiro, the SEC made a couple of decisions: one, to increase the amount of leverage that entities are allowed; and two, to give them a kind of voluntary regulatory approach. Would it be fair to say that contributed to the context in which this happened and that we have taken action to undo that?

Ms. SCHAPIRO. Mr. Chairman, the consolidated supervised entity program had to be voluntary because there was no authority in the statute for the SEC to bring investment bank holding companies under the regulatory umbrella. So when the EU directive required consolidated supervision for these institutions, the SEC, I believe at the time, felt it was stepping up to the plate to offer a consolidated supervisor so that they would be regulated.

The CHAIRMAN. What would the current legislation, the pending legislation, do in regard to that?

Ms. SCHAPIRO. The current legislation would give a systemic risk regulator the tools to see all of the entities and affiliated entities across the institution, which I think is very important.

In return for coming into this voluntary program and submitting to a holding company regulation by the SEC, the Commission permitted the broker dealers of these institutions to calculate their net capital in a different way, utilizing the alternative net capital rule, which took away the prescribed haircuts and instead allowed the firm to use value-at-risk models.

The CHAIRMAN. With the new authority you would get if the bill passed, would that still be allowed?

Ms. SCHAPIRO. The rules would still be allowed. Although there are no consolidated supervised entities any longer, presumably under the legislation they would be subject, these kind of entities, to the systemic risk regulator and the oversight of the council.

The alternative net capital rules do still exist. They have been cut back, and it is a question we are debating right now within the agency to eliminate them in their entirety.

The effect they had in 2004 was to allow firms by use of their models to support larger and larger positions against the same capital base that they had historically. To counterbalance that, though, they were required to hold $5 billion in early warning net capital and to have a liquidity pool—which raises all of its own issues—sufficient to cover their costs for a year if unsecured lending were unavailable.

So there were trade-offs and balances. The agency felt it was bringing the holding companies into the regulatory sphere, but at the same time it loosened some of the ties on firms.

The CHAIRMAN. The gentleman from California.

Mr. ROYCE. Thank you, Mr. Chairman. I am going to raise a couple of issues here, not to point fingers at the regulators, but because Congress is on the brink of passing legislation that will fundamentally change our financial sector. And it is not just Members on this side of the aisle who are saying this.

Over the weekend, I listened to one of our Democratic colleagues say that the Dodd bill would lead to permanent bailout authority and a fundamental change of our system. So there is that concern.

And the underlying premise of the bill is the belief that despite the regulators' performance in recent years, regulators are going to always know here what to do to mitigate the next systemic shock. They are going to know that.

The case of Lehman Brothers, I think, proves that this is a shaky precedent upon which we are basing the future health of our capital markets. Because there is another way to look at this, and I remember an argument Mr. Geithner made that I thought was a profound one—you said that the top three things to get done are capital, capital, capital. It is the fact that we allowed these institutions to overleverage, right? The regulators allowed them to overleverage. I agree with that.

I remember Mr. Greenspan said the reason the capital issue is so often raised is in a sense it solves every problem. And I remember Mr. Volcker saying the same thing, or essentially that. So that is where the reform efforts should be centered.

Now, the wider presence of the Dodd bill, which, frankly, a lot of economists are raising issue with this concept of a permanent bailout authority, but let's go over the regulatory experience here.

There is an expectation of regulatory competence in the market; counterparties, creditors, investors. They expect the Federal regulators to have a firm understanding of the solvency of an institution and whether or not that institution is basically accurately portraying their liquidity position; are those leveraged ratios really what they are supposed to be.

So we are looking at the examiner's report here and it says the SEC deferred to the Federal Reserve Bank of New York. We mentioned these stress tests. You did three stress tests. You were chairman at the time, Mr. Geithner, of the Federal Reserve Bank of New York, you were president of the bank, and Lehman failed all three. And in the words of the bankruptcy examiner, it does not appear that any agency required any action of Lehman in response to the results of this stress testing.

The New York Fed presumably had the authority under the memorandum of understanding with the SEC to require Lehman to take corrective action. Maybe you feel otherwise. But the bottom line seems to be that the Fed could have tightened terms and raised haircuts on collateral. Failure to use that leverage likely lulled the management of Lehman into believing that the government would save the day.

And that is the moral hazard problem I have with all of this. I want to see more market discipline in this legislation. Let me allow you to respond. But I think it is a signal to market participants that a firm that the Fed privately knew to be failing should be treated as just as an another counterparty. That is my concern. Could I have your observations on that? And let's get back to the capital capital capital statement you made earlier.

Secretary GEITHNER. Congressman, I really agree where you started. We cannot design a system that relies on the wisdom of regulators to act preemptively with perfect foresight, to come in and preemptively defuse pockets of risk and leverage in the system. That may be possible. We will do our best to do that. But you can't build a system that requires that level of preemptive exercise and perfect foresight. It is not possible.

The only way I am aware of to design a more stable system is to use capital requirements, as you said, to enforce a set and enforce constraints in leverage on institutions that could pose catastrophic risks to the financial system. That is the centerpiece of the reforms that this committee embraced.

To be able to do that on a consolidated basis for institutions exposed to systemic risk is the essential necessary reform that we all have to support. Now, it is not sufficient, but it is necessary.

You also, to make credible the possibility of allowing failures in the future, have to make sure that the system can manage those failures without collateral damage to the innocent. And, again, that is what the bill does.

Mr. ROYCE. Yes, I understand that. But under the Dodd bill, the creditors of any company that is resolved under the Dodd bill will have will a chance to be bailed out. If the creditors are not to take most of the losses as they did in Lehman, a fund isn't necessary. It is counterintuitive.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

I was listening carefully to Mr. Kanjorski and I join with him in talking about the importance of his amendment. I think that we should go further and not just allow, but require regulators to break up firms that have reached a certain size.

Mr. Kanjorski put forward the idea that either our Republican friends had failed to read the House bill or were deliberately mischaracterizing it. In an effort at bipartisanship, let me put forward a third possibility, and that is perhaps our Republican friends have read the Senate bill, which is unfortunately much closer to their characterizations than the House bill.

As for reading bills, I know the Secretary of the Treasury has stated that under the bill under consideration in the Senate, "the taxpayer will not be exposed to any risk of loss." I would refer the Secretary to sections 210 and 1155 of the Senate bill, in which the taxpayer clearly does take enormous risks, and that is similar to the risk they would take under section 1204 of the legislative proposal he made last year.

Under that legislative proposal, it is true that taxpayers don't take risks to bail out a failing institution for the benefit of its shareholders and management, but the taxpayers take tens of billions, perhaps hundreds of billions of dollars of risk, for purposes of taking care of the counterparties and the general creditors of these failed firms.

Mr. Bachus shares my passion for avoiding bailouts, but he says the way to do that is to strip from the Senate bill the $50 billion fund there or the $150 billion fund that this House makes available to provide for the creditors of a resolved institution. I would point out that the amount available under either the Senate or the House bill for taking care of creditors and counterparties is not just the $50 billion or the $150 billion; it is that, plus borrowings from the Treasury.

So if you eliminate the $50 billion or $150 billion fund, but you allow the borrowings, then the borrowings start with dollar one. I would think the ultimate, total victory for Wall Street would be to

tell them they don't have to pay into the $50 billion or $150 billion at the present time, but that they are available for the FDIC to borrow money and to bail out their creditors and counterparties.

Mr. BACHUS. If the gentleman will yield, if I could respond very briefly, what I said in bankruptcy, then the taxpayers wouldn't be exposed at all. So I am saying that one of the things that this bailout is not putting taxpayers—

Mr. SHERMAN. Reclaiming my time, I am more concerned with Senator McConnell's remarks where he seems to take aim at the $50 billion and $150 billion and leave the borrowing capacity.

Secretary Geithner, we are here to discuss Lehman Brothers. We are doing an autopsy to learn how to treat future patients, and one of the possible treatments is either the House or the Senate bill.

So let me take you back to September 1, 2008. It was too late, I would think at that point, to save Lehman Brothers, but it was not too late for an orderly resolution. The purpose of this bill is to give you and the other regulators the tools for an orderly resolution.

How much money would you need from outside the Lehman Brothers carcass to take care, in an orderly way, of the counterparties, say the County of San Mateo, which had put money in, seems relatively blameless. Would you tell them that, well, we will sell off Lehman Brothers assets and hope to give you a few cents on the dollar? Or would you use the tools of these bills to go into the $50 billion, the $150 billion, the borrowed funds, in an orderly way to provide more to the general creditors and to San Mateo County than the carcass of Lehman Brothers would provide?

Secretary GEITHNER. Congressman, you are a very thoughtful critic in many of your approaches in this area and I respect your views on this. So let me just describe again the basic idea underpinning the bill that passed the House and it is still in the Senate bill in this basic context.

The idea is to take a model that has existed for more than 3 decades for small banks. We have a lot of experience with that model over many recessions, many financial crises. That model allows the government to come in—

Mr. SHERMAN. Mr. Secretary, I have such limited time. Could you just answer my question of what you would do with Lehman Brothers?

Secretary GEITHNER. I want to get to your question. Your question is an excellent question.

With this authority we are proposing, the government would have been able to come in, put Lehman into receivership to wipe out equity holders, to replace management in the board, and to manage that institution's unwinding in a way that maximizes return to the taxpayer and minimizes risk of losses for the system.

Mr. SHERMAN. Mr. Secretary, how much money would you need?

Secretary GEITHNER. As you know, it is an unanswerable question. You can't know in advance how much.

Mr. SHERMAN. Tens of billions.

The CHAIRMAN. The gentleman's time has expired.

The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you for holding this hearing, and thank you all for being here. I really wish

we had had this hearing a long time ago, and I wish we had had the report from Mr. Valukas. I think it really is a document that is very important to our work here in this committee, and I think that we are sitting—it is getting kind of, I don't want to say political, but there are a lot of arguments here that I think that if we had had this before, that we would have had maybe a better discussion.

And I know the questions that I have always had are about the regulators and did they do the right thing, and now we are talking about did you all have the authority.

I think that one of the reasons, and I know I have asked Secretary Geithner so many times about having a council rather than having it through the Federal Reserve, and the reason for that is, and it seems apparent to me here, is the fact that the regulators in the report says you didn't really discuss this. Maybe at an early time where more action could have been taken. The regulators didn't meet and talk about it. And I would imagine that if there was such a crisis coming up, that it would have come to the committee, they would have come to the Financial Services Committee and say we have a problem here, and we don't think we have the authority. What can we do? How can this be solved? And that didn't happen.

So we are looking back on an a really serious issue, and now we are talking about maybe we have to take care of the risk, take care of a bank that maybe it is going to fail, but before the crisis. So we have to have the working together of everyone to solve these problems.

I kind of see that I don't want to see this get into back and forth and being kind of negative about all of this. But if we had the council, and I was thinking, I did FLAK where we actually wanted to bring all of the agencies together when there was a problem, and we did that with Hurricane Katrina, and found out there was a lot of duplication within the agencies.

What we need here is the authority for the regulators. But if we had a council and that was to discuss it, and somebody comes up with an issue and somebody else in another area has the same thing, that we would know ahead of time without so much government intrusion into these areas.

I look at this as saying we have the big banks. We are going to tell them they are going to fail. And yet are we going—is the next step going to be companies that we are going to tell them they can fail, what their compensation will be?

I think we are walking a really fine line here, and I hope there is more discussion on this, so that we really can find some answers. What is the difference between bankruptcy for Lehman Brothers and then having other ones that we are going to tell them that they are going to fail, but they don't go through bankruptcy?

What about a small company? We see these small businesses going out of business every single day because they can't operate within the barriers that either the State or the government has put up. I think we have a much huger problem here than just this.

But I really think that the examiner has done a really good job to highlight these, and I hope all of you who have worked on this would take this. I know, Chairman Schapiro, you have worked a

lot on this and came in at a time when it was very difficult, and all of you have lived through this, and I just hope—we really have to come up with the right answers. So I am not going to ask any questions. Thank you.

The CHAIRMAN. The gentleman from New York.

Mr. MEEKS. Thank you, Mr. Chairman.

I guess I want to direct my questions first to Secretary Geithner, but I can't resist the comment of saying that in prior Congresses, this question about power that was had, we were in the climate where I think the other side, all they were talking about was we had too much regulation, we needed to deregulize, deregulize, deregulize. Now that we have this problem, I hear some other things that are going on. And there need to be some changes, and it seems they are resisting those changes that obviously are so importantly needed.

But let me ask you first, Secretary Geithner, my colleague, Dennis Moore, and I had an amendment that passed this committee to require all systemically significant firms to run quarterly stress tests in accordance to standards and scenarios established by the Fed and to make the rules of these stress tests public. It also required the Fed to run similar stress tests every 6 months and to make their results public also. If a firm breaches the critically undercapitalized requirement under any of those scenarios, it must prepare and make a public and credible restructuring or dissolution plan which meets standards set by the Fed.

If this had been required as early as 2000, we believe red flags would have been raised about Lehman well before it failed. Would the capital market have limited the firm's additional growth and exposure of the firm, and therefore, if this was in place likely limited the likelihood and impact of an eventual failure as took place in Lehman Brothers? I would like to get your opinion on that.

Secretary GEITHNER. Congressman, I completely agree with you. I think you are in exactly the right place. I think requiring systematic stress testing on a regular basis and disclosing the results is a necessary, important thing and it would provide just the benefits you described. It would allow the market to make a better assessment of who is strong, who is less strong, about their potential capital needs, and give the regulators tools to force firms to raise capital earlier in the process. So I very much agree with you.

Mr. MEEKS. I hope we can get it in the Senate bill, because unfortunately it is not there now. I know there are some Senators who are going to make that amendment over the next couple of days. But any help that we can get that in the Senate bill would be deeply appreciated.

Let me go to Chairman Schapiro. Recent reports indicate that large financial institutions are engaged in the repo process today, that is still continuing. In fact, the Wall Street Journal reported that over the last 5 quarters, leverage ratios are 42 percent lower at the end of the quarter than from their peak for several financial suggestion institutions. It appears investment banks are temporarily lowering risk when they have to report results, and they are leveraging up with additional risk right after.

So my question is, is that still being tolerated today by regulators, especially in light of what took place with reference to Lehman?

Ms. SCHAPIRO. That is a great question. We have sent a letter and demanded information from the largest financial institutions to explain to us exactly how they are using repos, how they are accounting for and disclosing repos, and the impact on their balance sheet, whether they have changed their accounting models over the past 3 years, and, importantly, what have been their average debt balances over the period, so that we don't just have them dress up the balance sheet for quarter-end and then have dramatic increases during the course of the quarter.

So we are collecting all of that information. It was due to the agency last week. We are analyzing it. We will make those comments public before terribly long.

Then, on a parallel track, we are considering whether under SEC rules, we need new rules to prevent this sort of masking of debt or liquidity at quarter-end, as we saw Lehman do with the repo 105 transactions.

Mr. MEEKS. Let ask you, because you are the expert, you are a great securities lawyer, would you say that the failure to disclose leverage ratios over the course of the quarter constitutes intent to defraud investors, or is it a failure to disclose material information to investors? What would it be?

Ms. SCHAPIRO. Without concluding, because we obviously have an ongoing review of specifics in the Lehman area, I would tell you that current rules do require disclosure of off-balance sheet financial information and material trends in liquidity. And disclosure would be required if transactions are engaged in to present a better liquidity or leverage picture as of the reporting date.

So we think the disclosure requirements are quite robust here. The question for us is whether Lehman complied with those disclosure requirements as well as the accounting requirements.

The CHAIRMAN. The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. I thank the Chair.

As we begin, let me associate myself with some of the words of Chairman Schapiro as far as your position on the cause of this situation and the work that was a failure in the past and the good work you are attempting to do at this period of time.

I associate also, I think you referred a little bit to the CFC situation, and as you know, the inspector general pointed out that there were problems with that program, and I think that is right on the mark.

To Secretary Geithner, I didn't write it down exactly, but you said something, I got the first part of it, we can't rely on regulation to preemptively, I think it was dispel every—

Secretary GEITHNER. On the wisdom and foresight of regulators to act preemptively.

Mr. GARRETT. That is it, and I agree with that assertion. The question that comes up with this, that the market does however is going to—should be able to rely upon the proper and adequate execution by the regulators so they can make their investments and what-have-you appropriately.

Now, I know that you have been one who has been calling for a change in the system and supporting more transparency and disclosure, and basically the Senate bill and the like which characterizes changes in the markets, the derivatives markets and exchange programs, and putting things on the exchange and like.

But I have to say that after looking at the report, and again, under the other testimony, it seems that you are in a hard place to try to make that pitch for adequate transparency, light of the New York Fed's, not in your current capacity, but in the New York Fed's lack of disclosure during the period of time in question.

It is almost like that old movie line, "You want the truth? You can't handle the truth." And so the New York Fed decided that perhaps we would not disclose all of the truth going along.

The reason that we are hearing this, we are getting this pushback or some of that sort of statement, is because we are hearing, well, it is not the Fed's responsibility, it was not the New York Fed's responsibility to disclose all of this information.

But I remind you, I don't know if we have it up on the screen, you have the memorandum of understanding between the Board and Commission. It reflects the Board's and the Commission's intent to collaborate, cooperate, and share information in areas of common regulatory and supervisory interests to facilitate their oversight of financial service firms.

That tells me that back during this period of time, and even going back earlier than that, when I think the New York Fed put out a pamphlet that talked about who is responsible for all this as far as oversight, the New York Fed put out a pamphlet explaining that as a condition of obtaining access to the facility, primarily credit facility, investment banks would also be subject to supervision by the Federal Reserve. Since March 2008, standalone investment banks supervised exclusively by the SEC at that point have now come under the regulatory authority of the Federal Reserve as well.

So the responsibility, the overall responsibility for regulation there and supervision, was with the New York Fed during the period of time when you were there. Now, was it being done is what the market—the market should assume that it is being done properly, correct? The question is, was it?

In the report, it says the Federal Bank of New York was aware that Lehman was overstating its liquidity. This goes to a point that Ms. Schapiro was raising earlier, the necessity of making sure that the information is correct on Lehman's liquidity pool. In it, it says the New York Fed raised concerns with the SEC—strike that. The New York Fed did not raise concerns with the SEC about what it found because the New York Fed examiner said, "they did not perceive," this is your New York Fed, "did not perceive any duty to volunteer liquidity information to the SEC." Witnesses from the Fed also explained that its failure to take action and report this discrepancy stemmed from the fact that the Fed was not Lehman's primary regulator.

So my question initially is, during this period of time, you had regulatory authority; your examiner—was your pamphlet then not correct saying, when you set it out in March of 2008, that it is since March 2008, stand-alone investment banks supervised exclusively

by the SEC have come under the regulatory authority of the Federal Reserve as well?

Mr. BERNANKE. The authority, they became bank holding companies, and that is when the real authority came over. The MOU that you are quoting states in numerous places, including in the section you just quoted, that nothing should be construed as saying anything other than that the primary responsibility remains with the SEC and the Fed is not responsible as a primary regulator.

Mr. GARRETT. So was there not a responsibility to exchange information?

Mr. BERNANKE. There was excellent information exchanged. We had three phone calls every day between the SEC, the Fed, and Lehman Brothers. The couple of examples cited by the bankruptcy examiner are relatively minimal, and in each case, both parties had all the access to information independently that they needed.

Mr. GARRETT. So you knew about the problem—

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Chairman Bernanke, Fed Governor Daniel Tarullo gave a recent speech noting the benefits of publicly releasing results from stress tests. Mr. Meeks asked a question about the amendment that we both offered to require release of this information.

If we had had regular and transparent stress tests starting in 2000, wouldn't those stress tests become more effective over time? Wouldn't they help investors and regulators identify potential areas of unhealthy risk taking and improve market discipline?

Mr. BERNANKE. Again, we are talking about bank holding companies and the Fed's authority, not Lehman Brothers. We found the stress tests last year were extremely helpful; they provided a lot of information to the markets and increased confidence. We already use stress tests on a regular basis to try to validate and evaluate a bank's capital positions. But making them public is certainly something worth looking at.

Mr. MOORE OF KANSAS. Thank you, sir.

Secretary Geithner, did the on-site examiners not know what questions to ask? Do you think you deployed enough people to properly oversee the large financial firm? Did these examiners get to know the people at Lehman? Do you have any retrospective thoughts about this?

Secretary GEITHNER. Again, in that period of time, as Chairman Schapiro said, the Federal Reserve had no legal authority to act as Lehman's regulator or supervisor. We were very careful in designing the memorandum of understanding to make it clear to the public that this cooperative arrangement we put in place, where we were putting people in these firms to make sure we had a better sense of the risks we might be exposed to as a potential lender to Lehman Brothers and the other investment banks, did not come with or did not confer authority on us to act as their supervisor and regulator. We did not have that authority.

So we established a very limited presence with a limited purpose, and that limited purpose was to make sure that we were in a better position to assess the risks we might be exposed to in the event that Lehman and these other firms took advantage of the primary

dealer credit facility. But, again, we were very careful to make it clear that we had no supervisory authority, no authority as regulator, and that was an important distinction.

Mr. MOORE OF KANSAS. Chairman Schapiro, the same question to you. Do you have a comment on that, please?

Ms. SCHAPIRO. Yes. I think that the issue for the consolidated supervised entity program was that it was never adequately staffed. There were no more than 24 people at the peak in the program responsible for the 5 largest investment bank holding companies and their affiliates.

It was somewhat flawed in its design. It was a volunteer program. There were few mechanisms for the staff to require or mandate changes in risk management or other procedures. It was undermanaged, in my view, and it lacked clarity in its mission. Were we a prudential regulator or were we a disclosure and enforcement regulator? And those two things came into contact on multiple occasions, I think. So it was quite different than our historical approach to broker dealer regulation.

It is one reason I think the legislation is really critically important, because these investment bank holding companies as systemically important institutions would come under genuine mandatory comprehensive regulation that the SEC was trying to bootstrap itself into through the CSE program.

But, again, I have studied the examiner's report very, very carefully. I have looked at all of the flaws in the CSE program that are outlined there, and there are a number of ways where we either lacked authority or resources to do the kind of job that the American people had a right to expect.

Mr. MOORE OF KANSAS. Thank you very much.

Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. I am glad the discussion is a little less contentious now than it was earlier. But I would point out to my colleagues on the other side of the aisle who chose to impugn motives for people on this side of the aisle, that perhaps if there was not a bailout fund in the House bill or a bailout fund in the Senate bill, perhaps people would not be confused about the ultimate purpose of those funds. Perhaps those funds with the best of intentions are perhaps designed to ensure that no taxpayer funds are used. But, unfortunately, some of the people who designed them are the very same people who told us that Fannie and Freddie would never have a taxpayer bailout. We see what has happened there.

Chairman Schapiro, my first question is for you. I understand many of your criticisms of the Consolidated Supervision Entity Program. But I guess my question goes to, what did the SEC have the authority to do and not do?

As I read the language, it would appear that, number one, I am reading from title 17, chapter 2, part 240, that the Commission can impose additional conditions on a broker dealer, including restricting the broker dealer's business on a product-specific, category-specific or general basis; two, submitting to the Commission a plan to increase the broker dealer's net capital; and if the Commission

finds it necessary or appropriate, it may impose "additional conditions on the broker dealer or the ultimate holding company."

I know that Chairman Cox had previously testified before the Senate Banking Committee that, "The SEC had authority to monitor for and act quickly in response to financial or operational weaknesses in a CSE holding company or its unregulated affiliates that might place regulated entities or the broader financial system at risk."

I think the General Counsel has said similar words, as did the Deputy Director of the Division of Market Regulation of the SEC in testimony before this committee.

Is it not true that under this program, the SEC did have the authority to have caused Lehman to add additional capital?

Ms. SCHAPIRO. Congressman, my understanding is, and I wasn't there at the time, obviously, when the CSE program was in effect, the voluntary nature of the program related to the regulation and the supervision of the holding company and the affiliates of the broker dealers. The SEC does, as you point out, have broad and comprehensive authority with respect to the regulation of U.S. broker dealers.

Mr. HENSARLING. I am not sure if that answered the question or not. Under this voluntary program, I admit it was voluntary, could the SEC have required Lehman to post additional capital?

Ms. SCHAPIRO. With respect to the broker dealer, I believe they could have. With respect to the holding company, that is a question I don't think we really know the answer to. My view would be that we could have pushed the limits of our authority in this program much more than we did. That is because, while the program is voluntary, leaving the program meant being regulated by another regulator, in this case, likely a European regulator. So we had more leverage over these firms and than perhaps the staff thought they were free to exercise.

Mr. HENSARLING. So I think it is an important point, because as a practical matter, what would have happened had Lehman chosen to pick up their toys and go home, ultimately that sends a very strong signal to the market, or as you put it in all probability the EEU would have provided a regulator for them.

Okay. So you say that certainly you could have required more capital at the dealer broker level. How about the disclosure as far as what was posted into their liquidity pool and what was actually there, and at what point does the SEC not just have the authority to direct Lehman, say, to properly disclose, but to tell the public?

Ms. SCHAPIRO. My understanding is that with respect to the liquidity pool encumbrances, the staff knew of some, but did not know of others. With respect to the ones they knew about and knew about in a timely way, they directed Lehman to remove some of them from the liquidity pool for purposes of the prudential oversight program.

There was not communication to Lehman that they needed to recalculate or provide new disclosure with respect to the public of what their liquidity pool assets were and whether the number had been changed by the removal of some assets.

Mr. HENSARLING. And is the same true with respect to Repo 105? Could you have required—

The CHAIRMAN. The gentleman's time has expired.

Let me just explain—I don't think members ought to be able to start a new conversation after the red light. That has been my principle. I try and let things come down, but not have a new one.

The gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank the witnesses as well for helping the committee with its work,

I do think that Lehman's example in their participation in the derivatives market could be instructive going forward. Secretary Geithner, you actually lay it out very, very clearly in your testimony. You say rightly that Lehman was a major participant in the over-the-counter derivatives market, and as of August 2008, Lehman held over 900,000 derivatives positions worldwide, and the market turmoil following Lehman's bankruptcy was in large part attributable to the uncertainty surrounding the exposure of Lehman's derivatives counterparties. Also, you note correctly that the derivatives market went from $2 trillion in 2002 to $60 trillion at the end of 2007.

So we are trying to get at this in the House and the Senate bills by requiring a couple of things. One is clearing of derivatives trades, and you also are talking about reporting. Secretary Geithner, you and I have had this conversation before.

I am concerned on two levels: One, right now in the United States, 97 percent of the clearinghouse ownership is in just 5 firms, five banks. So I am worried about the concentration of ownership in the clearinghouse community.

Two, and maybe Chairman Schapiro, you could address this, the fact that we are requiring reporting may not be enough. It depends on what they are required to report. Many of the failings that we had and many of I think the misinvestments in CDOs stemmed from the fact we couldn't find out what was inside a CDO, and there was a lot of difficulty for investors to do that.

So if you could just maybe, Secretary Geithner, you could talk about the clearinghouse problem, and then maybe, Chairman Schapiro, you might speak about the report.

Secretary GEITHNER. Congressman, you are exactly right about what these bills tried to do. It is not just forcing central clearing of standardized products and bringing more transparency, but our view is standardized products that are centrally cleared should be traded on exchanges or on electronic trading platforms, and that the major participants in these markets have to be subjected to oversight to make sure they hold enough capital against these risks and we need to have more authority for the regulators to make sure they can police fraud.

Now, on your question about the clearinghouse concentration risk, in encouraging central clearing you concentrate risk—

Mr. LYNCH. Just to be clear though, we have an exemption there for very complex derivatives to be traded bilaterally, so that compounds the problem.

Secretary GEITHNER. You are exactly right. And our view is to make sure you can force people to hold enough capital in margin against the more complex products that can't be essentially cleared as a check and balance against the risks that people use that ex-

ception to evade the basic protection and benefits of central clearing.

Now, when you concentrate risk in a clearinghouse, you are concentrating risk, so it is very important that the clearinghouse be run in a way where it has a sufficient financial cushion against the risk of default by its participants. So we will have a strong interest in making sure that the clearinghouses, and there will be many that will exist, are managed very conservatively, so we are effectively managing a system where we are going to concentrate the risk in those clearinghouses.

Mr. LYNCH. Thank you.

Ms. SCHAPIRO. I would agree that the utilization of clearinghouses can make an enormous difference in this marketplace in the reduction of counterparty risk. Coupled with that is we really need high levels of transparency, both to regulators and very much also to the public.

With respect to the assets that underlie a variety of asset-backed securities, whether they are commercial real estate or home mortgages or auto loans, the SEC has recently proposed very extensive rules that would require detailed loan level disclosure in a very accessible, usable way for investors so that he they don't have to rely on rating agencies, but they can actually utilize their own analysis to determine what the quality of the assets are in those asset-backed securities.

We have also proposed a retention requirement that would hopefully better align the interests of issuers of asset-backed securities to hold higher quality assets in those pools.

Mr. LYNCH. I know time is getting short, but I am worried about these very complex derivatives that are bilateral. How do you get at that? How do you let an investor know what is behind these? Because they are extremely complex. I just don't know what the reporting requirements are.

Ms. SCHAPIRO. Our rule proposal, if it is ultimately adopted by the Commission, would provide investors with all of that information in the public markets as a condition of using shelf registration, and actually proposes to allow very much the same kind of disclosure in the private markets.

Mr. LYNCH. Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentlewoman from Kansas.

Ms. JENKINS. Thank you.

Madam Chairwoman, I had a question for you. I just wanted to follow up and clarify a small detail that you touched on with one of my colleagues' questions. It is my understanding that the accounting standard that governed the repo 105 transactions when Lehman was still around was Financial Accounting Standard 140, but it has recently been updated by a new standard, FAS 166. Is that true?

Ms. SCHAPIRO. Yes, FAS 166 and 167, which just went into effect in January, updated that accounting.

Ms. JENKINS. And 166 changed the disclosure requirement such that a repo 105 type of transaction, one that accounted for the sale, would be required to be disclosed under the new standard, is that correct?

Ms. SCHAPIRO. The standard sets out particular criteria for what can be accounted for as a financing versus as a sale, and really goes to the heart of what a true sale is so these assets can be held off the balance sheet.

Ms. JENKINS. Okay. But it requires reporting?

Ms. SCHAPIRO. Yes.

Ms. JENKINS. And as you said, it would just really take effect for reports that are just now coming out?

Ms. SCHAPIRO. I believe the standard took effect in January of this year. So we will be watching very closely to see the effectiveness of this standard while we continue to look at the data I mentioned earlier that is coming in from the 19 financial institutions on all of their repo accounting and disclosure.

Ms. JENKINS. Thank you. I just think it is important for the committee to have an understanding as to how these standards have changed since this happened.

The CHAIRMAN. If the gentlewoman would yield, I think it would be useful if all of those are submitted for the record. Let's get the actual text of all of the standards as part of the testimony.

[The standards referred to can be accessed at www.fasb.org/jsp/FASB/Page/PreCodSectionPage&cid=1218220137031]

Ms. JENKINS. Thank you, Mr. Chairman. We haven't seen a lot of media coverage on those standards and when they took effect. I appreciate that. I yield back. Thank you.

The CHAIRMAN. The gentlewoman made a very important point that should have been raised. Let's make sure we have the old and new standards in the record here.

The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Can I pass and come back? I am reviewing something now.

The CHAIRMAN. All right. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman, and I thank the witnesses for appearing.

I don't think that we can overstate the value of confidence in our system going forward. As a matter of fact, we want to make sure that we have confidence in our system at all times, and probably our system has functioned as well as it has, especially the FDIC insured system, because there is confidence in the system. Confidence is really a cornerstone of the system. And as we move forward, the question really isn't whether a large institution that poses a systemic risk should be allowed to fail if it is not properly managed, the question is, how do you allow that to happen and not create systemic risk? How do you allow that to happen and not have public confidence become a part of a crisis such that the public responds, if you are talking about banks, the public will respond by demanding the deposits.

And when that happens, you have what is known as a run, and with a run, we find that the institutions themselves become at risk. That is a broader problem that we are trying to resolve, not the institution that is failing, but more how does that happen without causing other institutions to become a part of the failure that is developing?

So with that said, I would like to start with Mr. Geithner. This plan that has been proposed to allow these institutions to fail, "too-big-to-fail," right size to separate, eliminate, this plan to do this, if the plan were in place, how would it have impacted a facility, an institution like Lehman, please?

Secretary GEITHNER. If this authority had been in place, then the government would have had the ability to step in early and effectively put Lehman Brothers or AIG into a form of receivership, into a form of bankruptcy, and again manage the unwinding sale dismemberment of that firm without risk, with less risk that would spread to healthy institutions.

What you said at the beginning is exactly right: you want the system to be designed to, in a sense, draw a circle around the failing institution to make sure that the fire can't jump the fire break and infect the rest of the system. That is the challenge.

Mr. GREEN. Chairman Bernanke, if you would respond as well?

Mr. BERNANKE. The Secretary put it very well. In this case, you would want to isolate the broker-dealer which remained healthy. You would want to unwind the derivatives positions.

A lot of discussion here has been on why didn't the SEC and the Fed insist on Lehman doing this, that, and the other thing. We were very insistent. We talked a lot to Lehman about raising capital and raising liquidity, but our stick wasn't very good. With a bank, you can seize a bank and say it is undercapitalized and break it apart. In the case of Lehman Brothers, you only had the nuclear option of essentially letting it fail. So with that tool, we would have had more ability to force Lehman to take precautionary actions and then we would have been able to plan the dismemberment over a longer period of time with the guidance of a living will and other types of tools. So I think it probably would not have completely insulated the system from the impact of failure, but it would have created an impact on many of the parts of the economy.

Mr. GREEN. Madam Chairwoman, if you would like to respond?

Ms. SCHAPIRO. Thank you. As the non-bank regulator in the group, we look at building confidence a little bit differently. We create confidence through transparency and honest disclosure in the belief on the part of investors that they can rely on the information that is contained in the financial statements of the company whose stock they may want to buy. And that is really the fundamental underpinning of confidence in the securities market. But we also do it through tough rules that level the playing field so that institutional and retail investors have as many of the same opportunities in the marketplace as possible. We do it through hands-on supervision, and we have to do it through rigorous enforcement when the rules are violated. And I think those are all components of building confidence in our securities markets as compared to our depository institutions.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Colorado.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

Thank you, members of the panel for your testimony today. Before I get going, I would like to thank Chairman Schapiro specifically. One of the funds I spoke about earlier in my testimony called CSAFE was sort of an indirect investor in Lehman Brothers, and

the SEC took very strong action in a number of lawsuits that had been filed in New York against the primary fund and the reserve fund and Lehman Brothers. And as a consequence, that fund that had lots of money from different entities in Colorado has received most of its money back. So I just want to say thank you on that.

I do want to compare really how the SEC is being handled now versus how it was handled under the Bush Administration and under Chairman Cox, and I am going to use some of the language, Mr. Bernanke, that you used in your interview with Mr. Valukas where on page 1497 of his report, in your interview, first there were interviews of various staff, and they said the primary weakness of the CSE program was SEC understaffing and the lack of higher level skill sets.

So that came from the testimony, I believe, of Thomas Baxter. Then in that same footnote, you say: "Those views peculated to the top. Mr. Bernanke observed that the Fed had some skepticism and concern about the SEC's capacity going back to Bear where they were blindsided to a significant extent there as well." Then you said, Mr. Bernanke was careful not to assign blame or fault, but observed that the SEC was "in over its head."

So, Mr. Chairman, sitting here having listened to a lot of testimony from you and other folks as we went through this hurricane in the fall of 2008, what appears from this testimony and this report and what I saw I believe firsthand was the SEC being an observer and not a regulator, kind of watching, monitoring, and then entities like those that I represent in my area in Colorado, the school districts, the hospital districts, and the fire protection districts, got clobbered.

You described the relationship and the communication in the testimony as tricky between the SEC and the Federal Reserve. Describe what was going on between the Federal Reserve and the SEC in that last year with respect to Lehman Brothers to try to get it under control.

Mr. BERNANKE. First, on that quote, like Chairman Schapiro, I had no concerns about the confidence of the SEC staff, but it was a voluntary program which limited authorities and the SEC came to it with an enforcement culture rather than an examination culture, which I think was a problem in some contexts.

Contrary to the impression given by the examiner's report, with very few exceptions, I think the communication between the Fed and the SEC was really quite good during the very short period from April through September when Lehman failed. We worked together designing those liquidity stress tests. We had multiple calls a day, not me personally, but staff. Secretary Geithner may speak for himself.

Mr. PERLMUTTER. So you would disagree with this statement by the examiner: "Although the SEC and the Federal Reserve Bank had equal access to the same data on Lehman, the personnel of the two agencies did not necessarily share their conclusions and analyses with one another; indeed, because of what Bernanke described as tricky issues, he and Cox became directly involved in the negotiation of a formal memorandum of understanding that would allow the exchange of information between the two agencies?"

Mr. BERNANKE. There are some tricky legal issues which you don't want to take your time for me to explain, but we came to a very amicable agreement in July when we signed the MOU. So that was not an issue. Throughout the process, information exchange was good.

Mr. PERLMUTTER. I will yield back.

The CHAIRMAN. I am going to take 30 seconds. Chairman Bernanke, I greatly admire you; but please, don't ever tell the committee of jurisdiction that there are legal issues that we don't want to get into. We would like to have that choice.

Mr. BERNANKE. I apologize.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Chairman Schapiro, you said a moment ago that the accounting rules have now changed, and the transactions that Lehman Brothers used to avoid reporting their liabilities, the repo 105 transactions, I think also the R-3 hedge fund investment. There were press reports at the time of the bankruptcy findings that suggested that other financial institutions may have used the same transactions for the same purposes. Have you determined if other institutions did that?

Ms. SCHAPIRO. First of all, I should say, we are scrutinizing very carefully in the Lehman context whether characterizing their repos as sales for their accounting treatment was proper given the very strict criteria around sales accounting there. And we are obviously looking very much at the truthfulness of the disclosure that was in public documents.

We have sent a letter to the CFOs of 19 of the largest financial institutions and asked them to provide us with very detailed information, as we are currently reviewing their 10-Ks that goes to all of their accounting for repos and securities lending, and any other transactions that involved the transfer of financial assets with an obligation to repurchase in the future.

We are reviewing that information right now. It has been coming in over the last 2 weeks. We expect it to be quite detailed. It will cover the accounting as well as the disclosure, and any changes they may have made to their accounting in the last several years, and we will make that information public.

Mr. MILLER OF NORTH CAROLINA. Thank you. One of the findings of the Lehman bankruptcy examiner was that it would have been better, if an institution is going to fail, it is better it to do it sooner rather than later. Life is much more complicated if all of the assets are pledged as collateral. It becomes more expensive and more disruptive to the economy.

I introduced an amendment in the financial reform bill along with Mr. Moore that Sheila Bair first recommended that would limit the priority, the preference that repo transactions get upon resolution. You can make the same argument with respect to derivative transactions and the collateral grabs by any creditor in a position to do it when a firm is obviously in a death spiral.

Given what we know about Lehman and the collateral grab there and at AIG, and the liquidity run that created, would it not impose more market discipline, useful market discipline, that was Chairman Bair's argument for that amendment to limit the preference

that repo transactions get or that collateral provided for derivative transactions get?

Chairman Schapiro, do you have an opinion on that or have you given any thought to that?

Ms. SCHAPIRO. I haven't been involved in that, and I don't have a deeply held opinion, but I think it would impart useful market discipline.

Secretary GEITHNER. I would not want to alter the claims established in bankruptcy without enormous care and thought because of the risks that would cause enormous uncertainty to markets that are hugely important to the way our system works.

But you are exactly right that the risks that accumulated in repo and in derivatives were hugely consequential. I think the best way to limit those risks is to make sure that those markets are run with much tighter constraints through margin requirements and capital requirements, and I think that is the best way ahead of the storm, ahead of the boom, ahead of the crisis, to limit the risk. You see leverage build up in those markets as well.

So I think you are exactly right about the risks. The question is about the means to confront them, and I would do it through margin and capital.

Mr. MILLER OF NORTH CAROLINA. One thing I am determined to come out of this, if I can, is that the same rules applies to the financial industry as apply to everyone else. It is very clear that repo transactions and collateral provided for derivative transactions get a very different treatment on bankruptcy. Given what we saw happen with Lehman Brothers, and I think the injustice that it works to other creditors who are not in a position to demand collateral, in those kinds of transactions, those kinds of preferences are set aside in bankruptcy routinely, but not with respect to these transactions. Do you think that the different treatment is justified?

Secretary GEITHNER. Again, I believe it is. I think there should be a difference between how you treat creditors who are unsecured and those who are secured. But I completely agree with you about the risk posed by a system that allows people to take enormous leverage in these products. And I think the right way to deal with this preemptively to reduce the risk of future crises is to make sure that you can set margin and capital requirements in these transactions ahead of the boom.

The CHAIRMAN. Our witnesses have to leave at 1:30. I can't speak for the other side, but if there are there any other Democrats, don't bother to come, because our dance card is full.

The gentleman from Indiana.

Mr. DONNELLY. Thank you, Mr. Chairman.

Chairman Schapiro, have you looked to see who else has repo 105 type transactions?

Ms. SCHAPIRO. Yes, we have. As I mentioned earlier, we sent a letter to the major financial institutions and asked them for a very detailed explanation of their use of repo and securities lending transactions, how they are accounting for them and how they are disclosing them. We are in the process of analyzing that information in the context of reviewing their 10(k) filings, and we will make that information public.

Mr. DONNELLY. Thank you very much.

Secretary Geithner, it is probably over a year ago where I talked about naked credit default swaps, and I mentioned that the only difference between that and a bet on my Chicago Bears was that if one side didn't pay up, everybody just left town, nobody got paid. These synthetic CDOs, when you look at Lehman Brothers and the exposure they already had and then you put the CDOs created throughout the other companies, it was like pouring additional gasoline on a fire.

They were made up of bonds from other bonds, and so, in effect, created out of whole cloth. One of the things that was mentioned at that time was that well, these products help mitigate risk. And in looking back on this now, it seems to me that all these synthetic CDOs did was tremendously increase the risk and the danger, and then we found out that besides being incredibly risky, the game is somewhat rigged. So I ask again, what possible value do instruments like this have?

Secretary GEITHNER. Congressman, that is a very good question. It is the heart of the dilemma we create in facing reforms.

There will always be products that some people like. They deem them innovation; they seem to prove some use. Our challenge is to make sure that the system is strong enough to withstand the risks that might come when those innovations go astray. Again, I think the best way to protect the system against the possibility in the future, people pile these kinds of risk upon piles of leverage is to make sure again that we are bringing the derivatives market out of the dark, giving the cops the tools to defer fraud and manipulation, force people to hold margin and capital against those commitments.

I think that is the best way to do it because again, we will never know soon enough in the future what particular innovation might pose catastrophic risk. The best thing we can do is make sure the system runs with the kind of shock absorbers that can allow it to withstand those mistakes in innovation.

Mr. DONNELLY. But unless I am looking at these wrong, these were basically fake instruments? They were made up from other products so it wasn't really that these were the original mortgage bonds, these were selectively picked by putting a team together and there are really no players there. When you look at this, I understand laying off risk for Southwest Airlines and for people who have obligations on one side on housing, but these were created almost out of whole cloth to in effect become betting instruments. How do they have any value?

Secretary GEITHNER. You are exactly right. These were derivatives on derivatives on derivatives, and they were designed to enable people to take huge leveraged bets on particular outcomes. In this case, and this was the catastrophic mistake, they were bets on a world in which people assumed house prices would rise indefinitely. So the products were complicated. They had fancy names, but the underlying misjudgment and miscalculation at the heart of all of this was a judgment that house prices would rise in the future and therefore people would not be exposed to a risk of default on anything like the scale we saw.

Mr. DONNELLY. And I guess the biggest concern was these transactions had nothing to do with mitigating risk. What they did was,

in effect, bet the casino, one side against the other, and the American people were the losers?

Secretary GEITHNER. I believe derivatives come with enormous risk. It is a searing, painful lesson for the American economy. But they do provide still a very useful economic function. Our job is to make sure that we can get the benefits of hedging without exposing the taxpayer and the American economy to catastrophic risk and loss.

The CHAIRMAN. The gentleman from Illinois.

Mr. FOSTER. Thank you, Mr. Chairman.

The line of questioning I would like to pursue has to do with contingent capital requirements, and how they would have been useful when the Lehman crisis hit, and how they would have been useful in preventing a Lehman-like situation from developing in the first place.

As you probably know, I was the author of the amendment that passed through this committee and through the House that was supported also by Representative Minnick and Representative Himes which authorized the incorporation of contingent capital into the capital structure of systemically important firms. I was gratified to see when The Wall Street Journal convened its panel of experts on how to reform our financial system, that recommendation number one was better capital requirements, including the incorporation of contingent capital. And I was gratified also to see the Senate proposal also included contingent capital.

My first question is, how would a contingent capital requirement have played out during the final crisis, both to limit systemic risk and counterparty panic and also in terms of keeping taxpayers off the hook, providing the shock absorber you just referred to, and I will start with Secretary Geithner first.

Secretary GEITHNER. The benefit of contingent capital is that it provides a tool that can be used in crisis to in effect create more capital right when firms need it. So if designed appropriately, and put in place on top of the required minimum capital requirements, in terms of common equity in particular, it can play a very useful stabilizing role as firms and financial institutions slip toward the edge of a crisis.

Mr. FOSTER. Chairman Bernanke, do you have anything to add?

Mr. BERNANKE. Yes, I think it is a very interesting idea and we are looking at it carefully. There are some design issues; for example, what would trigger the conversion. That is a very important issue that we are thinking about. There are some other ways to approach the issue. One is the resolution regime. Say if it required that all capital instruments, including say subordinated debt had to take losses, then that would effectively make subordinated debt into a contingent capital form, for example. So there are different ways to do it. But I think it would have helped considerably during the crisis.

Mr. FOSTER. My second question is, how would contingent capital requirements have discouraged Lehman-like situations from coming up in the first place? Simply the requirement to go and continuously market the contingent would provide a very strong market-based signal of which firms the market viewed as shaky.

Secretary GEITHNER. I agree with you. If designed appropriately, they could provide a very useful market signal early on of a firm that is facing the risk of losses that are large relative to its capital. Again, the virtue of capital is that it provides a cushion to absorb losses. You need more of it earlier to constraint leverage, and you want more of it in the capacity to mobilize it as firms slip toward financial distress.

Mr. BERNANKE. It is critical to make clear that whatever the instrument is, it will not be protected under any circumstances so there is no moral hazard or lack of market discipline. If you have an instrument like that, then its pricing or the requirement that you have to go out and sell that instrument is a very useful form of discipline.

Mr. FOSTER. It effectively requires firms to carry privately funded bailout insurance in some sense and makes the price for that insurance public so hopefully some of the CEOs would drive to work every day worried that they might fail a stress test than trigger the conversion of this debt rather than actually face the insolvency. Or worry simply about having a story in the Wall Street Journal that says hey, the last time we had an auction for our convertible debt, they got a very bad price. And why is it that the market thinks this firm is shaky. So it has a very powerful, to my mind, has a very powerful benefit of warning firms away from the cliff before they actually approach it. That was the point I wanted to make.

And one last thing, is there a baseline implementation that you have or would be willing to give us just in terms of your thinking on what the contingent capital would look like?

Mr. BERNANKE. We are still looking at it in the Fed and the Basel Committee is looking at it. There are some design issues that are not resolved, notably the trigger issue.

Secretary GEITHNER. To add one thing, Mr. Chairman, with your permission, the timeframe that the Basel Committee is working with is to reach broad agreement around the world on a new global capital standard by the end of this year, and part of that will be not just setting the new ratios, but deciding what forms of capital will be most appropriate in that context. That is the broad timeframe we are working on.

The CHAIRMAN. The gentlewoman from California.

Ms. SPEIER. Thank you, Mr. Chairman.

We have been discussing today the failure of Lehman and this is to you, Chairman Schapiro. There is no question in Mr. Valukas's report that the SEC was in charge of regulating Lehman. The report says the SEC did not learn of all of the precise facts until September 12th, but months earlier had learned of critical information that put it on notice. The SEC did not act on its knowledge. It simply acquiesced.

The SEC disapproved of Lehman's inclusion of the amount in its liquidity pool. It took no action to require Lehman not to do so.

The SEC knew that Lehman was in repeated and persistent breach of its own risk limits; yet, the SEC simply acquiesced.

The SEC knew that Lehman's internal stress tests excluded untraded positions, including commercial real estate; the SEC simply acquiesced. It goes on and on and on.

So would you just admit, it was not under your watch, but just admit that the SEC failed to do its job in regulating Lehman?

Ms. SCHAPIRO. The SEC didn't have the staff, the resources, or quite honestly, in some ways the mindset to be a prudential regulator of the largest financial institutions in the world. It was such a deviation from our historic disclosure-based and rules-based approach to regulation, to come in and be a prudential supervisor. The staff was never given the resources. This program peaked at 24 people for the entire universe of the five largest investment banking firms in the world. They didn't have the technology to support them. They didn't have the management leadership, in my view, to support them to do a good job.

Was it a success story? I don't think any of us would claim that the oversight of Lehman was a success. But this is also an agency that has learned and is learning from all of these mistakes and understands the importance of doing this right going forward.

Ms. SPEIER. Let me ask you this question. We are all talking about transparency, that to protect the investor, this has to be a transparent process. How can any of us sit here and suggest that repo 105s should be allowed to be operational in this country at any time? I would like to ask you all, isn't it time to ban repo 105 by the SEC?

Ms. SCHAPIRO. It is not at all clear that what Lehman was doing satisfied any of the then-current accounting and disclosure requirements. That is obviously very much a subject of our ongoing investigation. But if there is an accounting loophole here, if there is no reason to ever allow a sale where there is a repurchase in the future, we will look very carefully at that, having worked with the accounting standards setters, to see if that is something that should be absolutely cut off and prohibited.

Under current accounting, assuming that the asset is truly isolated, not available and so forth, there are limited circumstances where it is permitted to be accounted for as sales.

Ms. SPEIER. But that is the same strategy.

Ms. SCHAPIRO. I have profound questions about it. I agree with you.

Ms. SPEIER. Mr. Bernanke, should they been banned?

Mr. BERNANKE. If they are not a true sale, then it shouldn't be treated as a true sale. I would make two comments: one, Lehman went to the U.K. to get this approval; two, recognizing concerns about so-called "window dressing" and the quarter, the Federal Reserve for our bank holding companies reports quarterly averages to the public of assets held, etc., which should help, I think, in this regard.

Ms. SCHAPIRO. If I may just add, as I said earlier, we are looking at the possibility of requiring that kind of quarterly average disclosure by public companies in their quarterly reports so that the public would have a much better view of whether they are window dressing.

Ms. SPEIER. My last question is to you, Secretary Geithner. We have been in conversation now for months about Lehman's failure. We now have ample evidence that our regulators did not act. Why not now utilize your authority to try and make these cities and

counties whole or at least partially whole because they are the only ones that have been impacted like this?

Secretary GEITHNER. You are exactly right, not just in the Lehman losses, but on a range of other losses. The municipalities across the country suffered enormous damage from this crisis, caused incredibly damaging falls in revenue and deep damage to critical services that we all depend on. So I completely agree with you. That is why in the Recovery Act, we put so much money into support for State and local governments. I don't believe I have the authority under TARP. As you know, we have talked about this many times to directly compensate municipal authorities for their losses on their Lehman investments.

Ms. SPEIER. If we give you the authority, will you do it?

Secretary GEITHNER. If Congress writes authority for me to do it, of course, I would do that.

The CHAIRMAN. The time of the gentlewoman has expired. The gentlewoman from Ohio.

Ms. KILROY. Thank you, Mr. Chairman, and I thank the witnesses for their time here this morning. We are learning a lot about Lehman Brothers from the report of the bankruptcy examiner, and also learning a lot about the role of regulatory agencies. We want to make sure, as Secretary Geithner said, that the cops have the tools so we don't get in this position again.

One of the questions that I had was with respect to the stress testing that you talked about as being one of the tools that would help to get an early warning of a situation like Lehman. In the bankruptcy examiner's report, he indicated that Lehman's stress test suffered from significant flaws, like they put the repo 105s into play to disguise the true condition of the balance sheet. Apparently, the stress test excluded real estate investments and other risky holdings that Lehman had accumulated. How will we be assured that kind of situation will not happen again, that the true picture of the holdings will be revealed in the stress testing?

Ms. SCHAPIRO. Congresswoman, I think that rigorous, honest stress tests on a regular basis can be very, very important risk management tools. And they were thought to be an important component of the CSE program. But as we know from the examiner's report, they were not conducted, frankly, in an honest way. They did exclude commercial real estate. They also excluded private equity investments, and in some cases, leveraged loans. And we, unfortunately, did not demand real rigor from Lehman Brothers in conducting their stress test. So it is something that we obviously are very focused on right now. We recently, for example, required that money market funds undergo regular stress testing of their portfolios. It is something that we are looking at as part of our overhaul of our examination program, whether there should be a much more rigorous, routine requirement of stress testing for broker-dealers.

Ms. KILROY. Are you intending to issue further regulations in this regard?

Ms. SCHAPIRO. Certainly, as we go through the overhaul of our exam program, and we did issue regulations with respect to money market funds, it is possible that we will, yes.

Ms. KILROY. One of the other functions that should give some warning of a perilous financial situation is the risk management function, and I am very concerned with respect to Lehman that they repeatedly, despite the warnings of their risk managers, exceeded their risk management limits or then simply made them higher. That seemed to mean they had no risk management function at all. And when key personnel left, that should have been a big warning signal as well about something going amiss with that risk management function. What was the responsibility of those who were keeping an eye on Lehman Brothers, the regulators and the board, with respect to making sure that they heard from the risk managers?

Ms. SCHAPIRO. My view is that a best practice in the evolving world of risk management best practices is that risk management should report to the board, and that the board should have responsibility to understand and agree to the risk appetite of the institution, they should check the portfolio against that risk management appetite, that risk oversight functions have to be independent, and there is lots of good literature now articulating a number of requirements for risk management.

In fact, at Lehman, they did have risk appetite levels across the entire institution. They had concentration or transaction limits, and they had balance sheet limits. We already know the balance sheet limits were evaded by repo 105, and the other limits, as you correctly point out, were either just raised or blown through.

My understanding is that the staff and the Commission at the time thought that they should not substitute their judgment about risk management at the firm for the judgment of management; that their responsibility was to ensure that any changes to risk management levels or risk limits should be escalated within the firm's management and ultimately to the board, but that they should not substitute their judgment. That's my understanding of what happened at the time.

Ms. KILROY. One of the other things that has been discussed is pay structure and how pay structures relay into taking excessive risk. At Lehman, they had policies that were supposedly intended to prevent that; yet again, it seems those policies weren't followed. Are we now taking measures to address the issue of compensation structures and how they play into excessive risk?

Ms. SCHAPIRO. A quick answer is the SEC just put new rules in place for this proxy season that require boards to disclose how compensation structures incentivize risk taking, have a board oversee risk, and I think those will be very beneficial and provide a lot of transparency in this area.

The CHAIRMAN. The time of the gentlewoman has expired. Anyone on the committee who wishes to submit further questions, those will be incorporated into the record. The witnesses are thanked for their testimony. We will take a 10-minute break, and we will then resume with Mr. Valukas, the Lehman Brothers bankruptcy examiner.

Mr. KANJORSKI. [presiding] The committee will reconvene with our next witness, Mr. Valukas.

STATEMENT OF ANTON R. VALUKAS, PARTNER, JENNER & BLOCK LLP, COURT APPOINTED EXAMINER, LEHMAN BROTHERS BANKRUPTCY

Mr. VALUKAS. Mr. Chairman and Ranking Member Bachus, I appreciate the opportunity to appear before you today in connection with my role as the examiner in the Lehman Brothers bankruptcy.

Your letter dated April 14, 2010, inviting me to appear before this committee requested that I address six specific topics, and I have responded to each of those in my written testimony that I previously submitted to you.

I would like to briefly address two major points this afternoon before taking questions. First, although the public had a right to expect that firms like Lehman were being regulated in a meaningful way, in reality, they were not.

Second, because there was a failure of genuine cooperation in certain areas, and lack of cooperation in certain areas between government agencies, opportunities were missed all through Lehman's conduct before the situation reached the point of no return.

By at least 2007, various agencies of the United States Government were concerned at the highest levels with the prospects for Lehman's survival. The concerns did not translate into action. Governing agencies gathered information, they monitored, but no agency effectively regulated or compelled Lehman to alter its conduct. The Federal Reserve Bank of New York gathered and analyzed information from Lehman, but it viewed its role as a potential lender and not as a regulator, and it deferred to the SEC. The SEC was Lehman's primary regulator under its CSE program. It made a few recommendations, but in general, it collected information but it did not direct action.

For example, the SEC knew in 2007 that Lehman persistently exceeded its internal risk limits, limits that they had been told initially were hard limits and that would not be exceeded. But the SEC's limited response to assuring itself that Lehman had an internal process, which they did, for senior management to review these regions. The SEC never required that Lehman take steps to reduce its risk profile nor did it require Lehman to disclose that it was in breach of its limits.

So that was never publicly disclosed to rating agencies or anyone else. The inability of Lehman to liquidate some of these same assets in 2008, the assets which they acquired in breach of these risk limits, was, in fact, a contributing factor to Lehman's demise.

The SEC knew as early as June of 2008 that Lehman was reporting sums in its liquidity pool that the SEC determined were not, in fact, appropriately within that pool because they were encumbered, but the SEC did not require any action by Lehman, nor did they make any public disclosure of that. The SEC did not know that Lehman was manipulating its balance sheet to make its leverage appear better than it was by using repo 105 transactions that I describe in detail in my report. The SEC did not know this because it did not ask the right questions. Its failure to ask about off-balance sheet transactions in this post-Enron era is hard to understand.

Significantly, the SEC and the Federal Reserve Bank of New York failed to share certain information with each other about Leh-

man's liquidity and Lehman's inclusion of encumbered assets in its liquidity pool. Each agency had knowledge not possessed by the other. Had they combined that knowledge, they would have realized earlier the severity of Lehman's liquidity position when there was still possibly time to do something to at least to soften the fall.

The agency, with the skill sets to regulate a financial institution like Lehman, which might be the Fed, did not have the authority, and the agency with the authority, the SEC, may not have possessed the skill set. The two agencies were unable to smooth out the gaps in this critical area because they failed to have a full and open sharing of information in connection with this particular area.

I must emphasize, as I attempted to set out in the report, that Lehman's failure was the result of many factors. There is no single cause or actor involved here. There is no bright line action that can be said in retrospect, had the government done this, Lehman would not have failed. It is far from clear that the most engaged regulator could have saved Lehman from its fate. But what is clear is had the government acted sooner on what it did know or should have known, there would have been more opportunities to spare the markets and the American people the turmoil of Lehman's abrupt failure. What is clear is that the regulators were not fully engaged and did not direct Lehman to alter the conduct which we now know in retrospect led to Lehman's ruin.

[The prepared statement of Mr. Valukas can be found on page 193 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Valukas.

I guess we will start with my questions.

Listening earlier today to some of the testimony, and particularly to the speakouts of individuals as to who was responsible or totally responsible, I think one of my colleagues on the other side said that 95 percent of the problem with Lehman Brothers' failure was a result of the regulators.

Mr. BACHUS. If the gentleman would yield, what I said was 95 percent of the things that they needed to do, they could have done under the present regulations.

Mr. KANJORSKI. I stand corrected, if that is what you said or intended to say, but it struck me not too humorously; it was like Willie Sutton blaming the guards for allowing him to rob the bank. I think we have to get our hands around the proportions. The proportions were that Lehman Brothers took extraordinary liberty in dealing irresponsibly with their positions and their clients' positions which led to their downfall, and subsequently, its effect on the entire system; would you say that is correct?

Mr. VALUKAS. In substance, yes. Lehman made a conscious business decision in 2006 in connection with how they believed the market was going to operate and what was going to happen, particularly in areas involving real estate.

They, as one high-ranking individual described it to me, decided to double-down in terms of those investments.

Those investments, they were using their business judgment. They had in place risk matrixes which should have told them when they were exceeding those risk matrixes in these particular areas. They, in fact, had those in place and, in fact, they exceeded those. The regulators observed those exceedances, and acquiesced in those

exceedances, taking the position that as long as senior management knew about it, there was nothing more that needed to be done. So the regulators did not prevent Lehman from doing what it intended to do.

Lehman had a right under those circumstances, having disclosed this information to the regulator, to pursue its own business judgment, which it did. It turned out that judgment was clearly faulty. But the regulators were kept apprised of those risks. The regulators were kept apprised of the exceedance, and did nothing to stop those from taking place.

So when you say Lehman's decisions, they were clearly Lehman's decisions and judgments. No one told them to make those investments. Did the regulators do anything to prevent that from taking place, the answer is no. Were they fully apprised of it, yes.

Mr. KANJORSKI. Does that not that bring up the question as to what we should do in the future in reforming regulations so that this would never happen again. Paul Volcker has made a very strong point to me on a number of occasions that there are some times when Congress should enact in statute and mandatory requirements as opposed to just giving authority for things to occur, and that is why under the Volcker Rule, he is asking us to make it statutorily mandatory that proprietary trading not be allowed because he fears that perhaps the regulators or the businesses will pursue the course of trading if it is an option or if it is open, and that forces the regulator to be very stern.

His comment on that is—quoting Mr. Volcker—"I have been a regulator before, and it is very difficult to always remain stern in enacting activities from those who are regulated." So in the Volcker Rule, he wants it to be mandatory.

You know I am the author of an amendment that occasionally gets referred to as the "too-big-to-fail" amendment. It originated in the House, was attached in the bill that came through the committee, and ultimately, was passed on the Floor. That is a very encompassing amendment that basically gives unusual powers to the regulators using the systemic risk council to evaluate the largest financial institutions in the country, and if they look, even though they are sound at the moment, that they are doing things that are unusual or systemically, potentially systemically risky, they can give them orders to cease and desist.

They can require them to file better plans of equity and other positions that would lessen their risk. Do you think that amendment should still be allowed in the context that is in now to be an authority that the regulators could impose, or should we attempt to reduce that down to a mandatory role?

Mr. VALUKAS. Mr. Chairman, I don't feel qualified to answer that question, in all candor.

Mr. KANJORSKI. You are more qualified than we are.

Mr. VALUKAS. I can say, and what we can take away from this investigation and review, what we didn't have here was an agency, the SEC, that either acted or believed that it had the authority to make changes at the time they were making changes, and that was a problem. I think Chairperson Schapiro addressed that. So however that should be addressed, I don't know. But I think that is a problem that needs to be addressed.

Mr. KANJORSKI. Thank you very much. My time has expired, and I now recognize the gentleman from Alabama.

Mr. BACHUS. I want to commend you, Mr. Valukas, on an outstanding job as bankruptcy examiner. I think that had there not been a bankruptcy, we would not have known a lot of this. In your written testimony, you make the point that what is clear is had the government acted sooner on what it did know or should have known, there would have been more opportunities for a soft landing. Markets may have been spared the turmoil of what was Lehman's abrupt failure, which I think did catch the markets somewhat unaware.

Chairman Bernanke, however, has testified before this committee that, "The trouble at Lehman had been well known for some time and investors and counterparties had had time to take precautionary measures." Your assessment of this statement appears inconsistent with Chairman Bernanke's. Do you believe that the actions of the regulators helped mask the extent of Lehman's troubles and were investors fully aware of the problems?

Mr. VALUKAS. I think that it was well known by the spring and summer of 2008 that Lehman had significant problems. It was widely reported in the press that if there was another bank that was going to have a failure, it was likely to be Lehman. Those issues were clearly known, and Lehman's massive investments in the real estate areas which were becoming increasingly illiquid were certainly known.

What was not known by the public was at that same time, Lehman, as part of its explanation as to why it was okay was, for instance, reporting its liquidity pool at very record numbers.

What was not known and could not have been known by the investing public but was known and could have been known by the regulators was that in fact that liquidity pool was increasingly becoming encumbered. By August of 2008, 17 to 20 percent of that liquidity pool that was being reported publicly was in fact, in the estimation of Federal regulators, encumbered, and should not have been included. There was no disclosure of that to anyone. Would that have precipitated people being more concerned and taking up more affirmative action, I could speculate, but I would speculate that it would be a hash warning that people might look at.

Similarly, the regulators could have known that Lehman was using repo 105 to indicate better leverage than they actually had. And they were announcing that at a time when the rating agencies, as well as the analysts, thought these were critical issues. Had the regulators said tell us about all of your off-balance sheet transactions, how you are getting these leverage numbers, which after Enron you would think was a possible question, that would have been disclosed. What would that impact have been.

So my view on this was that there were things that the regulators should have known that would have triggered concerns earlier which would have given them time to deal with this issue rather than trying to cram it in on a weekend in September.

Mr. BACHUS. Okay, thank you. In your written testimony, you note that because neither the SEC nor any other agency directed Lehman to correct its misleading and incomplete public statements, the public did not know there were holes in Lehman's liquidity

pool, nor did it know that Lehman's risk controls were being ignored and that reported leverage numbers were artificially deflated. Billions of Lehman shares traded on misinformation. In your view, does this point to a problem with the regulations or the regulators?

Mr. VALUKAS. It certainly points to the problems of the regulators not having done the regulation they should have done in those areas.But it also points to a larger problem which I think needs to be thought of, which is that, in an institution as large as Lehman, as we tried to get our arms around this institution, which is a monster, that you need to have an agency or agencies or people who truly understand the scope of the issues, the scope of the agency, and the problems that could exist. And what we found is that neither of these agencies independently had that expertise. They had some but not all. And so you could say is that a problem with regulation or the regulators. I don't know. I do know that those were two problems, and you need to handle both of those.

Mr. BACHUS. As you said, if they had combined their skill sets, communicated, and shared information, they would have been much more at least successful or had an ability to be more successful.

Mr. VALUKAS. That is correct. Now, whether that would have solved everything, I can't say that, but it would have certainly solved some of these problems.

Mr. BACHUS. And I would agree with you and others that the Fed does have some special abilities with these large holding companies. And I think—

Let me ask you this as a follow-up to that. The public may have seen that memoranda of understanding between the SEC and the New York Fed that the New York Fed was going to come in and do certain things. And they did stress tests, and Lehman failed those stress tests. To your knowledge, as a result of those stress tests, was Lehman asked to do anything to remedy the situation or address their failures?

Mr. VALUKAS. No. They were encouraged to raise more capital and do something with regard to their liquidity, but no one directed them to do anything in particular. So as a matter of—pardon me, I didn't mean to cut you off. So as a matter of talking to them about the need to do something better in this situation but not directing them to do anything.

Mr. BACHUS. And, as you mentioned, that $45 billion that they said they had record liquidity, which turned out to be a material and blatant misrepresentation.

Mr. VALUKAS. At some point, that became—by the time—as of September 10th, Lehman was reporting $41 billion in their liquidity pool which was being cited by analysts as a good reason why Lehman was still viable. Internal documents show that maybe as much as $15 billion or more of that was, in fact, encumbered and should not have been included in the poll. That information was not disseminated to the American public.

Mr. BACHUS. Thank you.

Mr. KANJORSKI. The gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman.

Thank you, sir, for your willingness to come before the committee and help us with our work.

I wanted to ask you about the role of the auditor in this case for Lehman, Ernst & Young. You stated in your report that you thought there may be the possibility of a colorable claim against Ernst & Young for failing to disclose affirmatively the use of Repo 105 and other practices here. Would that be something normally that Ernst & Young or a firm in that place would report on?

Mr. VALUKAS. What we found, what I concluded, was there were colorable causes of action we believed against Ernst & Young, which means simply that someone could bring the suit and we thought that there were sufficient facts to support a malpractice case, not that it would necessarily be successful.

We laid out both sides. The two issues that we focused on with regard to Ernst & Young were the following:

An individual came forth and reported that there were $50 billion of off-balance sheet transactions which he thought were inappropriate. Ernst & Young, the audit committee of Lehman Brothers, had previously ordered or directed Ernst & Young and Lehman to review allegations of problems in the balance sheet. Ernst & Young was supposed to be conducting that investigation. In the course of that time, the allegation about the $50 billion of off-balance sheet transactions came to their attention.

They thereafter met with the board. The board told us that they never disclosed—Ernst & Young never disclosed to them about the $50 billion worth of off-balance sheet transactions which turned out to be Repo 105, nor did they do a follow-up. In our opinion, that is a colorable cause of action against them for malpractice for failing to advise the board and failing to follow up.

In terms of the disclosure of the Repo 105, the financial statements which were in fact reviewed by Ernst & Young affirmatively state in a footnote that Repo transactions are accounted for as finances. In fact, these Repo transactions were accounted for as sales. And that, to us, a fact finder could find that was affirmatively misleading to the public.

Mr. LYNCH. Sure. Thank you. That is a very clear answer.

Let me ask you about, as was pointed out in your earlier testimony, at the time that they went under Lehman had 900,000 different derivative positions globally, 900,000; and yet you point out that these risk limits that prevented Lehman both systemwide and per transaction to have certain limits that they could not exceed, and looking at some of these CDOs and some of the obligations on many of these positions, they almost have limitless risk that Lehman was sitting on. How do you reconcile the fact that there was a limit, at least on paper, for Lehman and yet in practice 900,000 open positions on derivatives globally, many of them very, very complex that had almost bottomless risk? I can't seem to reconcile those two positions.

Mr. VALUKAS. I am not sure I can for you, because I am not sure I can—I can tell you this—and the answer is, I am not sure I can do that now, but I would certainly be pleased to submit something to you subsequently.

I can tell you this. Lehman had, by the estimation of the SEC and others, a very robust risk analysis system in place, something

which would identify for them the nature, scope, and volume of their risk. And I would have to look back, and it is a very detailed thing, as to all that was covered by that risk analysis, but it was a very complete and very thorough analysis. Through 2007, they consistently exceeded those risks, identified the fact that they were exceeding those risks, and the response to that was simply to raise the risk limits so that they were no longer in exceedence.

As to specifically how the derivatives played in, I just can't give you that answer now, but I will get you that answer.

Mr. LYNCH. Is there any question in your mind, Mr. Valukas, that the purpose of the Repo 105 was simply to doctor up the quarterly reporting so that they would increase their cash and lower their debt limit?

Mr. VALUKAS. The internal documents of Lehman Brothers, which were contemporaneous with the time that this was occurring—put aside the testimony after the fact—but the contemporaneous documents describe this practice, the purpose of this practice is to adjust the balance sheet so as to affect the leverage numbers. That was the purpose of this transaction, specifically in a quarter end so that this would be the reported numbers.

Mr. LYNCH. Thank you, sir. I yield back.

Mr. KANJORSKI. Thank you, Mr. Lynch.

Now, we will hear from the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Getting back to this idea about a bailout fund, just a couple of hours ago, Majority Leader Steny Hoyer mentioned that the bailout fund was not central to the financial overhaul, in his words; and I think this is a step in the right direction. But I point out to the members here Mr. Sherman's comments to the previous panel, because I share Brad Sherman's worries about this, the permanent bailout authority concept that he and I have been warning about.

Let me just point out that if you take the fund out, but leave the line to the Treasury in place, you don't solve the problem. You still have that moral hazard problem. And when we talk about rewarding risky behavior, rewarding creditors and counterparties of a failed firm, and that basically is compounding the moral hazard problem, it is because it is the availability of the funds outside of the given failed institution that creates the problem and the implication here. And that is why some of us think this should be done with enhanced bankruptcy authority.

But, anyway, also, Mr. Geithner again compared the resolution authority that they are requesting to the authority that the FDIC uses to close commercial banks. And I was thinking about this. This is like comparing apples and oranges. Commercial banks are overwhelmingly made up of insured deposits and very small, straightforward loans, for the most part. In fact, 98 percent of the liabilities of banks and thrifts that have been unwound by the FDIC in the last couple of years, those were insured deposits.

But here this is in stark contrast with what we are talking about in the bill. Because many of the non-deposit-taking institutions that would be covered under a resolution authority are institutions like Lehman Brothers which doesn't have insured deposits, no depositors of any kind, and have complex assets and liabilities that

did not look anything like the simple small loans and residential and commercial mortgages that the FDIC has any familiarity with or deals with.

So the FDIC model works well for small, straightforward financial institutions. But applying that model to large, complex institutions will create a perception of a government safety net under those institutions likely to be resolved through the resolution authority, and for that reason you have all the problems then that come with a moral hazard and the implied government bailout and the lower cost of capital for these firms, so it is not the right approach.

I want to go back—and I am going to ask you a question. I am going to go back to Chairman Bernanke and Secretary Geithner's comments. They stated that neither the Federal Reserve nor the Federal Reserve Bank of New York was Lehman's primary regulator. In fact, both have been quick to disavow any regulatory responsibility for Lehman, claiming instead that the Fed's only relationship with Lehman was that of a lender and that any monitoring they did was purely to ensure that any sums that were loaned to Lehman would be paid back. Do you agree with this assessment?

Mr. VALUKAS. I agree that, as among the regulators, that all three of the regulators with whom we spoke took that position, including the position that the SEC also ascribed to that position as being that they were the primary regulators and that the Federal Reserve was not the primary regulator. And as I read the MOU, I am not sure that the MOU confers upon them regulatory authority that is held by the SEC. I am not sure they can do that. So I understand their point of view. We left it at that.

Mr. ROYCE. But it seems that during the spring of 2008, there was a general consensus that Treasury and the Fed, not the SEC, were in control of that situation. There doesn't seem to be any other interpretation from what was happening in terms of the market perception. The Fed appeared to be in control of the Lehman situation in the spring of 2008. I think that is the way the market read it. I think that is the way you assumed it when you were doing your report.

And, along those lines, do you believe there was a false sense of security in the market that Lehman was being supervised by the New York Federal Reserve and that Lehman would be bailed out, given that it was bigger and more interconnected than Bear Stearns? Bear Stearns had been bailed out. Do you think there was that market perception out there?

Mr. VALUKAS. I honestly don't feel qualified to answer that question because I do know that as that summer went on—and I am just speaking as a citizen who read what was going on at that time—there were those who said there will never be a bailout, there were those who said there might be a bailout, so I don't know what the market perception was at that time.

Mr. ROYCE. I am one who was very worried there was certainly going to be a bailout, and I am afraid there is going to be more if this bill passes.

Thank you very much.

I yield back, Mr. Chairman.

Mr. KANJORSKI. The gentleman from North Carolina, Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

The word of the day appears to be making parts in speeches completely unrelated to Mr. Valukas' testimony or expertise, but I would like to break from that for a moment.

Mr. Valukas, your report concludes that we would be better off if Lehman had become—had gone into insolvency, if they failed sooner rather than later. What difference would it have made if they had failed about the time that Bear did?

And there were certainly published reports then that Lehman was almost certainly next, that Lehman was certainly on very uncertain footing at that point. That would have just been, I guess, 7 years, 3 months, into a Republican Administration instead of 7 years, 8 months, into an Administration, but how much difference would that have been in the kind of disruption of the financial system?

Mr. VALUKAS. Let me—and I hope the report didn't convey the impression that we thought that if Lehman had failed earlier, things would have been better. What I tried to convey in the report was that had certain of these things taken place, and the focus been on the fact that they were in a more extreme position than they actually showed themselves to be, there might have been more affirmative action to soften the fall, possibly to push harder on Lehman executives to effect a sale, to push harder as it related to financing, to look for alternatives.

What it boiled down to is that when it came to the last weekend, if you read the various accounts, the numerous books, the television shows about what happened, is over a period of 3 days, everybody is frantically trying to do something about this. And the point is that a more orderly process, maybe spelled out over weeks or even a month, might have prevented the precipitous fall off the cliff which occurred. That is the point.

And the issue is, if you had known more, if you had known that the liquidity pool was being increasingly tied up, it was not as it was being portrayed, if you had known about the leverage not being where it is, might that have precipitated more dramatic action in an earlier time which might have softened the fall? That is the possibility to which we—that is what we are talking about.

Mr. MILLER OF NORTH CAROLINA. Mr. Valukas, obviously, Lehman continued to get a great deal of credit from those in the financial sector when everyone thought they were probably in a death spiral because of the preferred position that secure creditors got. If there were—to what extent was that a factor, the apparently limitless credit that was available so long as they had access to pledges collateral?

Mr. VALUKAS. You are talking about their ability to continue to do business. It disappeared overnight.

When you get to the end of September, the middle of September, that ability to do business, the loss of confidence had the people on the other side of the Repo transaction, the financing transaction, simply say we are not going to do business anymore and that ended it. That is what took place.

As of that point when you come to that September weekend, the understanding was that the market was now beginning to refuse

to do business with Lehman. They didn't have the resources to be able to continue to do business because they didn't have the dollars necessary in their liquidity pool or otherwise to keep it going.

I hope that answers the question.

Mr. MILLER OF NORTH CAROLINA. It does.

I yield back, Mr. Chairman.

Mr. KANJORSKI. Thank you very much.

The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. I thank the gentleman from Pennsylvania for continuing on with this hearing; and, to the witness, thank you for being here. Thank you also for all the extensive work that went into this report.

I am going to just give you a couple of examples taken out of the report in general, to just get your sense of this.

In your report, you describe how Thomas Baxter, who is the general counsel of the New York Federal Reserve, became aware of allegations that short sellers were unfairly insuring Lehman and how he came to believe that the short sellers may have been correct regarding the potential fraud at Lehman. And, according to your report, the New York Fed Reserve did not follow up on these allegations, even though one of the short sellers, as I mentioned previously, David Einhorn, called upon Chairman Cox and Chairman Bernanke and Secretary Paulson to "pay heed to the risk of the financial system that Lehman is creating and that will guide Lehman towards the problems that they had." So that was in your report.

And if I can find the other memo, there was a—Moody's came out—I think the second point was that Moody's came out in the spring or June—here it is. On June 13th, Moody's reported that Lehman's liquidity management and standalone liquidity position remain robust in June of that year; and Lehman ended with a record $45 billion of liquidity available to a holding company.

So that information, obviously, of Moody's is out there in the public domain. So that information is saying things are good as far as the public is concerned.

And then, as you may have heard me indicate previously, in your report you say, when the examiner questioned Lehman's executives and other witnesses about Lehman's financial health and reporting, I think a recurrent theme in response was that Lehman gave full and complete financial information to government agencies. And then he continued, the government agencies never raised significant objections or directed Lehman to take corrective action.

So everything I am reading so far is you have out in the public domain from Moody's and otherwise that things are going okay as far as their quarterly reports are concerned, as far as the liquidity situation, that the Fed, the New York Fed was aware of what the public information was about that. But, even if they weren't, in their primary supervising capacity they had the information at hand to say that really wasn't the case. Is that your understanding? Maybe you need like a timeline on that as well.

Mr. VALUKAS. Let me be specific, because this is a timeline.

In June 2008, the SEC learned that Lehman had made a $2 billion comfort deposit with Citibank—Citicorp and had included that in their liquidity pool. Initially, their staff was concerned about it

when it was elevated to a senior person. He specifically felt that it should not have been included in the pool. That was not disclosed to the Fed.

In July 2008, the Fed found out that Lehman had made a pledged $5 billion worth of collateral to JPMorgan Chase. They learned in August that had in fact been included in the liquidity pool.

So the SEC knew about the $2 billion. The Fed knew about the $7 billion—or the $5 billion. The Fed did not tell the SEC about that $5 billion until September 12th. So the SEC learned on September 12th that $5 billion which had been pledged to JPMorgan Chase had in fact been included in the liquidity pool. Both parties agreed it should not have been.

So the answer is, no, the public was not given the information that the Federal Government had about this liquidity pool; and the public pronouncements that were made about that liquidity pool, if you listened to the witnesses, were not accurate.

Now, did Lehman withhold any of that information from the Federal Government? To the best of my knowledge, no. When asked the question, they provided the information.

Mr. GARRETT. And the take that I had from the previous panel was: (A) neither one of them was the primary regulator; and (B) that there was lots of sharing of information, and that the points that are made in your report they are just merely aberrations as far as sharing of information, that, they didn't say this, but 99 percent of the time they are sharing information, but you are just picking on some of the aberrations as far as information not being shared. That was my takeaway. Is that a correct understanding of what was going on or was information truly not being shared?

Mr. VALUKAS. Let me say this. I have no reason to dispute what was said by Chairman Bernanke about the sharing of information, the agreement he made with Chairman Cox. I believe in fact they made that agreement.

I also know at the staff level, at least in this instance, which I consider to be a critical area, the view of the staff was it was, in part, if they asked a question, I would give them the answer, but they weren't volunteering. So, no, I don't think across-the-board that word filtered down.

And I don't know about all the other instances of sharing. I know when they did the stress test that was jointly done by the SEC and the Federal Reserve, so there was a sharing in connection with that, and that was done in connection with Lehman Brothers. So I can't dispute the fact that there was a sharing agreement, that at least at the top they instructed people to share. I can dispute the idea that sharing occurred in this particular instance.

Mr. GARRETT. Thank you.

Mr. KANJORSKI. Thank you very much, Mr. Garrett.

The gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman; and thank you, sir, for appearing today.

You indicated that—I am saying approximately. I think you used the number $50 billion was off the balance sheets, is that correct?

Mr. VALUKAS. That is correct.

Mr. GREEN. Is it also true that there was a company that received these off-balance sheets books? Is that a way to put it?

Mr. VALUKAS. The transactions—the Repo 105 transactions were done with essentially the same banks or institutions that they did regular repos with. So there were several counterparties, different counterparties, but they were typically the same counterparties.

Mr. GREEN. Was there a business made up of former Lehman employees who received these investments?

Mr. VALUKAS. Not to my knowledge.

Mr. GREEN. No reports of that?

Mr. VALUKAS. Let me double-check for a second.

I am not aware of any.

Mr. GREEN. You indicated that the disclosures were incorrect and misleading, is that true?

Mr. VALUKAS. Yes.

Mr. GREEN. Who does your report go to when you are finished, completely finished?

Mr. VALUKAS. During the course of this investigation—the short answer is that we have provided all the information we have to the United States Attorney's Office in the Southern District of New York, the Eastern District of New York, and the District of New Jersey, and to the SEC. During the course of the investigation, we cooperated with them completely and kept them apprised of what we were finding as we went along, and we have continued to do so.

Mr. GREEN. While this is not on all fours with the Madoff case, there are some similarities. You have a whistleblower, you have the appearance of assets that do not exist, and my concern is that no one to date has been arrested, no one has been charged. Are these fair statements, to the best of your knowledge?

Mr. VALUKAS. I am not aware of anybody being charged.

Mr. GREEN. And the concern really is this: How can this kind of thing—and you are not qualified to answer—but how can this go on and no one suffers some sort of criminal investigation to the extent that the public is aware of it?

This is just amazing. When I read this information, I was thunderstruck. Because I couldn't believe that all of this information is available and we haven't seen anyone arrested. The public at some point has to see some sort of effort to bring to justice people who do this and that take advantage of so many others with these misleading and incorrect documents.

You don't say that they were intentionally done, but it concerns me that we have all of this information and we don't have the criminal investigation that I am aware of either taking place such that at some point we would know whether or not a crime was committed, I suppose. There is no indication so far of a crime. But if this isn't fraud, it will do until fraud shows up. That is about as close as you can get to fraud, if it isn't fraud, and not have fraud. It really is quite disconcerting to see this kind of thing happen and not see the investigation.

But I thank you for what you have done to help us at least get some insight as to what was going on there. Thank you.

Mr. VALUKAS. Thank you.

Mr. GREEN. I yield back.

Mr. KANJORSKI. Thank you, Mr. Green.

The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you.

I would like to start by kind of clarifying your role. Because when I first saw that you were making a report I thought, here is somebody brought in from the neutral world, no allegiance to anybody involved, going to give us a report. I think you have a good report, but it is my understanding that, in effect, you work for the creditors of Lehman Brothers. They, of course, would like to find some deep pockets that can help supplement what they are otherwise going to receive and that it is not your job to throw away or ignore any colorable claim that they might have. Do I understand your role?

Mr. VALUKAS. No, that is not my role. My role as the examiner was to answer questions that were put to me by a court by court order.

I am by training an attorney. I was a former U.S. Attorney in Chicago and chairman of a law firm. And my role as examiner was to try to determine what the facts were, as I like to say, put the cards face up on the table; and to the extent that the facts—from those facts I could draw a conclusion as to whether there was a colorable claim to lay that out. And as I undertook this responsibility that also included to lay out all of the defenses that might exist for those colorable claims so that anybody reviewing the report could know what actually had taken place as best we can determine it and what might be possible causes of action. I did not report to, nor was I responsible for, nor did I find myself in any way indebted to the creditors committee, the debtors or anyone else.

Mr. SHERMAN. I stand corrected.

I want to move on to something else. Matthew Lee will be testifying later, and his written testimony states that on May 16th, he sent a letter to Lehman management raising issues about the scope of—within the scope of his responsibility. His letter is referenced in your report which was made public recently, and the letter that is in your report makes no reference to Repo 105.

In his testimony that he is going to give to this committee, he says that he prepared another writing—I will call it a second letter—that was sent to a Lehman officer addressing matters outside the immediate scope of his responsibility and that second letter did identify Repo 105.

Now, that second letter was not in your report. Are you aware of this second communication that Mr. Lee mentions in his testimony?

Mr. VALUKAS. There was an e-mail that was sent by his lawyer. There was then a discussion about that, and I remember we went and interviewed the individuals from Ernst & Young who had in their notes the information that was imparted to them which included the information that there had been off-balance sheet transactions of $50 billion, the purpose of which was to accomplish a goal.

Mr. SHERMAN. So there was this e-mail. Is that referenced in your report?

Mr. VALUKAS. I think the e-mail is referenced in the report yes. I will double-check that, but there was in fact an e-mail.

Mr. SHERMAN. Now, at about the time this e-mail was sent, was Mr. Lee trying to negotiate a severance package with Lehman?

Mr. VALUKAS. That is my understanding, that he had been terminated and was trying to negotiate a package. But if he is here, he will explain that.

Mr. SHERMAN. So this second communication, is it in your report or do you have a copy of it that you could provide to the committee?

Mr. VALUKAS. I will look back. If we have the e-mail, I will provide a copy for you.

Mr. SHERMAN. To your knowledge, who did Mr. Lee provide this e-mail to? Who did he send it to?

Mr. VALUKAS. I think the e-mail came from his lawyer, the one I am thinking of.

Mr. SHERMAN. I yield back.

Mr. KANJORSKI. Thank you very much, Mr. Sherman.

And now the gentleman from Ohio, Mr. Wilson.

Mr. WILSON. Thank you, Mr. Chairman.

Thank you for coming in today, Mr. Valukas. Your report provided some very interesting reading.

I only have 5 minutes, so I hope I can run through my questions as quickly as I can.

I know that Thomas Baxter told you in no way was the idea to make Lehman a poster child for a moral hazard. But do you believe that is not true?

Mr. VALUKAS. I don't know how to respond to that question. I apologize.

I did not find any evidence—nothing was said to me which indicated that somebody was deliberately trying to subvert Lehman's ability to survive. We did not find any communications. We went through 23 million or 25 million e-mails, documents, things such as that. There was nothing in there to suggest any of that. In the interviews that we had with individuals, nobody gave us any testimony suggesting that.

Mr. WILSON. What do you think was so much more saveable about Bear Stearns, for example, than Lehman?

Mr. VALUKAS. What we were told was that—in connection with Lehman—that the opportunity to lend to Lehman was dependant upon Lehman's ability to have collateral which could stand, which was sufficient to justify the loans; and they did not, as of that date, September 15th, have that type of collateral.

Mr. WILSON. I get the sense that the Fed thought that something could be done about this. However, since they weren't the regulator in charge, they stepped back. How do you feel about that?

Mr. VALUKAS. I am not sure that I am qualified to answer that question in terms of what we were trying to do. All I know is that over that weekend, there were all of these efforts that were being made. It would appear, on their face, at least, to be good-faith efforts to salvage Lehman or salvage some aspect of Lehman. I can't really comment beyond that.

Mr. WILSON. In your report, you cited many times the risk that Lehman was taking was far and above what their model was.

Mr. VALUKAS. Yes.

Mr. WILSON. So that was a building crescendo to what really came in September of 2008?

Mr. VALUKAS. What happened was they took on increasingly what turned out to be illiquid assets. They had in place or they told the SEC they had in place a risk matrix which limited the amount of risk to take in individual transactions. They exceeded that 30 times in a row by taking on more and more of these.

What they did at the end of the year was then they looked back and they said, we have exceeded—they had all these risk exceedences. They simply raised the level of risk which they were qualified to take. So that is the way they addressed it.

Now, as I said before, many of those assets, and some in particular, Archstone, were assets which later became in 2008 more or less an anchor around them and became a significant problem in their ability to survive.

Mr. WILSON. I found that a real contrast in your findings in some of the testimony that was given by, for example, Mr. Cruikshank, is there an opportunity to be able to compare those and match them up?

Mr. VALUKAS. I am not sure how I could do that. If you wish, I could read Mr. Cruikshank's testimony, if that is what you are asking.

Mr. WILSON. I think it is sort of implied that part of it was doing business. What really isn't implied is the fact that it was risky business, and that is how we got the report of the failure.

Mr. VALUKAS. What happened, as I said before, was they made a decision to increasingly take on these types of risks. These were business decisions which under the law they were entitled to make. They were escalated up, and people concurred in those decisions about the risk that they should take in making their business judgments.

What the regulators did not do is prevent them from doing so or say, no, you can't take on that risk or we prevented you from doing so. And under our system and the law basically businessmen are permitted to take risk and make judgments as to how much risk they take as long as it is not irrational. And in this situation, it was not irrational. It may have been excessive, ultimately, but we concluded that it was in the business judgment rule.

Mr. WILSON. Thank you for your answers.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. KANJORSKI. Thank you, Mr. Wilson.

And we will now hear from the gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Valukas, please forgive me. I missed some of your testimony. I had a different appointment. So if we plow some old ground, I apologize.

The first question I have concerns the Repo 105 practice, which I am sure you discussed in some detail.

I see on page 13 of your testimony: "I express no view on whether, as a technical matter of GAAP accounting, it is permissible to treat transactions as sales which are by all other measures financings."

So I assume it says what it means. You don't have an opinion on whether or not as a pure technical matter of GAAP accounting this violated the standard or not?

Mr. VALUKAS. I have no—we did not need to and we didn't express an opinion as to whether accounting for Repo 105 this way complied technically with that aspect of GAAP.

We did have a view which was that, even if you account technically, that this is technically correct. If it does not accurately reflect the entire balance sheet, the truth of what is there, then that is not compliant with GAAP. Because GAAP says it should be a fair picture of your financial situation. So you could technically have some portion which complies with FAS 140 and still make that balance sheet or that financial statement—

Mr. HENSARLING. To use a fairly nontechnical phrase, the way it was used by Lehman in your opinion doesn't pass the smell test. Is that a fair assessment?

Mr. VALUKAS. I am sorry. You will have to repeat that to me.

Mr. HENSARLING. I said, using a nontechnical phrase, is it fair to say that in your opinion the way Lehman used Repo 105 does not pass the smell test?

Mr. VALUKAS. I concluded that there were colorable causes of action against Lehman executives for filing false—filing financial statements which were false and incorrect based on their use of Repo 105.

Mr. HENSARLING. In your opinion, under the CSE program, could the SEC have compelled more complete disclosure of these Repo 105 transactions?

Mr. VALUKAS. Absolutely.

Mr. HENSARLING. There seemed to be some confusion on the earlier panel about that.

In your opinion, could the SEC have required them to set aside more capital against—to decrease their leverage and to increase their capital? Did the SEC have that ability?

Mr. VALUKAS. I understood the CSE program, the focus there was liquidity, capital, leverage. Those were areas in which, at least in the testimony before Congress, they were going to address because of the concerns of what would take place in those areas and the systemic risk that might occur in the event of a failure.

So I am presuming that meant—and I am in part presuming that based on the testimony of Chairperson Schapiro—that, yes, they could have mandated certain changes or said these are risks that either need to be disclosed or limited actions like that under the CSE program. Voluntary as it was, Lehman had the right then to step away from that program, but I doubt that they would have.

Mr. HENSARLING. I don't have at my fingertips the portion of your testimony where you talk about in some respects—I don't want to put words in your mouth—that the failure of, I guess, in some respects that the SEC and the Federal Reserve, to bring some of these matters to light, that there were literally millions of trades that were—uninformed trades that might otherwise have not taken place. Again, I don't have that passage at my fingertips. Is that a fair assessment?

Mr. VALUKAS. Yes. We conclude in the report that the failure to—that subsequent to the publishing of those financial statements

which excluded the information about the Repo 105, that there were literally billions of dollars worth of shares of Lehman Brothers that were traded by the American public.

Mr. HENSARLING. So you don't see this at all as a lack of authority by the SEC to act upon these matters. It might have been a lack of competence, some would maintained a lack of resources, lack of will, but you have concluded that it was not a lack of authority with respect to them compelling increased disclosure or lessening their leverage?

Mr. VALUKAS. With regard to disclosures, there is not even a—I have no question about their authority to order that disclosure.

And in terms of the leverage information, to the extent it was disclosure about leverage, I have no question about that.

Mr. HENSARLING. I see I am out of time. Thank you, Mr. Chairman.

Mr. KANJORSKI. The gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

Thank you, Mr. Valukas, for your testimony today. Thanks for putting this report together.

I feel obligated to respond to a couple of things Mr. Royce said about a bill that is pending on reforming Wall Street. And following up on Mr. Hensarling's questions, whether or not the regulations were in place, it was clear that the SEC, in my opinion, under the Bush Administration, no regulation was good regulation. That was a principle. That was a Bush doctrine. And based on what I hear my friends from the Republican side say, they don't want to do anything and want to allow Wall Street to run amuck.

Now, one of the things that you said—and I think it is on page 1,484—is that after Gramm-Leach-Bliley was passed, there was a void, I think your language is. The Gramm-Leach-Bliley Act of 1999 created a void in the regulation of systemically important large investment bank holding companies. Neither the SEC nor any other agency was given statutory authority to regulate such entities. So we are passing—we are hopefully going to pass a reform bill that reigns in Wall Street and these systemically large companies.

Now, Mr. Royce also was talking about enhanced bankruptcy authority. In connection with the Lehman Brothers case—and I don't know if you were charged as an examiner with this—but you did say it couldn't do any business anymore after September. It just didn't have the liquidity. What do you mean by that?

Mr. VALUKAS. I meant that what caused the failure ultimately was the lack of liquidity. They didn't have the cash resources, the money necessary to continue their business. They couldn't open up in the morning and continue to trade because they didn't have those resources.

Mr. PERLMUTTER. And they are a financial services business.

Mr. VALUKAS. In order for them to survive, they needed to do repo transactions to gather cash against collateral; and as of that weekend, that was over.

Mr. PERLMUTTER. What kind of bankruptcy are they in right now, Mr. Valukas?

Mr. VALUKAS. Chapter 11.

Mr. PERLMUTTER. Chapter 11? So are they doing business, or are they still liquidating Chapter 11?

Mr. VALUKAS. They are liquidating at this point.

Mr. PERLMUTTER. One of the issues that we have in front of this committee is whether or not a financial services organization should be allowed to reorganize or whether they should be liquidated as in a Chapter 7. And so the Republicans think they ought to be able to reorganize. The Democrats think they ought to be put out of their misery. We think they should be liquidated.

Now, one of the things that we have seen here, I am curious, did you look to see if there are any assets left for payment of creditors? You may have heard my area had some local governments that were hit hard by the Lehman Brothers bankruptcy. Is there something for them to collect against?

Mr. VALUKAS. I am not a bankruptcy lawyer, and I am not a bankruptcy lawyer in this particular case, but I do know from the reports that I have seen filed by the debtors' counsel, I think there are several billions of dollars left in the estate to which there are—and maybe more than several—for which there are numerous claims far in excess of those dollars.

Mr. PERLMUTTER. Mr. Royce and Mr. Garrett were sort of focusing on, while it is the Federal Reserve's responsibility, maybe it was the SEC's responsibility. One of the things that you found when you looked at these CSEs—and I think you said—page 1,512 of your report, you recite from the MOU, which says: "As the primary supervisor of CSEs, the SEC will provide the Federal Reserve on an ongoing basis with requested information." Did you look at the SEC as the primary supervisor, primary regulator in this, in the Lehman Brothers situation?

Mr. VALUKAS. Yes.

Mr. PERLMUTTER. And I think your testimony was that they took on more of a role of just an observer than an actor.

Mr. VALUKAS. My view on it was they acquiesced in this area. They acquiesced—when the risk exceedences occurred, they acquiesced in some of these other areas; and they were not directing them to do things which ultimately were issues that they should have directed them.

Mr. PERLMUTTER. Thank you. Nothing further.

Mr. KANJORSKI. Thank you very much, Mr. Perlmutter.

And now we will hear from—

Mr. BACHUS. Mr. Chairman, I appreciate Mr. Perlmutter clearing up a lot of my confusion as to where we were going.

Mr. KANJORSKI. I think you made it very clear.

The gentlelady from California, Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

Mr. Valukas, I just want to thank you publicly for an outstanding report. Your testimony—your statement here this afternoon could not be clearer as to who was responsible.

What is kind of humorous to me is how on many statements that we have before us today, they are attempting to rewrite history. One of them appears to be Mr. Fuld, who has said in his testimony, which you will be getting later, that he had absolutely no recollection whatsoever of hearing anything about Repo 105 transactions

while he was CEO of Lehman. Do you believe that statement could be true?

Mr. VALUKAS. I don't know that it is appropriate for me to comment on Mr. Fuld's credibility.

We concluded in the report that a fact finder could conclude that in fact he did know and acted upon information he knew or should have known. There was at least one witness who testified that he discussed Repo 105 transactions with him. In the magnitude of those transactions, there were documents that were sent to him by e-mail and otherwise which reflected the Repo 105 transactions which were dealing with balance sheet which were a great issue and concern to Lehman Brothers at the time.

The two presidents of Lehman Brothers acknowledged they knew about Repo 105. The three CFOs during that period of time claim they knew about Repo 105 and numerous other executives. Mr. Fuld's position was that he did not know about it. If an action is brought, someone will determine whether that is or is not credible.

Ms. SPEIER. You also referenced in your statement that you found that there were colorable claims against Lehman for violating regulation S-K, which requires a registrant to discuss known trends involving its capital resources, specifically including off-balance sheet financing arrangements.

Mr. VALUKAS. Yes.

Ms. SPEIER. So Lehman did not in its actual notification to investors talk about the off-balance sheet financing arrangements.

Mr. VALUKAS. They did not. And we asked executives of Lehman Brothers who were involved in the preparation and they told us that a sophisticated investor reviewing the balance sheets—reviewing the financial statements would never be able to observe anything which disclosed the Repo 105 transactions.

Ms. SPEIER. In your opinion, are Repo 105s potentially a very dangerous instrument that can be used as Lehman used it to create the impression that it was leveraged less than it actually was?

Mr. VALUKAS. I don't think there is anything inherently wrong with the Repo 105 transaction. It is simply another repo transaction, no different than any other, just putting additional collateral and securing the opinion of a lawyer in a different jurisdiction that it would qualify as a true sale. But it is in all other respects a repo transaction. It was a failure to disclose to the public and the regulators what they were doing and that they were using this to shift assets off balance sheets in order to affect their leverage at quarter end that we found to be the misstatement, not Repo 105 inherently as a bad instrument, because it is simply neutral. It is how we say it was used and, more importantly, not disclosed.

Ms. SPEIER. So do you think the issue would be resolved somewhat of all Repo 105 transactions had to be disclosed so there was the transparency that didn't exist in these?

Mr. VALUKAS. Yes. At that point in the instance of the Lehman situation, there would have been no reason to do a Repo 105 transaction if you are going to disclose it.

Ms. SPEIER. And then you also referenced that, as part of their CSE—being granted CSE status, they advised the SEC that they had robust procedures to calculate and set risk limits as a "binding constraint on its risk-taking that could not be exceeded under any

circumstances." So they make this statement, and then they go right ahead and violate it by lifting the limits on the risk that they can take, is that correct?

Mr. VALUKAS. That is correct. And they fully disclosed that to the SEC as they were doing it.

Ms. SPEIER. So they fully disclosed it. While we were granted CSE status because of the statement, we are now going to violate the statement, and they informed the SEC, and the SEC took no action.

Mr. VALUKAS. The SEC acquiesced. The SEC started—while they stated in that written position that it was a hard limit, they subsequently took the view that it was a soft limit. The SEC's position was, as long as they disclosed it to senior management, which they did, that the SEC and senior management reviewed it, which they did, that they would—that satisfied the SEC. So Lehman—when Lehman said they made full disclosure to the SEC in this area, they did in fact do that.

Ms. SPEIER. Thank you. My time has expired.

Mr. KANJORSKI. The gentlelady from Ohio, Ms. Kilroy.

Ms. KILROY. Thank you, Mr. Chairman.

And thank you, Mr. Valukas, for being here today. Like my colleagues, I very much appreciate your report. It is very useful in performing the sort of autopsy to find out more of what was going on and, from our point of view, what are the policy implications.

There are certainly some very real-world implications of what happened with Lehman Brothers. People in Ohio, people in California, people in Colorado, and people in other States as well had invested, worked their lives, had pension funds.

In my case, Ohio public employees, teachers, police officers—their pension funds were invested in offerings by Lehman. And we have learned that there is a substantial decrease in value, although I can't sort it all out entirely yet, but a substantial decrease in value between December of 2007 and September of 2008. So although the high-risk strategy may have been a business decision, that high-risk strategy certainly had consequences far beyond the Lehman boardroom.

One of the things that I gleaned from your report was that some of the reasons that you found some actions not to have violated or be a violation of fiduciary or other standards was because of the standard articulated by the court in Caremark; and I was wondering if you would advise us to take actions in legislation to tighten down those standards and to put more responsibility on corporate officers, boards, CEOs, and others who are engaged in high-risk gambling but maybe not telling the people financing it that they are on the way to the casino.

Mr. VALUKAS. You are asking me a policy question, and I am not sure that I am qualified to answer that question. So I am not comfortable answering it.

I can say this. Lehman had in place a process of reporting matters up. And in fact, we found that matters were reported up. For instance, they are elevated to the board. So the process that was in place at Lehman on its face was a good process.

The business judgment rule pretty much says that if you have this process in place and you are acting—you are making rational

decisions, you are permitted to do so. So it is not just—I would say that the issue wasn't necessarily just within Lehman as to what Lehman was doing so much as it might have been with regard to the regulators who need to be able to say to a businessperson, that might be a business judgment you are prepared to make, but we are not prepared to let you make that judgment. And that is where I see it. I don't necessarily see it is inherently an issue of internal regulation. Because, as I said in my testimony, they had those processes in place, and to some extent, I thought they were following them.

Ms. KILROY. To some extent, they were followed. Certainly, in other critical areas, they weren't followed. And some people—Mr. Gelband, Dr. Ancitick, Mr. Lee—made known their position inside the company that they were engaged in behaviors that were far too risky, they were overleveraged, that they were exceeding the risk management levels. And those people no longer work for the company, lo and behold.

In my opinion—I don't know if you share this opinion or not—that kind of activity with the key people who have spoken up being removed from the company or resigning from the company after speaking up has a chilling effect on the ability of other people to become whistleblowers.

So I guess the other question is, do you have any recommendations for us whether whistleblowers deserve or should have additional protection so that they can speak up when behaviors are risky and make sure that the appropriate people know it, not maybe just the next one up in the chain, but sometimes all the way up to the board?

Mr. VALUKAS. This is outside of my role as an examiner, but I believe that it is critical in corporations that whistleblowers be heard at the highest levels so that in fact their concerns, such as they are, should be responded to, and so that the highest officers to whom they respond—to whom they report are held responsible if they don't respond. So I think it is not simply to your superior. And I think my own experience is that with Sarbanes-Oxley and some of the other laws that have passed that it has gotten better within corporate America, significantly better.

Ms. KILROY. In this instance, the risk management function did not have a direct line to the board.

Mr. VALUKAS. That is correct.

Ms. KILROY. We also have learned that not only were Repo 105s moved off balance sheet at quarters end and presentations made to potential investors that make things look better than they actually were but that also when stress tests were undertaken that certain risky investments were also not included in those stress tests.

Mr. VALUKAS. That is correct. And we didn't find that it was deliberately excluded, but we did find that the stress tests in fact were not testing the things which were going to be the most significant problem for Lehman and ultimately turned out to be the most significant problem for Lehman. So that the items which were tested might account for $4 billion worth of potential losses, the items that were not being tested accounted for as much as $12 billion to $14 billion worth of potential losses. So the greatest problem that they might face was not being tested for.

Ms. KILROY. It seems that I might come to agree with one of the employees who has stated that everyone saw the train was coming, but no one got out of the way.

Mr. VALUKAS. That is to some extent true, yes.

Ms. KILROY. I think I am out of time, Mr. Chairman. I yield back.

Mr. KANJORSKI. Thank you very much.

Mr. Valukas, I just have to tell you that your testimony has been outstanding, and my great respect goes out to you. Anybody who can work on 25 million e-mails—

Mr. VALUKAS. I didn't look at them myself.

Mr. KANJORSKI. I trust you did not, but just to have that volume of material, and then to be able to so directly recall as much as you have today, certainly has helped us on the committee to get a grasp of at least what happened and the complications of this thing, so we thank you. I guess all Chicago lawyers are your caliber.

Mr. VALUKAS. Thank you.

Mr. BACHUS. Mr. Valukas, I think this gives us some valuable insight into anytime you want to fix the system, or at least you want to have regulatory reform, you first want to determine what went wrong and why. So I think this will help us, because it is one of the clearest pictures I think of lack of regulation. And I don't mean the laws. I mean lack of regulators enforcing the regulations or really also conveying to people or failing to convey information they knew to the general public even though it is their duty to protect investors and to withhold that information. And so I think it would be very valuable to us as we determine what to do in response.

Mr. VALUKAS. Thank you. It is an honor to be here.

I know what you are struggling with, but, as a citizen, we are all hopeful that you are going to help us get through this. It is critically important. So thank you very much for having me here.

Mr. KANJORSKI. Thank you very much, Mr. Valukas. Thank you.

I think we have had the feeding frenzy, if that is sufficient.

We now have the final panel. And our first witness on that panel will be Mr. Richard S. Fuld, Jr., former chairman and chief executive officer of Lehman Brothers.

Mr. Fuld?

STATEMENT OF RICHARD S. FULD, JR., FORMER CHAIRMAN AND CHIEF EXECUTIVE OFFICER, LEHMAN BROTHERS

Mr. FULD. Mr. Chairman, Ranking Member Bachus, and members of the House Committee on Financial Services, you have invited me here today to address a number of public policy issues raised by the Lehman Brothers bankruptcy report filed by the examiner.

Since September of 2008, I have given much thought to the financial crisis that forced Lehman into bankruptcy. The idea of the superregulator that monitors the financial markets for systemic risk, I believe is a good one. This new regulator should have actual experience and a true understanding of the business of financial institutions, the capital markets, and risk management.

The new regulator should also have access on a real-time basis to all information and data from all market participants regarding all transactions and positions and have clear standards for capital

requirements, liquidity, and other risk management metrics. The job of the new regulator can only be done with the creation and utilization of a master mark-to-market capability that has the responsibility for determining valuations and capital haircuts on all assets, commitments, loans, and structures.

As to the Fed and the SEC, officials from both were physically present in our offices seeing everything in real time, monitoring and reviewing our daily activities of liquidity, funding, capital, risk management, and mark-to-market processes.

After an extended investigation into Lehman's bankruptcy, the examiner recently published a lengthy report stating his views. Despite popular and press misconceptions about Lehman's mortgage and real estate, asset valuations, liquidity, and risk management, the examiner found no breach of duty by anyone at Lehman with respect to any of these.

The examiner did take issue, though, with Lehman's Repo 105 sale transactions. As to that, I believe the examiner's report distorted the relevant facts, and the press, in turn, distorted the examiner's report. The result is that Lehman and its people have been unfairly vilified.

Let me start by saying that I have absolutely no recollection whatsoever of hearing anything about or seeing documents related to Repo 105 transactions while I was the CEO of Lehman. Therefore, what I will say about Repo 105 transactions is based on what I have recently learned.

As CEO, I oversaw a global organization of more than 28,000 people, with hundreds of business lines and products, and with operations in more than 40 countries spread over 5 continents. My responsibility was to create an infrastructure of people, systems, and processes all designed to ensure that the firm's business was properly conducted in compliance with the applicable standards, rules, and regulations.

There has been a lot of misinformation about Repo 105. Among the worst were the completely erroneous reports on the front pages of major newspapers claiming that Lehman used Repo 105 to remove toxic assets from its balance sheet. That simply was not true. And, according to the examiner, virtually all of the Repo 105 transactions involved highly liquid investment-grade securities, most of them government securities. Some of the newspapers that got it wrong were fair-minded enough to print a correction.

Another piece of misinformation was that Repo 105 transactions were used to hide Lehman's assets. That also was simply not true. Repo 105 transactions were sales, as mandated by the accounting rule FAS 140.

Another misperception was that Repo 105 transactions contributed to Lehman's bankruptcy. That also was just totally untrue. Lehman was forced into bankruptcy amid one of the most turbulent periods in our economic history, which culminated in a catastrophic crisis of confidence and a run on the bank. That crisis almost brought down a large number of other financial institutions, but those institutions were saved because of government support in the form of additional capital and fundamental changes to the rules and regulations governing banks and investment banks.

As to Repo 105, the examiner himself acknowledges: first, Repo 105 transactions were not inherently improper; second, Lehman vetted those transactions with its outside auditor; and third, Lehman properly accounted for those transactions, as required by GAAP.

Repo 105 transactions were modeled on FAS 140. In 2000, the accounting authorities wrote rules which expressly provided for them, described them, and dictated how they should be accounted for. In 2001, Lehman's written accounting policy incorporated those accounting rules. E&Y, the firm's independent outside auditor, reviewed that policy and supported the firm's approach and application of the relevant rule, FAS 140. As I said, that rule mandated that those transactions be accounted for as a sale, and that is exactly what I believe Lehman did. Lehman should not be criticized for complying with the applicable accounting standards.

My job as the CEO was also to put in place a robust process to ensure that Lehman complied with all of its obligations to make accurate public disclosures. I had hundreds of people in the internal audit, finance, risk management, and legal functions to ensure that we did, in fact, comply with all of our obligations.

That process had a number of components: first, E&Y's role in auditing our financial statements and reviewing our quarterly and annual SEC filings; second, a rigorous certification process before every annual and quarterly SEC filing, involving hundreds of people who had firsthand knowledge of the firm's day-to-day business and the responsibility to review and certify for accuracy the firm's SEC disclosures before they were filed; and third, an all-hands, in-person, mandatory meeting chaired by Lehman's chief legal officer, including me and more than 30 other senior officers with responsibility for all parts of Lehman.

I relied on this certification process because it showed that those with granular knowledge believed the SEC filings were complete and were accurate. And I never signed an SEC filing unless it was first approved by the chief legal officer.

In conclusion—actually, given all that has been said, I would like to add that I am very much aware that one day we had a firm; the next day we did not. And a lot of people got hurt by that. I have to live with that.

So I thank you, Mr. Chairman.

[The prepared statement of Mr. Fuld can be found on page 158 of the appendix.]

Mr. KANJORSKI. Thank you.

We will next hear from Mr. Thomas Cruikshank, a former member of the board of directors and chair of Lehman Brothers' audit committee.

Mr. Cruikshank?

STATEMENT OF THOMAS H. CRUIKSHANK, FORMER MEMBER OF THE BOARD OF DIRECTORS AND CHAIR OF LEHMAN BROTHERS' AUDIT COMMITTEE

Mr. CRUIKSHANK. Thank you, Mr. Chairman. Thank you, Congressman Bachus. I would like to thank the committee for inviting me to appear at today's hearing.

No one can deny that the bankruptcy of Lehman Brothers has had a disastrous impact on the company, its employees, its investors, and even on our country and its economy. As a director of the firm, Lehman's collapse weighs on me personally each and every day. It is vital that we learn from Lehman's history so we do not repeat it.

The day Lehman filed for bankruptcy was probably the darkest day of my professional career. Looking back, I am sure there are things Lehman could have done differently, but what may seem crystal-clear today was much less so 3 years ago. Indeed, even after Bear Stearns nearly collapsed in March 2008, the then-Treasury Secretary stated that the worst was likely behind us. If only he and other financial leaders had been right.

Still, even in retrospect, the examiner found that there are absolutely no colorable claims against the independent directors in connection with our work on behalf of the company. This conclusion comports with our own belief that we did our absolute best to try and help navigate Lehman through what was the greatest financial tsunami since the Great Depression.

Between 2007 and Lehman's bankruptcy filing, our board and its committees convened on more than 80 occasions. We received detailed reports from management on Lehman's financial performance and other important issues. Board meetings were an active affair, as we probed management and demanded and received detailed, cogent answers.

One issue that management spent a great deal of time discussing with the board was risk. As directors, we took great comfort from their reports regarding Lehman's extensive risk management system.

In performing its oversight role, Lehman's board of directors relied upon the expertise of a variety of outstanding, outside professionals, including Ernst & Young. At no time during our numerous substantive discussions throughout 2007 and 2008, did they raise any red flags regarding Lehman's risk management valuation or the firm's certified filings.

As a board of directors, we also had confidence in what we understood to be Lehman's close working relationship with government regulators. Even before the financial crisis, Lehman voluntarily subjected itself to the scrutiny of the SEC. Lehman continued to work intimately with the SEC and the New York Fed as the financial crisis deepened.

Lehman took numerous steps to adjust to the worsening economic climate. They shut down the subprime mortgage lending unit, substantially reduced mortgage and asset-backed securities exposure by many billions of dollars, raised more than $15 billion in new capital, and pursued a number of strategic alternatives in order to help stabilize the firm.

The examiner's report has raised questions about certain transactions now known as Repo 105. As the examiner has concluded, this issue was never brought to the attention of the board. If there were any questions whatsoever about Lehman's accounting or disclosures, I believe our firm's auditors would have promptly raised it, and I would have expected them to do so. They did not.

Now, I am not so presumptuous as to say I know precisely why Lehman collapsed. I believe that there were many contributing factors, including the firm's real estate exposure, which was exacerbated by the rules from applying mark-to-market accounting; the short sellers who were fueling rumors; the tightening of the short-term credit market; and a loss of confidence in Lehman that led to a run on the bank.

That said, I was dismayed when the SEC and the New York Fed essentially told the board that Lehman needed to file for bankruptcy. I do not understand why the government did not help finance the sale of Lehman to Barclays, like it did in the case of Bear Stearns, or expand access to the Fed's primary dealer credit facility to Lehman, like it did for other major investment banks, or expedite Lehman's conversion to a bank holding company, as was done for Goldman Sachs and Morgan Stanley. There may be good and reasonable explanations for all of these distinctions, but I do not know what they are.

While we cannot rewrite history, had the government acted to stabilize Lehman so that it could have been sold or unwound, our country's financial crisis might not have been nearly as severe and widespread.

My thanks to the committee for the opportunity to speak with you today. And, while I may not have the knowledge and expertise of the other witnesses before you, I am happy to address any questions you may have.

Thank you.

[The prepared statement of Mr. Cruikshank can be found on page 149 of the appendix.]

Mr. KANJORSKI. Thank you, Mr. Cruikshank.

And now, we will hear from Mr. William K. Black, associate professor of economics and law at the University of Missouri-Kansas City School of Law.

Mr. Black?

STATEMENT OF WILLIAM K. BLACK, ASSOCIATE PROFESSOR OF ECONOMICS AND LAW, UNIVERSITY OF MISSOURI-KANSAS CITY SCHOOL OF LAW

Mr. BLACK. Members of the committee, thank you.

You asked earlier for a stern regulator. You have one now in front of you. And we need to be blunt, and you haven't heard much bluntness in hours of testimony.

We stopped a non-prime crisis before it became a crisis in 1991 by supervisory actions. We did it so effectively that the people had forgotten it even existed, even though it caused several hundred million dollars in losses, but none to the taxpayers. We did it by preemptive litigation and by supervision. We broke a raging epidemic of accounting control fraud without new legislation in the period 1984 through 1986. Legislation would have been helpful; we sought legislation, but we didn't get it. And we were able to stop that because we didn't simply continue business as usual.

Lehman's failure is a story in large part of fraud. And it is fraud that begins at the absolute latest in 2001, and that is with their subprime and their liar's loan operation. Lehman was the leading purveyor of liar's loans in the world for most of this decade. Studies

on liar's loans show incidence of fraud of 90 percent. Lehman sold this to the world with reps and warranties that there were no such frauds.

If you want to know why we have a global crisis, in large part, it is before you. But it hasn't been discussed today, amazingly. Financial institution leaders are not engaged in risk when they engage in liar's loans. Liar's loans will cause a failure. They lose money. The only way to make money is to deceive others by selling bad paper, and that will eventually lead to liability and failure as well.

When people cheat, you cannot as a regulator continue business as usual. They go into a different category, and you must act completely differently as a regulator. What we have gotten instead are sad excuses. The SEC—we are told there are only 24 people in their comprehensive program. Who decided how many people there would be in their comprehensive program? Who decided the staffing? The SEC did. To say that we only had 24 people is not to create an excuse, it is to give an admission of criminal negligence—except it is not criminal because you are a Federal employee.

In the context of the FDIC, Secretary Geithner testified today that this event pushed the financial system to the brink of collapse. But Chairman Bernanke testified we sent two people to be on site at Lehman. We sent 50 credit people to the largest savings and loan in America. It had $30 billion in assets. We had a whole lot less staff than the Fed does. We forced out the CEO. We replaced the CEO. And we did that not through regulation, but because of our leverage as creditors.

Now, I ask you, who had more leverage as creditors in 2008; the Fed, compared to the Federal Home Loan Bank of San Francisco 19 years earlier? Incomprehensibly, greater leverage in the Fed, and it simply was not used.

So let's start with the Repos. We have known since Enron in 2001 that this is a common scam in which every major bank that was approached by Enron agreed to help them deceive creditors and investors by doing these kind of transactions. And so what happened? There was a proposal in 2004 to stop it, and the regulatory heads—it was an interagency effort—killed it. They came out with something pathetic in 2006 and stalled its implementation to 2007, but it is meaningless.

We have known for a decade that these are frauds. We have known for a decade how to stop them. All of the major regulatory agencies were complicit in that statement in destroying it. We have a self-fulfilling policy of regulatory failure because of the leadership in this era.

We have the Fed, the Federal Reserve Bank of New York, finding that this is three-card Monte. What would you do as a regulator if you knew that one of the largest enterprises in the world, when the Nation is on the brink of collapse, economic collapse, is engaged in fraud, three-card Monte? Would you continue business as usual?

That is what was done. Oh, they met a lot. They say, we only had a nuclear stick. It sounds like a pretty good stick to use if you are on the brink of collapse of the system.

But that is not what the Fed has to do. The Fed is a central bank. Central banks, for centuries, have gotten rid of the heads of

financial institutions. The Bank of England does it with a luncheon. The board of directors are invited; they don't say no. They are sat down. The head of the Bank of England says, "We have lost confidence in the CEO of your enterprise. We believe that Mr. Jones would be an effective replacement." And by 4:00 that day, Mr. Jones is running the place, and he has a mandate to clean up all the problems.

Instead, every day that Lehman remained under its leadership, the exposure of the American people to loss grew by hundreds of millions of dollars on average. Aurora was pumping out up to $3 billion a month in liar's loans. Losses on those are running roughly 50 cents to 85 cents on the dollar. It is critical not to do business as usual, to change.

We have also heard from Secretary Geithner and Chairman Bernanke, "We couldn't deal with these lenders because we had no authority over them." The Fed had unique authority since 1994 under HOEPA to regulate all mortgage lenders. It finally used it in 2008. They could have stopped Aurora. They could have stopped the subprime unit of Lehman that was really a liar's loan place, as well, as time went by.

Thank you very much.

[The prepared statement of Mr. Black can be found on page 122 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Black.

And now, our last witness—I probably should reiterate that we ask our witnesses to confine themselves to 5 minutes to summarize your testimony—Mr. Matthew Lee, former senior vice president of Lehman Brothers.

Mr. Lee?

STATEMENT OF MATTHEW LEE, FORMER SENIOR VICE PRESIDENT, LEHMAN BROTHERS

Mr. LEE. Thank you, Mr. Chairman, Ranking Member Bachus, and the other members of the committee. Thank you for inviting me here today to answer questions about my story. I provided a written statement. I will give an even briefer oral statement.

Many people don't know me. I was born and educated in the United Kingdom. I have an undergraduate and postgraduate degree from the University of Edinburgh in Scotland. In 1977, I joined the Arthur Young London office in the U.K. I was transferred in 1981, 29 years ago, to the New York office of Arthur Young.

I have three accountancy qualifications, one of which is certified public accounting. I am registered in the State of New York. At Arthur Young, I specialized in financial services companies. I attained the position of principal, and I specialized in financing products, repo, reverse repo, securities lending. I also specialized in international securities and U.S. trust banks.

I made my career out of understanding internal control, identifying issues, figuring out potential issues, and resolving issues. That is what I did for a living. I was kind of like a professional whistleblower, if you would. Typically, my business was transacted by word of mouth. If you have a problem, you fix it—people usually fix it. I very rarely reduced my issue resolution to writing.

I joined Lehman Brothers just as it went public in 1994. I was hired in. I didn't answer an ad. I was approached because of my skill set as an issue identifier/resolver. They had an issue in their equity finance business at the time. I became global product controller, equity finance, in 1994. I held that position twice. I also held my final position twice, which was the global product controller of the global balance sheet—I am sorry, not global product controller—global financial controller of the firm's balance sheet and global legal entities.

There were a number of issues over the years at Lehman. If I fast-forward to the end of 2007, beginning of 2008, I had my normal load of issues, which were discussed regularly with my peers, with my boss. Those included the first five items in my May 16th letter, which I will get to in a second. They also included issues in the second e-mail that was talked about earlier that I am sure we will talk about later.

My own personal issues were not being addressed at all in the 6 months in 2008. Other issues were not being addressed. There was very little communication, between people senior to me and myself, giving me some kind of pacification as to why these issues weren't being resolved.

So, on May 16th, which was 2 weeks before the end of the second quarter, I hand-delivered my letter to the four addressees. And I will give a quick timeline of what happened. May 16th was a Friday. On the Monday, I sat down with the chief risk officer and discussed the letter. On the Wednesday, I sat down with general counsel and the head of internal audit and discussed the letter. On the Thursday, I was on a conference call to Brazil; somebody came into my office, pulled me out, and fired me on the spot without any notification.

I stayed another 2 weeks. I had other meetings with internal audit. I realized that nothing was being done about my letter. I was so mad that nothing was being done that I said, okay, I am going to write down some issues that were outside my domain. I drafted a second letter. I sent it to my attorney, who decided not to issue it. Instead, he wrote the meat of the letter in two paragraphs in an e-mail that was discussed earlier.

Sorry, I have gone over. I will keep going.

The Repo 105 issue was included in there. I mentioned that was outside my domain. That e-mail was issued on June 10th. On June 12th, I met with Ernst & Young for the first time. In attendance also was the general counsel of Lehman Brothers and the head of internal audit. At one point, the general counsel and head of internal audit left. I was left alone with Ernst & Young, two partners.

As I said, I started out life, I worked several years for Ernst & Young. I have a loyalty to them. I said, well, if Lehman Brothers is not going to address this—they had already dismissed my e-mail through my attorney—that they were having nothing to do with my issues and other people's issues. So I told the contents of that e-mail—I didn't have the e-mail with me—to Ernst & Young, which is where they learned about Repo 105 and a couple of other issues. There was an audit committee the next day. I think we next—sorry, I am just ending now.

The only other point of note is on page 960 of the examiner's report, there is a reference to a presentation to the audit committee about my May 16th letter, some of the points. It does not have any content of the e-mail in it. I was not asked to give any input to that presentation or to the audit committee.

Sorry, I have overrun my time. I will accept any questions. Thank you.

[The prepared statement of Mr. Lee can be found on page 175 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Lee.

I am going to take my 5 minutes to start with.

I thought, when the first two witnesses started, it was going to be a boring session. Then, I heard the next two witnesses, and I wondered why we didn't provide baseball bats. There seems to be a material disagreement as to whether there is any responsibility at Lehman, or whether or not any rules or regulations were violated. Certainly, that is obviously the conclusions we draw from the latter two witnesses.

Let me just simply try and classify your testimony, Mr. Fuld. As I heard you testify, you did nothing wrong, you performed to the standard one would expect from the chief executive officer, and the termination of Lehman Brothers was just something that happened. Is that a relatively correct summation of your testimony?

Mr. FULD. Mr. Chairman, I wish it were that easy.

Mr. KANJORSKI. I did not hear you take any responsibility.

Mr. FULD. I have testified before where, at that time, I said both in my written and oral testimony that I take full responsibility for the decisions that I made. And all I can say to you is that I made those decisions, I had the information at the time that I thought was accurate and, with that, made a prudent decision.

Mr. KANJORSKI. What caused the demise of Lehman Brothers?

Mr. FULD. A number of factors.

Mr. KANJORSKI. What are they?

Mr. FULD. A little bit of history. I am not going to go back for a whole 150 years, because that is not appropriate. Lehman started as a public company in 1994. We were predominantly a fixed-income house. We grew over time, added an equity capability, added a strong investment banking capability, built out Europe, built out Asia. We eventually built out to an organization that had 28,000 people, hundreds and hundreds of business lines and products, as I talked about, 40 countries, five continents.

Mr. KANJORSKI. I am not sure I understand. You became too large? Is that the point you are making?

Mr. FULD. No. I think there were other organizations that were larger than ours.

Mr. KANJORSKI. I agree. But what happened? Can you succinctly tell us just why did Lehman Brothers fail?

Mr. FULD. There were a number of initiatives that we undertook as we grew. Please understand that the last 5 years of our operation were all record years. We had grown from an organization that went from net income of about $100 million to an organization that had $4 billion. We went from an organization that had equity of about a billion to about $28.5 billion. We had been known for strong risk management. We had been known for, "when in doubt,

fall back and do the right thing." We had been known for strong culture.

I am trying to put in place, though, the pieces of what were the bases upon which we made decisions. You are asking me specifically where did we go wrong.

Mr. KANJORSKI. Very simply, what caused your demise? I do not think it is hard—did you over-invest in risky obligations? Did you have a less than adequate staff hired and executive execution? There have to be some fundamental reasons. I can agree that you will not give us one cause. But do not give me an advertisement of 25 years or 20 years of the company.

Mr. FULD. Mr. Chairman, I didn't mean to do that. I was trying to lay a foundation, though, for the mentality of the place from which we were coming.

Mr. KANJORSKI. You heard the testimony earlier that you had reserve funds that were inadequate because they were pledged in two different categories.

Mr. FULD. That we had what? I am sorry.

Mr. KANJORSKI. You had capital reserve funds, but that they, in fact, had been pledged in different directions so they were not adequate and should not have been exposed on your balance sheet as reflecting the standard of equity that you had. Is that true or not true?

Mr. FULD. I am not sure of what you meant by that, but—

Mr. KANJORSKI. There was testimony earlier, I think by the examiner, that in one instance, you had $2 billion on the books and in another instance, you had $5 billion on the books, neither of which should have been on the books because they were encumbered in some other transaction.

Mr. FULD. You are talking about liquidity; I am sorry.

Mr. KANJORSKI. Yes.

Mr. FULD. We built a strong liquidity base from the mid-20s, 30s, to the low 40s. We had a series of stress tests with the Fed. I went, personally, to all three of those. Not once did I hear any feedback that led me to believe that we were deficient.

Mr. KANJORSKI. How about the day when they told you that you had to go down? Do you mean to say that nobody ever told you that you were insufficient or you did not realize you could not cover your obligations on that famous Sunday?

Mr. FULD. There was a facility in place where Lehman had access to the Federal Reserve borrowing window—

Mr. KANJORSKI. So you were looking for a bailout?

Mr. FULD. I did not say that.

Mr. KANJORSKI. No, well, let us say it. When you were looking at the Federal Reserve access to funds, if you cannot get that, what was your methodology to stay in business and where were you going to get the sufficient collateral to do so?

Mr. FULD. My meaning for saying that was that facility had been in place. We had never needed it. We had not used it. We financed ourselves that Friday night. When the Fed opened the window for all the investment banks for additional collateral, we all turned to each other and said, "We are fine. We will get through this." We then learned that window was denied to us.

Mr. KANJORSKI. Yes, that was not quite correct, was it, because obviously you went down?

Mr. FULD. The window was closed to us that night.

Mr. KANJORSKI. Let me ask the question: Did you falsely go down? Were you able to survive, and the Federal Government forced you to go into bankruptcy in some way? Then, we have a whole different—

Mr. FULD. I can just tell you the facts. The facts are that—

Mr. KANJORSKI. My time has expired, so I am going to pass along to my friend from Alabama. But—

Mr. BACHUS. Let me ask unanimous consent—

Mr. FULD. You hit on a good question. I would love to—

Mr. KANJORSKI. Unfortunately, we do not have all afternoon for an answer. I was hoping we would get a simple response.

The gentleman from Alabama?

Mr. BACHUS. Before my time starts, if you will, could we have an additional 3 minutes on our side too?

The CHAIRMAN. To make up for that, I would certainly have no objection.

Mr. BACHUS. I will divide it as a minute between the three gentleman who are here presently on this side. Thank you. Thank you, Mr. Chairman.

My first question, Professor Black, both Secretary Geithner and Chairman Bernanke, in answer to my question about the failure of the Federal Reserve and Federal Reserve New York to require Lehman to correct its material misrepresentations on the grounds that they said they didn't because they weren't Lehman's primary regulator, do you find that explanation convincing?

Mr. BLACK. No. I think I have it word for word that Secretary Geithner said that this pushed the financial system to the brink of collapse. I don't follow business as normal when I was a regulator when that happens.

Mr. BACHUS. Right.

Mr. BLACK. I insist that the problem be fixed. And the Fed had astonishingly large leverage, all the leverage that it needed, if it had exerted it. And, of course, Chairman Bernanke was the one who should have been excerpting it.

Mr. BACHUS. Right. And they ignored what the examiner has I think correctly said, material misrepresentations on the grounds that they weren't acting in a regulatory capacity.

Is it ever appropriate for a government regulator to look the other way because he is not the regulator?

Mr. BLACK. It is worse than that. We have a duty as regulators—we swear an oath to protect. We have a duty to make a referral to the Securities and Exchange Commission when we find any evidence of securities fraud. We always did that as regulators. And we have a duty to make criminal referrals. I didn't hear anything about criminal referrals, except from the bankruptcy examiner.

Mr. BACHUS. Right. They were also a creditor and a counterparty, and they are obviously an agency of the U.S. Government and the taxpayers.

Mr. BLACK. That makes it even more bizarre. As I said, we had a staff at the Federal Home Loan Bank of San Francisco, a far smaller place, of 50 going through the credit files. If we were going

to take exposure to something like Lehman, which was vastly more complicated and had far more problems, we would have had a staff—the equivalent staff would be sending 300 people from the Federal Reserve Bank of New York. Instead, they did a pittance.

Nothing squares. You can't believe that the whole global system is about to come down and then say, "Well, sorry, we can't do anything, and we won't try."

Mr. BACHUS. Right. Also, the bankruptcy examiner described Secretary Geithner's fear that if Lehman had tried to reduce its leverage by selling assets, the markets would have discovered air in the marks in those assets. In other words, the markets would have discovered they were grossly overvalued.

What do you make of Secretary Geithner's comments about the air in the marks of Lehman assets and the fact they didn't disclose that to the investing public?

Mr. BLACK. Well, he was asked about it twice that I recall, and he didn't answer either time.

Mr. BACHUS. Right. I asked him once.

Mr. BLACK. Yes, but another Member brought it up. He didn't respond either time.

It is, of course, the most obvious reason why the Fed wouldn't require honesty in accounting. Because honesty in accounting would have shown that the problem was not liquidity at Lehman. That was a symptom of the underlying problem that it was massively insolvent, which is, of course, what the bankruptcy examiner commented to someone when he said that the liabilities are grossly in excess. And those are Secretary Geithner's own words. That is not any of us creating a hypothetical.

Mr. BACHUS. Thank you.

Mr. Fuld, did you ever, in 2008, mention oversight by the SEC or the Fed in an effort to convey the impression that Lehman was sound or in good financial shape?

Mr. FULD. Did I ever mention it?

Mr. BACHUS. Yes, as a reason why people should consider Lehman as financially sound.

Mr. FULD. I don't recall that I did.

Mr. BACHUS. Okay. What about Andrew Sorkin in his book, "Too Big To Fail," where he quotes you as telling Jim Cramer, "I am on the Board of the Federal Reserve of New York. Why would I be lying to you? They see everything." And you were explaining to him that you all were sound by saying the Fed and the New York Fed and the SEC are in there every day, they are watching everything we are doing, and we are financially sound. What did you mean by the statement, "They see everything?"

Mr. FULD. I don't recall that comment specifically. But, in all fairness, the Fed and the SEC were on premises, they saw our liquidity, they saw our capital positions, they saw our mark-to-market processes. And I believe they saw everything that we were doing real-time.

Mr. BACHUS. Yes. And I could agree that would convey a sense of confidence by them at least that you were doing things right.

Did they ever question what you were doing? Did the SEC or the Fed ask you to do something different? Did they ever ask you to

change something you were doing for safety and soundness reasons?

Mr. FULD. Not that I am aware of. But I do recall conversations, less so with the SEC, more so with President Geithner, where we talked about potential capital providers and potential structures. I believe I discussed with him the vast number of people with whom we had conversations about additional capital, potential investors, about a structure for commercial real estate. And I actually thought those conversations were strong and productive.

Mr. BACHUS. Did they lead you to believe that they might interject capital into Lehman or bail you out as they had done Bear Stearns?

Mr. FULD. No.

Mr. BACHUS. All right.

My final question is this. You said you were on the board of directors of the New York Fed. If you said that to Mr. Cramer, what would—and you don't recall that conversation at all, is that what you are saying?

Mr. FULD. I do recall having lunch with him, but specifically that comment, no.

Mr. BACHUS. All right. If you said that, what would you be trying to convey, that you were on the board of directors of the New York Fed?

Mr. FULD. As I think about it now, my conversation—I don't know. In all fairness, you have asked me a question, so I will try to answer that. If they had something to say, they would have said it to me.

Mr. BACHUS. Who is "they?"

Mr. FULD. If the Fed had something to say to me regarding our position or condition that needed to be corrected, modified, or changed, I had enough conversations with Fed officials that they would have said it to me. And that is why, at the third quarter, in my announcement, I actually said, I believe these last two quarters are behind us.

Mr. BACHUS. Okay, that is fair enough. Thank you.

Mr. MILLER OF NORTH CAROLINA. [presiding] The gentleman's time has expired.

The Chair recognizes Chairman Frank for 5 minutes.

The CHAIRMAN. Thank you.

I wanted to pick up on something Mr. Black said as I was coming in. I apologize for the fact that I had to be elsewhere. And it was a very important point referencing the fact that in 1994, this Congress passed the Homeowners' Equity Protection Act. It was actually largely led by my predecessor as the senior Democrat, John LaFalce, who was not the chairman at the time. Chairman Gonzalez was the chairman; the Democrats were in the majority.

But that bill was passed in 1994, and it was then explicitly ignored by Mr. Greenspan. And that is really very important, because there has been a lot of discussion about what happened and why we had the subprime mortgages.

And, as Mr. Black also noted, the Federal Reserve 14 years later used that authority. And that is important to note, because the authority that Mr. Bernanke used to regulate subprime mortgages was exactly the authority that Mr. Greenspan had had, it ought to

be clear. Some have said, "Well, the authority was deficient." But what Mr. Bernanke invoked in 2008 was exactly the same statutory authority that Mr. Greenspan refused to use.

And that is important because there has been this debate. And some have argued—and I think this is an important one—that the Federal Reserve is responsible for the housing bubble because it failed to deflate the entire economy, or that it allowed interest rates to be set by other considerations. Frankly, I was supportive of those decisions. I think to have, in effect, added to unemployment to deal with the housing bubble would have been excess.

The Fed had an alternative, and I appreciate Mr. Black making it clear. There was a way to deal with the subprime problem under Federal Reserve authority other than deflating the whole economy or restraining growth, to be more neutral, in the whole economy. It was to use the specific authority that was given by the Congress in 1994 to Mr. Greenspan. And there were efforts to get it used.

My colleagues, the gentleman from North Carolina, Mr. Miller, who is now presiding, the gentleman from North Carolina, Mr. Watt, working with the Center for Responsible Lending and others in North Carolina who identified this early—first we tried to get Mr. Greenspan to use that authority. When he refused to do it, there was an effort in the Congress specifically to mandate what didn't happen. We were frustrated. It became an ideological dispute. We were then in the minority.

In 2007, when Congress again changed hands, we did pass such a bill in the fall of 2007 to mandate what the Fed had been permitted to do but didn't do. The bill did not pass the Senate.

There is a phrase on the recorder's word processor that says, "The bill did not pass the Senate." He only has to hit one key to get that printed. It saves a lot of time.

But the Federal Reserve, to its credit, then acted. Now, I say that in part to note—and this becomes relevant—when we deal with the consumer agency, people have pointed to actions taken by the Federal Reserve under Mr. Bernanke, and that is accurate. But in every single case, action by the Federal Reserve came after this committee had initiated some action, or the whole House. But I did want to just thank Mr. Black for that point.

Let me now—just one question to Mr. Lee. When you raised these issues, what was the general response you got?

Mr. LEE. From within Lehman, annoyance. From Ernst & Young, they knew it. They knew the points.

The CHAIRMAN. They knew it, but were they supportive? Did they say, "Oh, yes, but that is okay?" Did they defend it? What did Ernst & Young say?

Mr. LEE. They certainly didn't support it. On the Repo 105 issue, they knew about it. They did not appear to know the number was so large. It had risen from 25 sometime in 2007 to over 30 by November 30, 2007, to 49 at the end of the first quarter.

The CHAIRMAN. Let me ask you, to the extent there was any ambiguity, do you think the FASB's subsequent revisions have improved the situation?

Mr. LEE. I can't really comment on that. FAS 140 needs to be killed, if it is not already.

The CHAIRMAN. They have replaced it. All right, I appreciate it. I guess there is a certain historical sense of justice in that Lehman Brothers went to the United Kingdom to get their opinion, and so the United Kingdom sent you back to get even. So I think that at least you have sort of made us a little bit more whole vis-a-vis the United Kingdom in this.

Thank you, Mr. Chairman.

Mr. MILLER OF NORTH CAROLINA. Thank you.

The Chair recognizes the gentleman from California, Mr. Royce.

Mr. ROYCE. I am going to defer to the gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Fuld, I assume you were here for Mr. Valukas' testimony earlier. Yes or no?

Mr. FULD. I did hear a good piece of it, yes, sir.

Mr. HENSARLING. On page 3 of his testimony, he represents that Lehman represented to the SEC in writing that its firm-wide risk appetite limit was a "binding constraint" on its risk-taking that "could not be exceeded under any circumstances," but management did not observe the limits.

Do you agree or disagree with that assertion?

Mr. FULD. We set up risk appetite with a lower-level hurdle of 8 to 10 percent. That was the level below which we were not allowed to go, as an internal standard.

Mr. HENSARLING. But what did you represent to the SEC?

Mr. FULD. What we represented to the SEC was that, given our—actually, the same thing. But given our level of revenues—let me explain first what risk appetite was, if I may, just to put it in context. I don't mean to be too technical, but it is important that you understand it.

Risk appetite was the amount that the firm could lose in a year and still pay all of its expenses and create an after-tax ROE of 8 to 10 percent. Now—

Mr. HENSARLING. Mr. Fuld, I understand that. Here is the bottom line, and my time is limited. Mr. Valukas says that Lehman made a representation to the SEC that they were binding limits, but yet the limits were breached. So do you agree or disagree with that assertion?

Mr. FULD. The binding limit was at 8 to 10 percent. Our risk appetite was set at $4 billion. It changed, in all fairness, between $3.6 billion, $4 billion, $4.2 billion. Had we, in fact, lost $4 billion, that would have triggered a 12 to 12.5 percent ROE. So the risk appetite was set with a huge cushion.

Mr. HENSARLING. I understand that. It is just a simple question. Do you agree or disagree with the assertion?

Mr. FULD. The assertion was that at 8 to 10 percent, we were not supposed to go below that internal standard.

Mr. HENSARLING. On page 4 of Mr. Valukas's testimony, he states that Lehman had in place a stress-testing program designed to assess whether Lehman could survive a series of both hypothetical and historical stress scenarios, but Lehman did not include many of its riskiest assets in its stress testing, such as commercial real estate.

Again, a simple question: Do you agree or disagree with that assertion?

Mr. FULD. That was the case until, I believe, towards the end of 2007. The day-to-day marking of commercial real estate was an impractical exercise. But then again, that was—the risk committee and the executive committee said, regardless of that we will include commercial real estate because it is becoming more an important part of our portfolio.

Mr. HENSARLING. So, at some point it was included. Is that what you are saying, Mr. Fuld?

Mr. FULD. I am sorry, I didn't hear—

Mr. HENSARLING. At some point, you are saying the commercial real estate was added to the stress test? Is that what I am understanding from you?

Mr. FULD. Yes, sir, it was. Yes, sir.

Mr. HENSARLING. Okay.

Let's talk about the Repo 105 transactions. Mr. Bart McDade is the former president and COO of Lehman; is that correct?

Mr. FULD. Yes, sir.

Mr. HENSARLING. So he would have answered to you. I assume you were there contemporaneously, served at the same time; is that correct?

Mr. FULD. Yes.

Mr. HENSARLING. Okay. Are you familiar with the e-mail exchange between himself and a Mr. Lee, not the Mr. Lee at the panel—it is exhibit 7, if we could get if it up on the chart—where we had Mr. Lee asking Bart, "I am sure if you are familiar with Repo 105, but it is used to reduce net balance sheet in our government's business around the world." The answer from former president and COO: "I am very aware it is another drug we are on."

Are you familiar with this e-mail exchange, Mr. Fuld?

Mr. FULD. Yes, sir, I am.

Mr. HENSARLING. Do you have an opinion on what your former president and COO meant by, "it is another drug we are on?"

Mr. FULD. No, I do not. As I said before, I clearly was not aware of Repo 105.

Mr. HENSARLING. How about Mr. Michael McGarvey? I am led to believe he was a senior member of Lehman's finance group. Are you familiar with Mr. Michael McGarvey?

Mr. FULD. Michael McGarvey?

Mr. HENSARLING. You are unfamiliar with this gentleman? He had an e-mail exchange with another Lehman employee, "So what is up with Repo 105?" Answer from Mr. McGarvey, "It is basically window dressing. We are calling Repos true sales based on legal technicalities."

I was informed that Mr. McGarvey was a senior member of the finance group. You are unaware of his existence? You are not familiar with the gentleman of this particular exchange?

Mr. FULD. I am not.

Mr. HENSARLING. I see my time has expired.

Mr. MILLER OF NORTH CAROLINA. Thank you.

The Chair recognizes Mr. Moore for 5 minutes.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Mr. Fuld, in your written testimony dated April 20, 2010, you say, "Let me start by saying," and this is a quote, "I have absolutely no recollection whatsoever of hearing anything about Repo 105 transactions while I was CEO of Lehman."

Is that correct, sir?

Mr. FULD. Yes, sir.

Mr. MOORE OF KANSAS. Were your employees hiding this from you?

Mr. FULD. No, they were not.

Mr. MOORE OF KANSAS. Then why would you not know about this? Did they not know about it?

Mr. FULD. It was nothing about hiding. These transactions were sale transactions of government securities that occurred on the government trading desk—let me try to put this in some context, if I can, for you.

Mr. MOORE OF KANSAS. Well, please do.

Mr. FULD. On any given day, Lehman moved through its system over a trillion dollars. On any given day, Lehman traded between $50 billion and $100 billion of governments. We were probably one of the largest government dealers in the world. That is $50 billion to $100 billion a day. There is no reason why I would have known about a sale of governments, there is no reason why I would have known about these Repo 105 transactions, because there was inherently nothing wrong with them.

As CEO, I ran more of a "what do I really need to be focused on" mentality. I was focused on less liquid assets, commercial real estate, residential mortgages, leveraged loans. I was not focused on the most highly liquid securities, I was not focused on government securities day to day that could vary between, as I say, $50 billion and $100 billion a day.

My focus was more about, what could impact our capital? Governments very rarely, if ever, impacted our capital. Less liquid assets, they impacted our capital position. Over the 2 years of 2007 and 2008, Lehman wrote down close to $25 billion that were essentially tied to our less liquid asset position. That was my focus.

Mr. MOORE OF KANSAS. Let me stop you there, sir. You say your focus was on what impacted our capital, correct?

Mr. FULD. Yes, sir.

Mr. MOORE OF KANSAS. Was the fact that your firm was offloading $50 billion worth of assets at the end of each quarter to cover up how overleveraged its balance sheet had become, was that not important to you at all?

Mr. FULD. These government securities were sold. They were gone. On any given day, another 50 could be sold.

Mr. MOORE OF KANSAS. I know $50 billion might not seem a lot to Wall Street, but shouldn't a CEO be aware of transactions involving that kind of money, sir?

Mr. FULD. Whether it is Wall Street or anywhere, $50 billion is a lot. It is always a lot. And I do not want to leave the impression that $50 billion, regardless of any industry, is an insignificant number.

But I must say to you that, with the focus of less liquid assets, whether our balance sheet, which is an indication of one point in

time, was up or down $50 billion or $100 billion of governments, I will say to you, sir, that was not my focus.

Mr. MOORE OF KANSAS. In view of what has happened, should it have been your focus?

Mr. FULD. I wasn't involved in those transactions or the structuring.

Mr. MOORE OF KANSAS. You are the CEO, aren't you, sir—weren't you?

Mr. FULD. I was very much the CEO, sir.

Mr. MOORE OF KANSAS. Okay. Shouldn't you have been focused on some of that, then, in what you know now?

Mr. FULD. In what I know now, we had a thorough process around us, our auditors approved it, legal counsel signed off on disclosure. And, as I have come to understand this, there was nothing wrong with the Repo 105 transaction.

Mr. MOORE OF KANSAS. And looking back now, your testimony is there was nothing wrong with what happened at Lehman Brothers?

Mr. FULD. That is a different question.

Mr. MOORE OF KANSAS. Answer that question for me, if you would, sir.

Mr. FULD. Which goes back to the earlier question of, what did we do wrong?

What we did wrong is I believe that we did not understand the contagion of one security, one asset class to the next. I believe that we did not—and I take responsibility for this—I did not see the depth and violence of this crisis. I believe early on we had too much commercial real estate. I believe we corrected that; we went from $50-some-odd billion down to $32 billion. We corrected our residential positions; we went from 30-some-odd down to 17. We corrected our leverage loan positions; went from 45 in mid-2007 down to less than 10. We raised capital and—

Mr. MOORE OF KANSAS. Let me stop you, sir. I am about out of time here. Mistakes were made, correct?

Mr. FULD. I would say that bad judgments were made regarding the market, yes.

Mr. MOORE OF KANSAS. And I hope that other CEOs of other companies can learn from the mistakes that Lehman Brothers and you made, sir. Would that be a worthwhile goal here?

Mr. FULD. Yes, sir, it would.

Mr. MOORE OF KANSAS. Thank you.

I yield back my time.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Moore.

Mr. Royce of California for 5 minutes.

Mr. ROYCE. Thank you, Chairman.

I want to return to an argument made earlier by the chairman of the committee that the policies at the Fed on inflation could have been offset by the regulatory oversight, proper regulatory oversight. And perhaps that is true, but it was Chairman Bernanke who argued for setting the Fed funds rate in 2002, June of 2002, at a negative level, below inflation. Fed fund rates for 4 years running was negative.

And the argument that Congress was making at the time to put everybody in a home, regardless of whether they had means for a

downpayment, we were allowing over at Fannie and Freddie the types of overleveraging that also introduced that on top of the bubble.

So, for the record, I would make the observation that running negative interest rates for 4 years running doesn't help unemployment. In fact, it guarantees that when the bubble bursts, there is going to be much higher unemployment because you have made money so cheap that basically you have misallocated capital. You have sent to the market the wrong signals, and you have misallocated capital.

And I think it is important, at some point, that be understood as one of the contributors to this besides the kinds of malfeasance—in addition to the malfeasance that we are talking about that occurred in the boardrooms.

And, as for the boardrooms, I want to go into a couple of questions here. Given this ongoing presence—I will ask Mr. Fuld—of the Fed and the SEC mentioned in your testimony, and the fact that your much smaller competitor, Bear Stearns, which was far less interconnected, received government assistance just months, by the way, prior to your situation, were you working under the assumption that Lehman would be bailed out?

Mr. FULD. No, sir, I was not.

Mr. ROYCE. You were not? Or a similar arrangement, perhaps, as to what happened with Bear Stearns, the diamond deal? You weren't working under the assumption that might happen in your situation, as well?

Mr. FULD. No, sir, I was not.

Mr. ROYCE. So, in your view, these bailouts do not create a moral hazard that, at least in your instance, created the anticipation that you might get the same workout as other companies.

Mr. FULD. I—

Mr. ROYCE. Okay. With respect to the firms you did business with, your creditors and your counterparties, do you believe that there was the presumption that Lehman should be treated as just another counterparty, or do you think they assumed that, like Bear Stearns, there might be the government behind it?

Mr. FULD. You have touched on a very interesting piece which I would like to talk about.

There were two claims at the end of—or September 15th after Lehman. One was that there was a huge capital hole. Some said $30 billion; some said some other numbers. One thing that the examiner's report pointed out was that, as you went through the different asset classes, there were some pluses and minuses, some reasonableness, some unreasonableness, but at the end of the day, it was somewhere between an immaterial difference of $500 million and, let's say, $1.7 billion, rounded off to $2 billion. That would have lowered our equity from 28.5 to, let's say, 26, positive.

The world believed that we had a capital hole. So for those who thought it was 30—

Mr. ROYCE. Well—

Mr. FULD. This is important, though, sir—

Mr. ROYCE. It is important, and we have your answer for the record. From my standpoint, what I think the world believes is that

once we have done bailouts, we are going to do future bailouts. I voted against the bailouts. I thought it was a very bad precedent.

But I will just go back to, Hayek won the Nobel Prize in 1974 by explaining exactly how government intervention in these cases helps cause this boom-bust cycle in the economy. And I can't for the life of me see why people can't understand why running interest rates that are negative for 4 years in a row and then failing to control the overleveraging, and then Congress' culpability in terms of going in and allowing further leveraging, wouldn't have this impact.

And I don't want to see those who are CEOs have the ability in the future to get a bailout at the expense of the taxpayers. And this underlying legislation is the wrong approach to prevent it.

Thank you. I yield back.

Mr. MILLER OF NORTH CAROLINA. Thank you.

The Chair now recognizes himself for 5 minutes.

I want to pursue the line that Mr. Royce just raised about the role of Fannie and Freddie. I understand that you were direct competitors with Fannie and Freddie. You did the same thing they did. You bought mortgages, you created pools, you sold securities based upon those.

Only, unlike Freddie and Fannie, you did not have a dual mission. Your only mission was making money, not making money and supporting affordable housing. Isn't that right? You were just about making money; there was no affordable housing goal for Lehman Brothers. The Treasury or HUD wasn't setting affordable housing goals for you, right? You were just under a requirement to your shareholders to make money, to make profits. Isn't that right?

Mr. FULD. I believe all of us had a clear-minded view that the Administration wanted everybody in the industry to extend themselves to fulfill the American dream.

Mr. MILLER OF NORTH CAROLINA. But you were also making a very tidy profit from securitizing mortgages, isn't that right? You spoke earlier, in response to Mr. Kanjorski's questions, about how much you grew largely as a result of your participation in the residential mortgage real estate market. Isn't that correct?

Mr. FULD. We did in the early years. The latter years, we did not.

Mr. MILLER OF NORTH CAROLINA. Okay. Did Freddie and Fannie have anything to do with Lehman's failure or with your buying subprime mortgages and selling securities based upon them, or Alt-A, what Mr. Black called liar's loans, and selling securities based upon them? It didn't have anything to do with Fannie and Freddie, did it?

Mr. FULD. Not the way you are asking that question. But the events of the weekend before did impact us, yes, sir. Different question, but—

Mr. MILLER OF NORTH CAROLINA. Your business over the course of the last decade, your participation in the subprime market, your participation in the Alt-A market, at the liar's loan market, didn't have anything to do with Fannie and Freddie, did it? You were competitors with them, were you not?

Mr. FULD. Sometimes, we were competitors, and sometimes, we sold into their conduit. So we were both a client and a competitor.

Mr. MILLER OF NORTH CAROLINA. All right.

Now, Mr. Fuld, you just said in response to Mr. Royce's questions that you never expected a bailout. That is different from other accounts—Andrew R. Sorkin's account, Secretary Paulson's account. They have both written books so far. All of the published accounts say that you assumed until the very end, until that weekend, that, in fact, you would be rescued.

And Mr. Valukas, what he said earlier about the kind of things that could have been done earlier that would have made the collapse a little less catastrophic for the entire economy were, in fact, passed on. There was an opportunity to sell Lehman, all or part of Lehman, to a Korean firm, the Korean Development Bank, to sell half of it to a Chinese bank, Citic. There were apparently discussions about selling your assets management unit that never happened; selling your headquarters that never happened.

Mr. Fuld and also Mr. Cruikshank, as a member of the board, what do we have to do to impress upon CEOs and boards of directors that they will be allowed to fail and they will not be rescued?

Mr. FULD. Let me go first, if I may, because you mentioned me first.

We got to that fateful weekend. Looking at the asset valuations, we had strong capital. We had lost $30 billion of liquidity in 2 days. There was another claim we had no collateral. We had plenty of collateral, as evidenced by the fact that on that Monday we put up $50 billion of collateral to get a loan from the New York Federal Reserve Bank—all of which, by the way, was paid back 100 percent.

So we had collateral, we had capital. We did not need a capital bailout; we needed a liquidity bridge so that we could consummate the sale to a potential buyer. That is what we needed. Or we needed the window to be extended to us as it was extended to the other investment banks and banks that Sunday night.

To be even more clear, when we heard that the bank was being opened, that the Federal Reserve window was being opened that Sunday night, we all said, "We are fine. We are going to get this done." We then heard it was not being opened to us, specifically.

Mr. MILLER OF NORTH CAROLINA. But, Mr. Fuld, that really isn't at all responsive to my question.

Mr. FULD. Then I apologize. I must have missed that then.

Mr. MILLER OF NORTH CAROLINA. Mr. Cruikshank, what can we do to convey to boards of directors and CEOs that they are going to be allowed to fail, that there is no safety net? That if they become insolvent, they will be taken into a receivership, that CEOs will lose their jobs, top management will lose their jobs, boards of directors will lose their jobs, shareholders will lose everything, creditors will not get paid, and taxpayers are not going to be on the hook? What do we need to do to convince you that is what the future holds?

Mr. CRUIKSHANK. Frankly, Mr. Chairman, I was convinced at the time that there would not be a bailout. And don't misinterpret my statement, because what I was saying was that I think we could have avoided a lot of disruption by putting into place now what they say they don't have. I wondered if some of these actions that they took with others would have gotten us to a much softer land-

ing. I am not talking about a bailout. I thought right up to the end that, after the flak that had been received by the Fed and the Treasury after Bear Stearns, that it would be highly unlikely they would want to do that again.

Mr. MILLER OF NORTH CAROLINA. The Chair recognizes Mr. Lance.

Mr. LANCE. Thank you, Mr. Chairman.

And good afternoon to you, gentlemen.

Mr. Cruikshank, to follow up, in your remarks, do you believe there were corporate governance failures at Lehman?

Mr. CRUIKSHANK. No, I don't. I think our governance procedures were really very good.

I have stated in my statement that I believe the major problems with Lehman were just what I said. Basically, if you will remember, in 2006, we had had years of very profitable real estate operations in this country. Real estate was thought to be pretty much gilt-edged.

Then the market was going up, we had had record earnings, we were getting bigger, and the business decision was made to expand our proprietary investments. And part of that was going into real estate. I think it ended up that real estate was one of our major problems, obviously.

The other thing was that an investment bank cannot continue to exist once confidence is lost and there is a run on the bank. You can hardly have enough capital for that. And that occurred for a lot of reasons, some of which I have also outlined in that statement.

Mr. LANCE. But it is your opinion that you did not think you would be bailed out simply because there had been a bailout earlier in the year regarding another entity?

Mr. CRUIKSHANK. I would certainly not have counted on that.

Mr. LANCE. Thank you.

Mr. Lee, in your opinion, were the executives at Lehman Brothers hiding the true nature of the firm's global balance sheet from either the SEC or the Federal Reserve or both?

Mr. LEE. I think on the basis of disclosure, the answer is yes.

Mr. LANCE. And could you elaborate on that?

Mr. LEE. I am not an accounting financial disclosure expert, but based on the knowledge I have gained over the years, I think that the public was misled as to the true leverage of Lehman Brothers, at least during fiscal 2008.

Mr. LANCE. Thank you, Mr. Lee.

And, Professor Black, both Secretary Geithner and Chairman Bernanke have excused the failure of the Fed and of the Federal Reserve Bank in New York to require Lehman to correct its material misstatements on the grounds that they were not Lehman's regulators.

Do you find that explanation convincing? And is it ever appropriate for a governmental regulator to ignore wrongdoing on the grounds that it is not acting in a regulatory capacity?

Mr. BLACK. It is never correct. You have a responsibility. And if the Fed does not have rules mandating that its employees make referrals to the SEC and to the Justice Department, they should change that today. There is still a little bit of time to do that.

But I believe that you will find that they have guidelines in place that require those kinds of referrals. And, unfortunately, it was hit with complete indifference. This is the quotation from the report from the Federal Reserve Bank of New York official: "How Lehman reports its liquidity is between Lehman, the SEC, and the world. We have no responsibility to deal with a violation of law that we found."

Mr. LANCE. Thank you, Professor.

And finally, Mr. Fuld, you indicate in your testimony that, beginning in March of 2008, the SEC and the Fed conducted regular, indeed daily, oversight of Lehman. You have answered questions from other members of the committee regarding this, but do you think that management at Lehman was given a false sense of security that the government might ultimately bail you out?

Mr. FULD. I don't believe that to be the case.

Mr. LANCE. Thank you.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. MILLER OF NORTH CAROLINA. Thank you.

The Chair recognizes Mr. Green of Texas for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

I do believe that fraud is important, because I think the American public would like to know if fraud was committed.

And, Mr. Black, you have indicated that you think fraud was committed. Is this with reference to the Repo 105?

Mr. BLACK. That is one of—

Mr. GREEN. That is the one I would like to focus on.

Mr. BLACK. Certainly.

Mr. GREEN. Explain to us how you contend that fraud was committed with the Repo 105.

Mr. BLACK. Because the Valukas examination report shows—and several of the things were quoted in this hearing—that the purpose of the transactions was to produce an artificially deflated idea of the exposure, the leverage of the corporation. That is important, that is material, to securities investors. So, if you deliberately create a deceptive representation that is material to investors, that is securities fraud. That is actually a felony.

Mr. GREEN. And are you of the opinion that this was committed at Lehman with the 105s?

Mr. BLACK. Repeatedly.

Mr. GREEN. I will come back to you if time permits. I will go to Mr. Lee.

Mr. Lee, you indicated that you delivered a message, hand-carried a codified message. You didn't say exactly what it was. Are you indicating to us that you were trying to tell the auditors that something improprietous was taking place?

Mr. LEE. Sir, I delivered my May 16th letter by hand. The auditors I never gave anything to. I verbalized what was in an e-mail. And, as I said—

Mr. GREEN. Let's talk just for a moment about the content. Were you trying to indicate that something improprietous was taking place?

Mr. LEE. In my mind, yes.

Mr. GREEN. And were you trying to indicate that this act could be harmful to investors?

Mr. LEE. That was underlying it, yes.

Mr. GREEN. Did you ever have an opportunity to communicate this?

Mr. LEE. What does "this" mean?

Mr. GREEN. The fact that there was something improprietous taking place that may be harmful to investors with reference to Repo 105s?

Mr. LEE. All my knowledge of Repo 105 was well-known in the firm. The other factors were well-known in the firm. I only—

Mr. GREEN. Excuse me. I would like to know how they became well-known. Did you tell some specific person or did you give it to someone in writing that these Repo 105s were in some way improprietous and may harm, at some point, investors?

Mr. LEE. At only one stage, did I put it in writing. But for months, years, it was—

Mr. GREEN. Is your answer yes, that you did convey this?

Mr. LEE. Yes, I did.

Mr. GREEN. And did you convey this to the audit committee?

Mr. LEE. I have never attended any audit committee.

Mr. GREEN. Did you convey it to an auditor?

Mr. LEE. I did, to two auditors.

Mr. GREEN. To two auditors?

Mr. LEE. Yes.

Mr. GREEN. Did you receive a response with reference to what you conveyed?

Mr. LEE. No, I did not.

Mr. GREEN. There was simply nothing said to you after you passed this on?

Mr. LEE. There was just acknowledgement that they knew about the issue. As I said earlier, they didn't know the amount, I don't think.

Mr. GREEN. Now, you have heard Mr. Black. He has used the term "fraud." Are you of the opinion that there was fraud?

Mr. LEE. I am not a lawyer. I can't comment.

Mr. GREEN. I will accept your answer.

Mr. Black, I do have enough time to come back to you. In your opinion, based on what you have said, it seems that you think that there was not only fraud in a civil sense but also fraud in a penal sense. Is this a correct statement?

Mr. BLACK. Yes. The elements are the same; there is simply a higher burden of proof of establishing those elements. So, if there is civil fraud, there is, in fact, criminal fraud, as well.

Mr. GREEN. Have you conveyed what you are sharing with us and perhaps other information to some authority that has the authority to investigate fraud?

Mr. BLACK. If you are familiar with my writings, I do this on a weekly basis.

Mr. GREEN. I would like it for the record. We have a record that we are trying to establish.

Mr. BLACK. Right. It is in my prepared testimony.

Mr. GREEN. Is your answer yes?

Mr. BLACK. Yes.

Mr. GREEN. And have you received a response with reference to what you called to the attention of these authorities?

Mr. BLACK. The SEC has never contacted me about any of the things I have attempted to alert the SEC about.

Mr. GREEN. My final question to you will be simply this: Name the authorities that you took evidence of fraud to.

Mr. BLACK. No, I took them public. I didn't take them simply in some secret letter to them. I wrote saying, the following things are frauds and need to be prosecuted.

Mr. GREEN. If you just write and publish it in the newspaper, how are you to assume that the proper authorities will know? I am sure that everybody reads your writing, but maybe someone might miss it who is in a position to do something.

Mr. BLACK. The SEC is, I can guarantee you, aware of the fact that I have been writing these things. And, this is something I have been doing for several decades.

Mr. GREEN. I will have to relinquish my time now. Thank you, Mr. Chairman.

Mr. MILLER OF NORTH CAROLINA. Thank you.

The Chair recognizes Mr. Wilson for 5 minutes.

Mr. WILSON. Thank you, Mr. Chairman.

My questions, gentlemen, are to Mr. Fuld and to Mr. Cruikshank.

The report finds that you made a deliberate and decisive move to embark on an aggressive growth strategy, to take on even greater risk. And when this strategy seemed to slow, instead of pulling back, you made the conscious decision to double down. Is that correct?

Mr. FULD. No, sir, it was not.

Mr. WILSON. Okay. Were there models of risk that you had that you were to go by and you were above them on numerous occasions most of the time. Is that true?

Mr. FULD. The model of risk for us—or the model of growth, I should say, for us was more about a wallet share of clients. It was a client-focused business. So it wasn't about taking on more risk.

The second piece of your question, though, is, if I heard it correctly, there were risk levels, we ignored them. Is that—or did I make that up?

Mr. WILSON. My understanding was you had models of risk that you were to go by and that you were consistently above the amount those models called for.

Mr. FULD. Those were internal guides that we set. I had this conversation with the examiner. I thought I explained it. And what I said was, we would look at these levels and understand why we tripped above a certain trigger. Some might have been volatility, some might have been because the hedge didn't work, some might have been because change of diversification.

One of the biggest moves in our risk appetite was our changing our own diversification benefit. We took exactly the same portfolio, gave a lower weighting to the diversification benefit, which moved our risk appetite, I forget the specific numbers but let's just say for example, from $3.6 billion to $4 billion. That was all our doing. It wasn't that we had bought something.

And, in all fairness, given the market, the way it was, you could have the same position from one day to the next, and because of

volatility and triggers and interaction of hedges, that, in itself, exactly the same position, could change your risk appetite.

And, in response to that, we reacted in a very strong, aggressive way and brought down those vulnerable securities—I won't take your time with it, but, again, commercial real estate, residential mortgages, leveraged loans. That was our focus.

Mr. WILSON. A lot of risk and a really increasing gamble. Do you gamble, Mr. Fuld?

Mr. FULD. Not the way you are asking, no.

Mr. WILSON. Because some would say the behavior that went on at Lehman was more that of a gambler than an executive on Wall Street.

Mr. FULD. I think that those who don't have the information and the accurate information might say that.

Mr. WILSON. You feel that, with the information that you have provided, that it wouldn't look like as much of a gamble; is that correct?

Mr. FULD. The information that I provided today is a tiny microcosm of who we were. Please understand—I hesitate to say this because you will—whatever. We were risk-averse. Commercial real estate—I know, I know, I—

Mr. WILSON. How can you say that?

Mr. FULD. —walked right into that one.

Commercial real estate was an area where, over the last 7 to 8 years, a terrific team, very talented, smart decisions. And I will tell you that the decisions that we made on the properties that we bought in commercial real estate—strong management teams, strong properties, strong locations. I will look at you, though, and tell you: terrible timing, bad timing. No, terrible timing.

Mr. WILSON. I have a couple other questions I would like to get in.

Before the Lehman bankruptcy, Treasury Secretary Paulson and Federal Reserve Chairman Bernanke told us our financial system could handle the collapse of Lehman. It is clear that was not true. And, from this report, it appears to me that the company knew that. Why? Do you agree with that?

Mr. FULD. I am sorry, you say "the company," meaning?

Mr. WILSON. Yes, Lehman.

Mr. FULD. We told Secretary Paulson on that fateful weekend that if—because we had been mandated, we didn't choose, we had been mandated by the Fed to declare bankruptcy. We told Secretary Paulson, "If you do that, there can be no orderly wind-down. There will be massive repercussions in the swaps and derivative markets that you will not be able to control, and this will be a disaster."

Mr. WILSON. Do you believe that there were people inside the Lehman organization fighting for government help, besides your conversation that you had with Mr. Paulson?

Mr. FULD. Not that I am aware of, sir.

Mr. MILLER OF NORTH CAROLINA. The gentleman's time has expired.

Mr. Donnelly for 5 minutes.

Mr. WILSON. Thank you, Mr. Chairman.

Thank you, Mr. Fuld.

Mr. DONNELLY. Thank you, Mr. Chairman.

Mr. Lee, at the end of every quarter, transactions were temporarily removed from the balance sheet. When were they put back on?

Mr. LEE. It is a continuous process which peaked at the end of a reporting period. So if you read the examiner's report, it is like a 10-day stretch. There is not a set number of days. And there was always a level base of Repo 105 that was on all month long.

Mr. DONNELLY. So, Mr. Fuld, when you were talking about any given day there were a number of sales transactions, is it fair to say that at the end of the quarter with Repo 105 it was completely different than the rest of the quarter?

Mr. FULD. I will say that the examiner's report had a very interesting chart which showed that it spiked on the quarters.

Mr. DONNELLY. Do you know why it spiked on the quarters?

Mr. FULD. On the quarters' ends, I should have said. I apologize.

Again, I will say I was not there for the structure or the creation of these. But I will say that these transactions were not created by Lehman Brothers. They were created and modeled after FAS 140. I do not believe that FAS 140 created this rule to give firms the ability to create a gimmick or mislead—

Mr. DONNELLY. Let me ask you this: Do you think that the use of Repo 105 transactions, do you think when you use those it fairly reflected the condition of Lehman Brothers?

Mr. FULD. I do, because there was, in fact—and this is a piece that was said before, which I did not have a chance to respond to. Given what I said of our ability to sell, not monthly or weekly, but daily, $50 billion—

Mr. DONNELLY. Right, but—

Mr. FULD. If I may, sir, please.

Mr. DONNELLY. I am just trying to save as much time as possible. Go ahead.

Mr. FULD. I am usually pretty quick.

Mr. DONNELLY. Okay. Go ahead.

Mr. FULD. I apologize.

We really could have sold $50 billion a day, and we did. The reason that we took these back, there had to have been a business purpose. And the examiner himself talks about a business purpose, because even in the sale transaction there was an implied spread. The examiner talks about it himself. There would have been no other reason to buy these securities back. They could have sold 50, 50, and another 50.

Mr. DONNELLY. Let me ask you this. Did the chief financial officer or the chief risk officer or the head of capital markets product control, did any of those folks tell you about the existence of Repo 105?

Mr. FULD. As I said before, not to my recollection at all did I have any conversations.

Mr. DONNELLY. Okay.

Mr. Cruikshank, when did you first become aware of Repo 105? Just a quick when did you find out?

Mr. CRUIKSHANK. During the examiner's investigation when he interviewed me.

Mr. DONNELLY. Okay.

Mr. Fuld, in talking about risk-averse, at 30:1, did you think that was risk-averse, a leverage figure? Is there any leverage figure that crossed your risk-averse concern?

Mr. FULD. I think the 30:1 is a misconception. Fifty percent of our balance sheet was a matchbook. Not to get technical—

Mr. DONNELLY. No, that is fine.

Mr. FULD. —matchbook was a series of short-term financings where we would sell securities to clients, buy them back and finance them. They were a series of 3-, 5-, and 7-day transactions with a limited tail and very little, if any, risk. So I looked at our balance sheet without—

Mr. DONNELLY. So you feel those 30:1, 40:1 references, those are not fair, in your mind?

Mr. FULD. Correct, sir.

Mr. DONNELLY. All right. Now, let me ask you this: Do you think that packaging no-doc loans, no-document loans, do you think those are solid products? Do you think it made sense to be involved in those?

Mr. FULD. I can only tell you that, at the time when we made those loans, or, actually more importantly, not so much we made the loans but we bought as a conduit, that our investors—I will put it to you differently. We never created a package thinking that our investors were going to lose money. That is not what our firm was about.

Mr. DONNELLY. So let me ask you this. No-document loans, interest-only loans in some mezzanines that you look and you go, how could they ever repay, were you, was anybody in the firm aware of the fact that each step of this made it much more likely that these bonds or loans could never pay off?

Mr. FULD. When we operated our own origination platforms, we stepped in and we changed the management where we thought it was appropriate, we changed underwriting standards where we thought they were lax, we discontinued certain products where we thought there was vulnerability.

I believe that we did take a very solid and prudent approach to—our goal was not to sell securities that were going to hurt clients or hurt those people who were taking mortgages. We didn't want to be in the repossession business. That was not our goal.

Mr. DONNELLY. Let me ask you one last question. And going back to your initial remarks about, there was not a capital hole—but Lehman still went away. Was it a loss of confidence? If the capital was there, the $26 billion was there, why did we wake up and see Lehman gone?

Mr. FULD. Why did we wake up—

Mr. DONNELLY. Yes. Why, if the $26 billion is there, you had your board of directors firing away, working hard, how did it go down finally? Was it a loss of confidence, everybody calling in on you at once?

Mr. FULD. I think it was a loss of confidence. I think people have heard me talk long enough about naked short sellers; I don't want to do it again.

I think that we could not convince the world about the condition that we were in, that we had collateral, that we had capital, we had a solid plan. And we did, in fact, have a solid plan.

We could not convince the world—S&P came out with a report, don't hold me to a date but a week or 10 days after, and said, why was Lehman single A? They talked about our strong franchise, they talked about our having raised capital, they talked about our ability to earn money, they talked about our liquidity, they talked about those things. We lost, I don't know, $25 billion of liquidity in 2 days.

Mr. DONNELLY. Thank you very much.

Thank you, Mr. Chairman.

Mr. MILLER OF NORTH CAROLINA. The Chair recognizes Ms. Speier for 5 minutes.

Ms. SPEIER. Thank you, Mr. Chairman.

Mr. Fuld, tens of thousands of people in my district are out of work, and have lost the opportunity to build classrooms because they invested in investment-grade Lehman Brothers stocks and bonds. They have lost it all. Now, I have no consolation in the fact that you may have to live with that every day. That is not good enough.

Why is it you sold your home in Florida to your wife for $100?

Mr. FULD. That was misrepresented. Long before Lehman had any problems—this is a little bit personal, but you have asked me the question, so I will—

Ms. SPEIER. It is public information.

Mr. FULD. Kathy decided to sell some of her art. And so that we had equal assets—it was her art in her name—I put the house in her name to rebalance that. Very plain, very simple. That was decided long before Lehman went down—

Ms. SPEIER. But it took place in October.

Mr. FULD. —blown way out of proportion.

Ms. SPEIER. It took place in October after Lehman had fallen.

Mr. FULD. I had made the decision back in May and June.

Ms. SPEIER. All right. Let's move on then.

Mr. FULD. No, I am sorry. In all fairness, these things don't get done overnight.

Ms. SPEIER. I understand. You have answered the question. Let me move on to another question.

You have said in your testimony that you feel vindicated by the results in Mr. Valukas's report. And yet Mr. Valukas clearly states over and over again in his report that there are colorable claims that can be made against Lehman for misrepresenting the 10K and the SK document. In fact, he says, "Billions of Lehman's shares traded on misinformation."

So there is nothing in this report that vindicates you. There is plenty of information in this report that suggests that the SEC did not do its job, that the Fed may not have done its job, but that you, in fact, misrepresented Lehman's status.

Now, you had said that you did not know anything about Repo 105, and yet, according to Mr. Valukas, having looked at 25 million e-mails, he says that there is every reason to know that you did.

But, having said that, you have to be concerned as the CEO of the company with the rating agency's rating of Lehman, correct?

Mr. FULD. Yes.

Ms. SPEIER. That has to be number one on your priority list, to make sure they continue to rate your company and your products as investment-grade, correct?

Mr. FULD. On my list, but clearly not number one. But on my list, yes.

Ms. SPEIER. Was it number 10?

Mr. FULD. I can't quantify. My number one concern was protection of our capital and shareholder equity.

Ms. SPEIER. And shareholder equity has everything to do with whether or not the rating agencies are grading your products as investment-grade.

Mr. FULD. That is actually a very interesting question. The rating agencies reacted more to our stock price than they did to our timeliness. The rating agency focus on debt is the timely ability to pay back debt. They reacted more to our stock price where they heard the rumors about the hole in the balance sheet and thought that we couldn't raise equity.

One of the real shortfalls was our ability—when I said we couldn't convince the world, there were so many rumors about Lehman's condition that people thought that, given that hole, we wouldn't be able to raise equity, when, in fact, we had the equity.

Ms. SPEIER. Okay. Mr. Fuld, excuse me, but my time is about to run out. Let me ask you one last question. Have you ever shorted securities that you were selling to the public?

Mr. FULD. I, myself?

Ms. SPEIER. Pardon me?

Mr. FULD. I, myself?

Ms. SPEIER. Your company.

Mr. FULD. Not that I am aware of.

Ms. SPEIER. Thank you.

Mr. MILLER OF NORTH CAROLINA. Thank you.

Ms. Kilroy is recognized for 5 minutes.

Ms. KILROY. Thank you, Mr. Chairman.

Mr. Fuld, there have been several things that you have answered today or answered to the bankruptcy examiner "not that you are aware of" or "not that you recall." Did you review any documents in preparation for today's hearing?

Mr. FULD. Yes, ma'am, I did.

Ms. KILROY. And what were those?

Mr. FULD. I don't even know how to begin to answer that.

Ms. KILROY. Did you practice your answers for today's hearing with any kind of a murder board?

Mr. FULD. I am sorry, with a who?

Ms. KILROY. Did you rehearse? Did you go over some practice questions?

Mr. FULD. I wrote questions for myself. I thought about them.

Ms. KILROY. Did you engage in a murder board preparation, where other people asked you questions?

Mr. FULD. A murder board?

Ms. KILROY. You have not heard that term before? All right, move on.

Mr. FRANK. Will the gentlewoman yield? Let me ask unanimous consent for 15 seconds. I don't want to leave that hanging for people who don't know.

A murder board is what they call it in an Administration when they prepare a nominee who is facing confirmation to appear before a Senate committee and be attacked.

Mr. FULD. A separate group? No. I actually wrote out a number of questions, myself.

Ms. KILROY. So did you consider that we might ask about the warnings Mr. Paulson gave to Lehman about the state of Lehman's balance sheet? Did you review that?

Mr. FULD. No, I didn't.

Ms. KILROY. And you don't—do you recall Mr. Paulson's warnings?

Mr. FULD. I have read his book, I am embarrassed to say, but I read his book.

Ms. KILROY. Do you recall Mr. Geithner's concerns and urging that Lehman move to a more conservative place with its balance sheet?

Mr. FULD. Secretary Geithner and I had a number of conversations regarding liquidity, potential capital raise. I do not recall a warning from him.

Ms. KILROY. Okay. Do you recall a warning from the Office of Thrift Supervision that you were materially overexposed?

Mr. FULD. I do not.

Ms. KILROY. Do you recall the concerns of Michael Gelband or Matthew Lee with respect to the risk management of the risk levels of Lehman or off-balance-sheet accounting?

Mr. FULD. I will start backwards.

I saw Matthew Lee today. He reminded me that he and I had met at a social event. So I was not familiar with him.

Michael Gelband was a long-time member of the firm. I will only tell you that the day after Mr. Gelband left the firm, the senior officer who took his place came to see me, told me that we were overexposed in leveraged loans. I said, how bad is it? He took me through it. I said, what is your recommendation? He said, let me bring it to the executive committee, but I would like to bring it down. I said, bring it to executive committee; start to bring it down today. And, from that point, we took it down something like from $45 billion to $7 billion.

Ms. KILROY. And did any of these discussions of lowering your exposure or lowering your leverage include lowering leverage specifically for a quarterly report to investors filed with the SEC, with specific targets of lowering your leverage for the quarterly reports for the investors?

Mr. FULD. I am sorry, are you asking me, did I ever set a specific target? No.

Ms. KILROY. And you continue to say that you do not recall engaging in any decision-making or even hearing about the use of Repo 105s with respect to that quarterly report and moving them on or off balance sheet to improve how that balance sheet looked for those investments?

Mr. FULD. I recall no conversation, and I recall seeing no document.

Ms. KILROY. Do you recall an individual by the name of, I believe, David Einhorn?

Mr. FULD. I know his name.

Ms. KILROY. Were you concerned with what short sellers were saying about your company?

Mr. FULD. Yes, I was.

Ms. KILROY. And was he one of those short sellers?

Mr. FULD. I believe he was.

Ms. KILROY. And were you aware of a speech that he gave to a high-level group of investors in which he criticized your first-quarter report and questioned the numbers in your first-quarter report versus your 10-Q filing?

Mr. FULD. I don't have all the pieces of that, but I was very much aware that he was claiming that we misrepresented items in our, I forget, CDOs and CLOs, claiming that they were all mortgages. They, in fact, were not. They were corporate loans. We tried to tell him that. He ignored that. He continued to talk about Lehman—I will be kind and just say, in an unflattering way.

Ms. KILROY. In any of that discussion, in taking a look at what the reasons were for maybe some of these discrepancies, did the use of Repo 105s come up at all?

Mr. FULD. Not at all.

Ms. KILROY. Am I over time?

Mr. MILLER OF NORTH CAROLINA. Not as gloriously as some other members, but yes, somewhat.

The Chair does thank all the witnesses for their testimony today.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

This hearing is adjourned.

[Whereupon, at 5:10 p.m., the hearing was adjourned.]

A P P E N D I X

April 20, 2010

Representative Anna G. Eshoo (D-CA)
Committee on Financial Services
United States House of Representatives
2128 Rayburn House Office Building
April 20, 2010

"Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner"

Mr. Chairman and Members of the Committee, thank you for inviting me to testify today. I particularly want to thank you for your extraordinary leadership in helping to steer our nation out of the worst financial crisis since the Great Depression.

This hearing on the public policy issues raised by the report of the Lehman bankruptcy Examiner continues to demonstrate your vigilance on behalf of the American people.

Up until days before its declaration of bankruptcy, Lehman Brothers was considered one of the most trusted, reliable, and safest of firms to invest in. The Examiner's report clarifies just how risky the practices and lack of transparency that sank Lehman really were. This behavior exemplifies Wall Street's reckless behavior which brought our economy to the brink of ruin. When we look at the case of Lehman, we are really examining the root causes of the crisis.

We learned in the Examiner's report that:

PAGE 732 - "Lehman employed off-balance sheet devices, known within Lehman as "Repo105" and "Repo 108" transactions, to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days, and to create a materially misleading picture of the firm's financial condition in late 2007 and 2008." "Lehman accounted for Repo 105 transactions as "sales" as opposed to financing transactions....By recharacterizing the Repo 105 transaction as a "sale," Lehman removed the inventory from its balance sheet."

PAGE 733 - "Lehman regularly increased its use of Repo 105 transactions in the days prior to reporting periods to reduce its publicly reported net leverage and balance sheet. Lehman's periodic reports did not disclose the cash borrowing from the Repo 105 transaction – *i.e.*, although Lehman had in effect borrowed tens of billions of dollars in these transactions, Lehman did not disclose the known obligation to repay the debt."

Why did Lehman do this? Let me quote the Examiner's report again:

PAGE 735 - "Starting in mid-2007, Lehman faced a crisis: market observers began demanding that investment banks reduce their leverage. The inability to reduce leverage could lead to a ratings downgrade, which would have had an immediate, tangible monetary impact on Lehman."

PAGE 738 - "By engaging in Repo 105 transactions and using the cash borrowings, Lehman reduced its reported leverage ratios."

PAGE 739 - "In this way, unbeknownst to the investing public, rating agencies, Government regulators, and Lehman's Board of Directors, Lehman reverse engineered the firm's net leverage ratio for public consumption."

Senior executives at Lehman were fully aware of this. The Examiner's report further states:

PAGES 742-743 - "A senior member of Lehman's Finance Group considered Lehman's Repo 105 program to be balance sheet "window-dressing" that was "based on legal technicalities." Other former Lehman employees characterized Repo 105 transactions as an "accounting gimmick" and a "lazy way of managing the balance sheet."

The bottom line is that despite senior management knowing full well the perilous situation they were getting themselves and their investors into, they kept moving forward. The Examiner concludes:

PAGE 746 - "Repo 105 transactions were not used for a business purpose, but instead for an accounting purpose: to reduce Lehman's publicly reported net leverage and net balance sheet."

PAGE 853 - "In order for this off-balance sheet device to benefit Lehman, the firm had to conceal information regarding its Repo 105 practice from the public."

With Lehman Brothers engaged in such risky behavior, this begs the question: Where were the SEC, the Treasury, and the Federal Reserve? The Examiner's report concludes that these three agencies were monitoring the situation since early 2007. They were aware that Lehman was in trouble given their highly-leveraged balance sheets. The agencies warned the firm about the risk of collapse if they did not move to more conservative investments. However, the leadership at Lehman Brother's continued to maintain their pattern of deception. The Examiner's report goes on to say:

PAGES 1482-1483 - "At the highest levels, each of these agencies recognized – as early as 2007 but certainly by mid-March 2008, after the Bear Stearns near collapse

- that Lehman could fail. Treasury Secretary Paulson, Fed Chairman Bernanke, FRBNY President Geithner and SEC Chairman Cox all had direct communication with (former Lehman CEO) Fuld. The day after Bear Stearns Weekend, teams of Government monitors from the SEC and FRBNY were dispatched to, and took up residence at Lehman to review and monitor its financial condition."

PAGE 1482 - "When the Examiner questioned Lehman executives and other witnesses about Lehman's financial health and reporting, a recurrent theme in their responses was that Lehman gave full and complete financial information to Government agencies, and that the Government never raised significant objections or directed that Lehman take any corrective action."

So, we had one of the largest banks in our nation teetering on the brink of bankruptcy. The executives of that bank were masking accounting gimmicks that inflated their quarterly earnings. The agencies responsible for monitoring these banks, specifically the SEC, were taking a hands-off approach when it came to regulation.

The rest of the story we know all too well.

Lehman Brothers was forced to declare bankruptcy, and left a trail of devastation in its wake.

In my Congressional District, San Mateo County and its public institutions were severe victims and still are of the Lehman Brothers bankruptcy.

San Mateo County is required by California State law to hold operating funds, reserves and bond proceeds in an investment pool. Their investment pool which held funds on behalf of the county and local cities, school districts, transit agencies and the community college district, were invested in the most highly-rated, conservative Lehman securities.

When Lehman collapsed, San Mateo County lost $155 million.

As a result, the County and its 735,000 residents are now reeling financially. Teachers are being laid off. Schools are not being built or renovated. Roads are not being improved. Transportation plans are being scrapped, and critical upgrades in public safety have ceased.

The financial plight of San Mateo County was recently profiled in detail in a February 24, 2010, Wall Street Journal article entitled. "Lehman's Ghost Haunts California." Mr. Chairman, I respectfully request that this article be included in the record.

The San Mateo County leaders did nothing wrong. They were not playing the market. They were not rolling the dice to optimize their dollars. They invested in the safest, most conservative instruments. And yet when Lehman Brothers went down, their funds were lost.

It's not only San Mateo County who made the mistake of trusting this institution. More than 40 other municipalities from around the country lost close to $1.7 billion when Lehman collapsed.

Mr. Chairman, we've worked for well over a year now to find a solution for San Mateo County and the other affected counties throughout the country. This work resulted in explicit language in the *Emergency Economic Stabilization Act of 2008,* which gave the Secretary of the Treasury the authority to purchase the troubled assets held by local governments. In that legislation, Section 103(7) states:

"In exercising the authorities granted in this Act, the Secretary shall take into consideration ...the need to ensure stability for United States public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil..."

I communicated this to Secretary Geithner on multiple occasions. Each time I called to his attention the economic crisis that still exists in San Mateo County and other counties around the nation. Each time I asked him to use his statutory authority to provide them relief. Each time, the Secretary has refused to use TARP funds to assist these localities.

The amount of TARP funds that could be used to assist the municipalities affected by the Lehman collapse is miniscule compared to the hundreds of billions of dollars the Treasury Department has provided to banks. The $1.7 billion these municipalities lost represents one-quarter of 1% of TARP funds.

In his most recent letter to me on March 11th the Secretary said, "I appreciate your concern. However, Treasury does not intend to make purchases of Lehman Brothers securities from public instrumentalities."

This is where I must reference the Examiner's report again. On page 1504, when referring to an interview with Federal Reserve Chairman Bernanke, the Examiner says:

PAGE 1504 - "Bernanke noted that, after passage of the TARP legislation, the Treasury had authority to inject capital directly into institutions: "If we had that [TARP] authority on September 14, we would have been able to save [Lehman], no question about it."

Congress has since vested the Secretary with the authority to correct the harm done, but he has chosen not to exercise it.

Let's fast forward to today. We now know that the federal government is earning billions of dollars in profits from the sale of the troubled assets. In a March 29, 2010, AP article I also request be submitted for the record, it was reported that the federal government will receive $7.5 billion from the sale of the 27 percent stake in Citi they now have. To date, the federal government has already earned $15.4 billion from dividends, interest, and the sale of bank stock.

These transactions will total more than TEN times the amount of money that all the counties in the country lost with the Lehman collapse.

I believe it's time for the federal government to do for local governments what we've done for big banks.

I'm introducing legislation that will require portions of these profits coming into the Treasury from the sale of their interests in financial institutions to be used to provide relief to counties affected by the Lehman collapse.

It will clarify a way for the federal government to assist local governments impacted by the Lehman collapse.

At a time when saving those institutions which were deemed "too big to fail," we shouldn't overlook those who are being treated as though they are too small to help.

It's time to serve the best interests of the American people. They lost their taxpayer dollars which they intended to be invested in their community for vital services.

Thank you, Mr. Chairman and Members of the Committee. I look forward to partnering with you and my good friend and colleague Congresswoman Speier in moving my legislation forward to assist the public agencies who trusted Lehman, invested hard-to-come-by tax dollars, only to see them evaporate. The Examiner's report describes in excruciating detail the shocking condition of Lehman Brothers, yet nothing was done. My abiding hope is that we will make this right by not only legislating reforms so it can never happen again, but also by assisting our public institutions who are required to carry out their responsibilities to our mutual constituents.

THE WALL STREET JOURNAL.
WSJ.com

FEBRUARY 24, 2010

Lehman's Ghost Haunts California

By JOHN CARREYROU

SAN MATEO, Calif.—Little more than a year after the worst of the financial panic, Wall Street is bouncing back. But in this county just south of San Francisco, pain from the financial system's near-collapse is still felt every day.

San Mateo, a scenic swath of peninsula between the Pacific Ocean and San Francisco Bay, saw $155 million evaporate when Lehman Brothers went bankrupt in September 2008. On top of deep budget cuts brought on by California's fiscal crisis, the loss on Lehman securities means San Mateo's 735,000 residents are taking a hit.

Public schools here have laid off dozens of teachers and delayed or canceled renovations. Local community colleges are slashing classes and scrapping new facilities, even as enrollment surges because of the bad economy. The county trimmed its commuter rail service and shelved plans to build a new women's jail to alleviate overcrowding.

The biggest factor behind San Mateo's trouble is California's spending cuts. But its Lehman losses make a bad situation worse. The problem underscores the diverging fortunes of Wall Street and Main Street and helps explain the populist anger still simmering in many parts of the country. Last week, Barclays PLC reported that its 2009 profit more than doubled to $14.7 billion thanks in part to its acquisition of Lehman's North American operations.

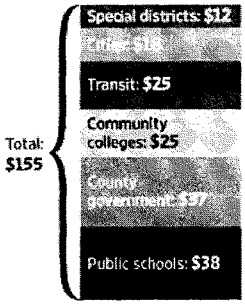
Lehman Brothers' collapse is "old news for most of America," says Richard Gordon, a member of the county's board of supervisors. But in San Mateo County, he says, "It's a continuing story that continues to unfold."

A report by Beacon Economics, commissioned by the county, estimates that the Lehman losses reduced local government spending, especially on construction projects, by $148 million over two years. The consulting firm says this resulted in 1,648 jobs lost or not created. County unemployment now hovers around 9%, double what it was 18 months ago.

Dozens of cities and counties around the country, from Sarasota, Fla., to Boulder, Colo., lost a total of $1.7 billion when Lehman went under, because they held Lehman bonds or other securities. The two worst hit states are Florida and California. Florida public agencies lost a total of more than $400 million, mostly from a state investment pool. California municipalities lost a total of $250 million across some 28 cities and counties.

Money Breakdown

San Mateo County's losses on Lehman securities, in millions



Source: San Mateo County Treasurer's Office

San Mateo County's loss was the biggest of any municipality. Under state rules, the county government, city governments and area school districts hold their operating funds, reserves and bond proceeds together in an investment pool that lost about 6% of its value when Lehman went under.

The investment pool owned highly rated Lehman bonds and notes, which currently trade around 20 cents on the dollar. Any recovery from the bankruptcy process will take at least another year. A recovery of 20 cents on the dollar would leave the pool with a loss of roughly $125 million.

Much of the anger in San Mateo is directed at the Obama administration and, specifically, at Timothy Geithner, the Treasury secretary. Mr. Geithner has declined to use funds from the government's Troubled Asset Relief Program, or TARP, to bail out municipalities.

"There's too big to fail, and we're too small for them to care," says Mary McMillan, the county's deputy manager.

Before Wall Street's crash in late 2008, San Mateo County was on track to balance its $1.7 billion annual budget within five years. California's cutbacks and the Lehman collapse torpedoed that.

The county government lost $37 million when Lehman Brothers went under. That's on top of a $100 million deficit due in part to state cutbacks. San Mateo County has limited power to increase taxes: Boosting sales taxes requires two-thirds voter approval, and two efforts have failed in recent years.

The schools were hit hard, too. In one typical case, Lehman-related losses at the Sequoia Union High School district, one of 25 in the county, totaled $6.2 million, an amount equivalent to 7% of the district's annual budget. Meanwhile, the state cut its funding to the Sequoia district this school year by $1.9 million and is cutting it again next school year by another $3.4 million.

San Mateo ranks among California's most diverse counties. Home to software giant Oracle Corp. and biotechnology pioneer Genentech, it encompasses both wealthy enclaves and working-class, immigrant cities such as Daly City and East Palo Alto that depend heavily on county services. In East Palo Alto, unemployment is 20%.

When Lehman Brothers filed for bankruptcy-court protection on Sept. 15, 2008, the news was met with a mix of panic and disbelief by local officials. The county's schools took the worst hit, losing $38 million overnight. Two county school districts, the Sequoia

district and the Menlo Park City Elementary School District, had just sold more than $90 million worth of bonds to fund renovations and expansions and deposited the proceeds in the county investment fund. The lost bond proceeds totaled nearly $8 million, a debt local taxpayers will be paying off for the next 30 years.

Jean Holbrook, the county's superintendent of schools, says the Lehman losses came on the heels of deep funding cuts from the state that had already cost the jobs of 91 of the school's 681 employees, including 21 teachers. In the ensuing year, 60 more school employees would have to be let go, resulting in larger class sizes and fewer elective courses.

San Mateo's board of supervisors ordered an independent review of the way the county investment fund was run, but found no wrongdoing. In keeping with rules California passed in the mid-1990s (following Orange County's disastrous experiment with derivatives), San Mateo's treasurer had invested in highly rated securities and put no more than 10% of the fund in any single issuer.

With Lehman bonds trading at pennies on the dollar, county officials held little hope of recovering their investment through bankruptcy proceedings. So they opted for a two-pronged strategy: They sued former Lehman Brothers executives for fraud, and they lobbied their state congressional representatives to insert language in TARP legislation that would let municipalities tap the federal rescue program.

Though such language was included in the final bill, bailing out municipalities was low on the list of the federal government's priorities in late 2008 as the financial system flirted with collapse.

To rally support and keep the issue alive in Washington, Ms. McMillan, the deputy county manager, began reaching out to other counties and cities ensnared in the Lehman bankruptcy.

In May 2009, as financial institutions began to stabilize and the specter of a depression subsided, the House Committee on Financial Services agreed to hold a hearing on the matter.

In their testimony before the committee, Democratic Reps. Anna Eshoo and Jackie Speier, whose districts span parts of San Mateo County, argued that the $1.7 billion municipalities were asking for amounted to just one-quarter of 1% of TARP funds and paled in comparison with the hundreds of billions of dollars the Treasury Department had provided to banks.

Ron Galatolo, chancellor of San Mateo's community colleges, told the assembled congressmen that he felt it was "highly inequitable to use TARP funding to shore up banks and to bail out failing corporations but fail to protect agencies' taxpayer dollars, such as ours."

After the hearing, Rep. Eshoo sought a meeting with Mr. Geithner, but says the Treasury secretary didn't respond to her letters and phone calls for months.

Rep. Eshoo finally met with him on Oct. 28, followed by a second meeting on Dec. 2. She says Mr. Geithner told her that TARP was intended only for financial institutions and that rescuing municipalities would open a Pandora's box of claims from other investors.

Rep. Eshoo invoked the passage inserted a year earlier in the TARP bill, which refers to "the need to ensure stability for U.S. public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil."

She says Mr. Geithner said the passage fell short of mandating use of TARP funds to bail out municipalities.

While declining to comment on the meetings, a Treasury spokeswoman says: "There are countless well-intentioned ideas for deploying TARP funds, but we determined that making Lehman Brothers' creditors whole is not consistent with what Congress intended for TARP funding."

In San Mateo, reverberations from the Lehman losses were on display on the campus of Cañada College, one of the county's three community colleges, earlier this month.

Students held a two-day teach-in to protest faculty layoffs, course cancellations and fees that jumped 30% this year.

Lilliam Castellanos, a 35-year-old student majoring in Latin America studies to become an interpreter, said she could no longer afford textbooks because the funding for a program that handed out book vouchers to Hispanic students had been cut sharply. Other students complained about long wait lists to get into courses and a reduction in the number of counselors.

Mr. Galatolo, the chancellor, says the colleges' $25 million Lehman loss compounded funding cuts made by the state, forcing him to slash the colleges' annual budget by one-fifth, to $100 million from $125 million.

Of the $25 million loss, $20 million had been earmarked for new buildings and classrooms that he says now won't be built. The remaining $5 million came directly out of the colleges' operating fund.

Mr. Galatolo says he's angered by the return of multimillion-dollar bonuses on Wall Street "while we can't make ends meet for our students." As for Mr. Geithner, he says, "He had the ability to help us, and he chose not to."

On the other side of the peninsula, in the wind-swept, rural community of Half Moon Bay, Robert Gaskill, superintendent of the Cabrillo Unified School District, says his

district's share of the Lehman loss was $1.4 million, out of an annual budget of $28 million.

Mr. Gaskill says he had to lay off five teachers and projects that 20 more will be let go in the 2010-11 school year, out of 177, because of state funding cuts. The district is also paring back summer school.

Michael Bachicha, former director of the schools' special programs, sat through the school-board meeting at which his job was eliminated in April 2009. Because he had tenure, Mr. Bachicha was able to land another job teaching at the district's "continuation" high school for students who are falling behind. But his salary dropped from $105,000 to $72,000. Around the same time, his wife lost her job as a kindergarten teacher at a local private school.

Mr. Gaskill, the district superintendent, says the teaching job that Mr. Bachicha took bumped someone else less senior off the payroll, resulting in one of the five teacher layoffs.

Ms. McMillan, the deputy county manager, hasn't given up on getting the Lehman money back. She holds conference calls every two weeks with officials from other affected counties and cities to plot strategy. On last week's call, 35 people dialed in from across the country.

In the meantime, the county is gearing up to dismiss hundreds of employees this spring, the first time it has had to resort to mass layoffs, according to Mr. Gordon, the member of the board of supervisors.

Write to John Carreyrou at john.carreyrou@wsj.com

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Gov't will sell Citi stock, reap bailout profits

By STEVENSON JACOBS, AP Business Writer Stevenson Jacobs, Ap Business Writer Mon Mar 29, 6:10 pm ET

NEW YORK – Bank bailouts are turning out to be great business for the government. Unfortunately for taxpayers, other federal rescues will almost certainly wind up in the red.

The Treasury Department said Monday it will begin selling its stake in Citigroup Inc. at a potential profit of about $7.5 billion — not a bad haul for an 18-month investment.

The move is a major step in the government's effort to unravel investments it made in banks under the $700 billion Troubled Asset Relief Program at the height of the financial crisis.

Yet a year and a half after Congress passed the big bailout, other parts of it — particularly troubled automakers General Motors and Chrysler and insurer American International Group — show no signs of being profitable.

Despite the returns from Citi and other banks, analysts and even the Treasury Department predict the bailout will wind up costing taxpayers at least $100 billion. The bailouts of mortgage giants Fannie Mae and Freddie Mac, which were not included in TARP, will add billions more.

But the money the government makes off banks helps offset the damage. With the sale of the Citi shares, the eight major banks that got bailout money funds will have repaid the government in full. Those investments have netted the government $15.4 billion from dividends, interest and the sale of bank stock warrants, which gave the government the right to buy stock in the future at a fixed price.

Based on Monday's share price, selling its 27 percent stake in Citi would add about $7.5 billion in profits. The stock fell 3 percent to $4.18 a share Monday after news of the planned Treasury sales. But that still puts it well above the $3.25 a share the government paid. The government also still holds Citi stock warrants, which will add to its profits down the road.

Overall, it's a 14 percent rate of return on the $165 billion invested in the biggest banks. Hundreds of smaller banks also received money and have been paying the government a steady stream of dividends and interest.

By comparison, someone who invested money in the Standard & Poor's stock index in early October 2008, when the bailout was passed, would actually have lost about 3 percent.

"Overall, TARP may cost taxpayers money. But the banking part of it is going to be a moneymaker," banking analyst Bert Ely said. "When you strip away all that emotion," he added, "this has turned out to be a good bet."

The government's bank profits can be misleading. The banks benefited heavily from other subsidies, including the $182 billion bailout of AIG. Tens of billions of that money went to banks that had suffered losses with AIG, and the banks didn't have to repay a penny.

"It's baloney to say we've made money off the bank bailouts," said Simon Johnson, a professor at the Massachusetts Institute of Technology and a former chief economist at the International

Monetary Fund. "You have to add up all the money we've put into the economy and other firms" related to banks.

Douglas Elliott, a fellow at Brookings Institution and former investment banker at J.P. Morgan, predicted the government will lose about $100 billion on the overall bailout program. That's slightly less than Treasury's own estimate of $117 billion.

Most of those losses are for the bailouts of AIG, General Motors and Chrysler, and automaker financing arms GMAC and Chrysler Financial.

And those estimates don't include losses expected from the takeover of Fannie Mae and Freddie Mac. In September 2008, the government seized the mortgage companies and has since pumped $126 billion into them to keep the housing market from plummeting further. That number is only expected to grow, and the Obama administration has not detailed any exit strategy.

The banks have been the one bright spot in the government's portfolio. And few benefited as much from taxpayer help as Citigroup.

Citi, one of the hardest-hit banks during the credit crisis and the recession, received a total of $45 billion in bailout money, one of the largest rescues in the TARP program.

Of the $45 billion, $25 billion was converted to the government's ownership stake in the bank. Citi repaid the other $20 billion in December.

The government received 7.7 billion shares of Citigroup in exchange for the $25 billion. It said it will sell the shares over the course of this year, depending on market conditions.

Understandably, the government will probably hold on to its shares if prices fall steeply. But Citi stock has been steadily rising with the broader market in recent months, which means the Treasury Department stands to pocket a hefty profit.

The Treasury had been planning to sell 20 percent of its stock at the time Citi was issuing new shares late last year. At a price of $3.15 a share, the government would have lost $158.7 million on the sale, so it opted to wait.

Selling at today's prices would give the government an 18 percent return on its $45 billion investment in Citigroup, according to Linus Wilson, a finance professor at the University of Louisiana at Lafayette.

But he said taxpayers could have done even better if the government had paid market value when it bought the bank's preferred shares. Instead, it paid a hefty premium to help boost the bank's capital.

"Citigroup stands to be our most profitable bank investment, bar none," Wilson said. "But we also took the most risk with Citi."

Others say that even if the government were to lose money on the deal, it was worth it.

"It kept the recession from getting considerably worse," Brookings' Elliot said. "That's worth whatever amount we end up losing."

AP Business Writers Daniel Wagner and Marcy Gordon in Washington and Stephen Bernard in New York contributed to this report

OPENING STATEMENT OF
CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON THE PUBLIC POLICY ISSUES RAISED BY
THE REPORT OF THE LEHMAN BANKRUPTCY EXAMINER

APRIL 20, 2010

Mr. Chairman, we meet once again to examine yet another massive corporate failure. We have heard this sad song of corporate greed and regulatory breakdowns one too many times in recent years in instances like the accounting misdeeds at Enron, the massive Madoff fraud, and the audacious bets of American International Group. The events that led to Lehman's collapse add another verse to this troubling refrain in American capitalism.

In the Lehman tune, it deeply troubles me that we must once again explore how reckless Wall Street titans profited at the expense of innocent shareholders on Main Street. I am also deeply disappointed in the performance of auditors and regulators who failed to uncover wrongdoing, mismanagement and capital shortfalls even as they fiddled in Lehman's offices. The American people -- those who invest their hard earned savings and retirement nest eggs in our markets -- deserve not only answers about what happened, but also the enactment of real solutions designed to reform the way Wall Street functions.

The Valukas report also reveals that Wall Street executives continue to embellish the truth, tell half-truths and hide behind their power in the marketplace. Lehman's former managers claim not to recall transactions or not to have spent meaningful time examining those very transactions important to investors. I find their excuses difficult to believe, especially in the wake of the corporate accounting and attestation reforms mandated by the Sarbanes-Oxley Act.

Moreover, Lehman's unscrupulous practices illustrate exactly why the Senate needs to quickly pass -- and the Congress needs to swiftly finalize -- a Wall Street reform bill. The bill already passed by the House would force major participants in our markets to hold more capital and leverage less. Additionally, the House-passed legislation and the pending Senate bill include provisions to end the era of too big to fail, like my amendment directing regulators to break up financial firms that have become too big, too interconnected, too concentrated or too risky.

The thoughtful Valukas report additionally highlights the importance of my whistleblower reforms and tipster bounties contained in the House bill. Furthermore, his report proves the need to fundamentally change the way the U.S. Securities and Exchange Commission operates. Among other things, the House bill doubles the Commission's budget over 5 years and requires a comprehensive review and overhaul of the Commission's operations.

In sum, today's hearing builds the case for Wall Street reform. Hopefully, this Lehman hearing will be one of the last arias of this all too gloomy opera about the dark side of American capitalism. The proverbial fat lady has begun to sing; we must now complete our work.

Statement of Representative Jackie Speier,

Financial Services Committee hearing April 20, 2010:

Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner

Mr. Chairman, thank you for holding this important hearing.

More than 18 months have passed since Lehman Brothers collapsed. But the repercussions of its failed—and possibly criminal-- leadership continue. As was detailed by my colleagues on the first panel, state and local governments across the country who invested taxpayer dollars in supposedly safe Lehman investments have had to cancel important projects, layoff employees and make other drastic service cuts to make up for their losses.

They lost, but others profited handsomely from Lehman's reckless actions.

Lehman CEO Richard Fuld is before us today. He certainly profited handsomely. He made almost $500 million in salary, bonuses and stock options since 2000. You note I did not say earned. He has publicly stated that he felt "horrible" about the failure of Lehman. I say that is not enough. Give it back00disgorge yourself of the money. It is time that those whose greed, arrogance and fraud caused this crisis be held responsible. The bankruptcy examiner makes a compelling case that fraud took place and that Mr. Fuld is lying about his role in it. I guess that is to be expected since he is trying to avoid liability. It's funny—Repo 105 is more like Criminal Procedure 101.

The executives of Enron were held criminally and civilly responsible for their fraud. Their accountants were held liable. We must demand the same here, not just for Lehman, but for all those on Wall Street who

have bought into the culture of greed and profit for themselves no matter the cost to others.

The executives are not the only ones responsible. Government regulators bear a large share of the responsibility. Mr. Fuld argues that Lehman could have survived if it had been one of the "club" favored by the Fed and Treasury and provided a bailout just like Merrill and Bear Sterns and AIG. Instead, the government chose to let Lehman fail. And as we can now see thanks to the diligent and exhaustive work of Mr. Valukas, Lehman's failure should not have come as a surprise to the SEC or New York Fed.

Its collapse was months and years in the making as Lehman executives dramatically increased risk, used accounting shell games like "Repo 105" to hide that risk, and then "doubled down" on what was essentially gambling with other people's money. The regulators and rating agencies who were supposed to be protecting investors and the public were apparently too bought into the culture or incompetent to stop them.

So the residents of my county have now lost twice—as taxpayers they had to bail out the Wall Street firms like JP Morgan, Citigroup and Bank of America who participated in Lehman's demise, and through their supposedly "safe" investments in Lehman corporate bonds and notes, they lost the taxes they paid for local schools, roads, and public safety.

It is far beyond time for the Treasury Secretary to use the authority given to him by Congress to repurchase these investments from the state and local governments—and the taxpayers they serve-- that continue to suffer as a result of the government failure that led us to today. It is time to end a culture where executives routinely with their armies of high paid lawyers claim that what they do is not technically illegal. It is time to pass real and meaningful financial reforms that will bring

accountability and transparency back to our financial system and ensure that taxpayers will never again have to bail out Wall Street while Main Street takes it on the chin.

For release on delivery
April 20, 2010
11:00 a.m. EDT

Lessons from the Failure of Lehman Brothers

Statement

by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

April 20, 2010

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate the opportunity to testify about the failure of Lehman Brothers and the lessons of that failure. In these opening remarks I will address several key issues relating to that episode.

The Federal Reserve was not Lehman's supervisor. Lehman was exempt from supervision by the Federal Reserve because the company did not own a commercial bank and because it was allowed by federal law to own a federally insured savings association without becoming subject to Federal Reserve supervision. The core subsidiaries of Lehman were securities broker-dealers under the supervisory jurisdiction of the Securities and Exchange Commission (SEC), which also supervised the Lehman parent company under the SEC's Consolidated Supervised Entity (CSE) program. Importantly, the CSE program was voluntary, established by the SEC in agreement with the supervised firms, without the benefits of statutory authorization.

Although the Federal Reserve had no supervisory responsibilities or authorities with respect to Lehman, it began monitoring the financial condition of Lehman and the other primary dealers during the period of financial stress that led to the sale of Bear Stearns to JPMorgan Chase.[1] In March 2008, responding to the escalating pressures on primary dealers, the Federal Reserve used its statutory emergency lending powers to establish the Primary Dealer Credit Facility and the Term Securities Lending Facility as sources of backstop liquidity for those firms. To monitor the ability of borrowing firms to repay, the Federal Reserve, in its role as creditor, required all participants in these programs, including Lehman, to provide financial information about their companies on an ongoing basis. Two Federal Reserve employees were placed onsite at Lehman to monitor the firm's liquidity position and its financial condition generally. Beyond gathering information, however, these employees had no authority to regulate Lehman's disclosures, capital, risk management, or other business activities.

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[1] Primary dealers are broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York.

During this period, Federal Reserve employees were in regular contact with their counterparts at the SEC, and in July 2008, then-Chairman Cox and I negotiated an agreement that formalized procedures for information-sharing between our two agencies. Cooperation between the Federal Reserve and the SEC was generally quite good, especially considering the stress and turmoil of the period. In particular, the Federal Reserve, with the SEC's participation, developed and conducted several stress tests of the liquidity position of Lehman and the other major primary dealers during the spring and summer of 2008. The results of these stress tests were presented jointly by the Federal Reserve and the SEC to the managements of Lehman and the other firms. Lehman's results showed significant deficiencies in available liquidity, which the management was strongly urged to correct.

The Federal Reserve was not aware that Lehman was using so-called Repo 105 transactions to manage its balance sheet. Indeed, according to the bankruptcy examiner, Lehman staff did not report these transactions even to the company's board. However, knowledge of Lehman's accounting for these transactions would not have materially altered the Federal Reserve's view of the condition of the firm; the information we obtained suggested that the capital and liquidity of the firm were seriously deficient, a view that we conveyed to the company and that I believe was shared by the SEC and the Treasury Department.

Lehman did succeed at raising about $6 billion in capital in June 2008, took steps to improve its liquidity position in July, and was attempting to raise additional capital in the weeks leading up to its failure. However, its efforts proved inadequate. During August and early September 2008, increasingly panicky conditions in markets put Lehman and other financial firms under severe pressure. In an attempt to devise a private-sector solution for Lehman's plight, the Federal Reserve, Treasury, and SEC brought together leaders of the major financial firms in a series of meetings at the Federal Reserve Bank of New York during the weekend of September 13-15. Despite the best efforts of all involved, a

solution could not be crafted, nor could an acquisition by another company be arranged. With no other option available, Lehman declared bankruptcy.

The Federal Reserve fully understood that the failure of Lehman would shake the financial system and the economy. However, the only tool available to the Federal Reserve to address the situation was its ability to provide short-term liquidity against adequate collateral; and, as I noted, Lehman already had access to our emergency credit facilities. It was clear, though, that Lehman needed both substantial capital and an open-ended guarantee of its obligations to open for business on Monday, September 15. At that time, neither the Federal Reserve nor any other agency had the authority to provide capital or an unsecured guarantee, and thus no means of preventing Lehman's failure existed.

The Lehman failure provides at least two important lessons. First, we must eliminate the gaps in our financial regulatory framework that allow large, complex, interconnected firms like Lehman to operate without robust consolidated supervision. In September 2008, no government agency had sufficient authority to compel Lehman to operate in a safe and sound manner and in a way that did not pose dangers to the broader financial system. Second, to avoid having to choose in the future between bailing out a failing, systemically critical firm or allowing its disorderly bankruptcy, we need a new resolution regime, analogous to that already established for failing banks. Such a regime would both protect our economy and improve market discipline by ensuring that the failing firm's shareholders and creditors take losses and its management is replaced.

Thank you. I would be glad to respond to your questions.

Statement by

William K. Black

Associate Professor of Economics and Law, University of Missouri – Kansas City

before the

Committee on Financial Services

United States House of Representatives

regarding

"Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner"

April 20, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for your invitation to discuss public policy issues arising from Lehman's failure. I will address the six issues you asked that I comment on in your letter of invitation.

1. The extent to which corporate governance should be enhanced to appropriately manage firm risk. Please share your views regarding the communication, knowledge and understanding among risk managers, Boards of Directors and senior management.

2. The role of the SEC as Lehman's primary regulator in oversight, examination and enforcement in advance of Lehman's bankruptcy filing, and the role of the other government agencies, including the Federal Reserve Bank of New York (FRBNY), that were monitoring Lehman during the crisis.

3. The relationship and means of communication, especially formal and informal information sharing, between the SEC and FRBNY as Lehman's financial condition deteriorated as well as between Lehman, the SEC, the Treasury Department, the Board of Governors Federal Reserve, and the FRBNY.

4. Please reflect on the appropriateness of accounting practices such as Repo 105 or 108 and the adequacy of the disclosure of such accounting practices.

5. The quality of Lehman's Management Discussion and Analysis disclosures in its public filings for the 2007 reporting periods.

6. Other issues that you deem relevant to the public policy issues raised by the Lehman Report.

I begin with a short description of my background that is relevant to your questions. My primary appointment is in economics. I have a joint appointment in law. I am a white-collar criminologist. My research specialization is financial fraud by elites and financial regulation. I was a senior regulator during the S&L debacle (and had the honor of testifying many times before this Committee). As a regulator, I was:

- The Litigation Director of the Federal Home Loan Bank Board (Bank Board). We had independent litigation authority – we were not represented by the Justice Department.

- The Deputy Director of the Federal Savings and Loan Insurance Corporation (FSLIC)

- The staff leader of the reregulation of the S&L industry in 1984-1987

- The Senior Vice President and General Counsel of the Federal Home Loan Bank of San Francisco (FHLBSF)
- The Senior Deputy Chief Counsel for Enforcement and Litigation (West Region) of the Office of Thrift Supervision (OTS)
- The Deputy Staff Director of the National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE)

Several aspects of this background may be of particular use to the Committee.

1. The Bank Board was both a safety and soundness regulator and a securities regulator for publicly traded savings & loan holding companies. We were vigorous in bringing actions against those that abused the accounting rules.
2. I worked extensively, and cooperatively, with many other regulatory agencies.
3. The Federal Home Loan Banks (before the passage of FIRREA in 1989), were similar to the Federal Reserve Banks. The FHLBs had boards of directors dominated by industry members and had both a lending function and a regulatory function. We used the information gained through, and the leverage inherent in, the FHLBSF's lending activities to aid our, and our sister agencies', supervisory effectiveness.
4. We always made extensive referrals to the SEC, the FBI, and the Department of Justice when we found evidence of unsafe and unsound practices or violations of law. I was one of the officials charged with making sure that these referrals became far more effective. One result was that the government obtained over 1000 priority felony convictions of S&L insiders and those that aided and abetted their frauds.
5. In late 1983, the agency recognized that the S&L crisis, which began as an interest rate risk crisis was entering a new phase in which elite frauds were the dominant problem. The agency realized that the frauds would defeat any regulatory approach based on standard operating procedures (SOP). Instead, the agency went to an emergency footing in which, for example, it took over 20 percent of the entire national examination force and sent it to the region (Dallas) where the frauds posed the greatest danger to the public.
6. Bank Board Chairman Gray, over the intense opposition of the administration, the industry, Speaker Wright, a majority of the Members of the House, the "Keating Five", and the financial press, proceeded to reregulate the industry. The administration was so outraged that OMB threatened to file a criminal referral against Chairman Gray – on the grounds that he was closing too many insolvent S&Ls. Because I was the staff leader of this reregulation, Speaker Wright tried to get me fired by Gray's successor, Chairman Wall. (The Speaker succeeded in getting Wall to fire our top supervisor in Texas.)

> Charles Keating was so threatened by reregulation that he directed his chief political fixer that his "Highest Priority" was to "Get Black … Kill him Dead." Keating hired private detectives twice to investigate me and filed a $400 million *Bivens* action against me and other regulators in our personal capacity. But we stayed the course.

The Members of the Committee know that the practices I have just described contrast sharply with the manner in which the federal officials behaved with regard to Lehman, as documented in the Valukas Report. The Senate Banking investigation of WaMu and the Treasury IG investigation of its regulators reveal equally distressing disregard for the public interest and the regulators' oaths of office.

1. The extent to which corporate governance should be enhanced to appropriately manage firm risk. Please share your views regarding the communication, knowledge and understanding among risk managers, Boards of Directors and senior management.

The Report documents at least three major deficiencies in Lehman's corporate governance that need to be addressed globally. First, it points out that Lehman, and many other Delaware corporations, have eliminated the fiduciary duty of "care." This statutory change is the product of a naïve "law and economics" theory of corporate law that I addressed in an article (Black 2003). Judge Easterbrook and Professor Fischel are the leading proponent of the theory. They view managers as so pure that "a rule against fraud is not an essential or even necessarily an important ingredient of securities markets" (1991: 283). Alan Greenspan has admitted that he had a similar view and that events have falsified this naïve account. It is insane to withdraw accountability for negligence. Doing so encourages negligence. Congress should mandate that corporate officers and directors be subject to the fiduciary duties of care and loyalty. They will still, of course, have the very substantial protection of the business judgment rule.

Second, there same individual should not serve as the CEO and Chair of the Board of Directors of a large corporation. The imperial CEO is a consistent problem in this and prior crises.

Third, Lehman ignored its stated risk "limits" and simply increased its limits retroactively to accommodate its violations of its risk limits. In plain English, that means it had no meaningful limits. Systemically dangerous institutions (SDIs) (aka "too big to fail") should be required to have, and comply with, prudent risk limits.

I have a different view than Mr. Valukas about the overall state of Lehman's corporate governance. First, Lehman's nominal corporate governance structure was a sham. Lehman was deliberately out of control with regard to "risk" in its dominant operation – making "liar's loans." Lehman did not "manage" the risk of making liar's loans. It engaged in massive, fraudulent transactions that were "sure things" (Akerlof & Romer 1993). The Valukas Report bears witness to the consequences of these transactions. The Report provides further evidence of the accuracy of Akerlof's and Romer's famous article – "Looting: Bankruptcy for Profit." George Akerlof is

a Nobel Laureate in Economics (2001) and Paul Romer is a Professor of Economics at Stanford, so their work is an important component of modern economic understanding of the elite frauds that can cause economic crises. The "looting" that Akerlof & Romer identified is a "sure thing" in both directions – firms that loot through accounting scams will report superb (fictional) income in the short-term and catastrophic losses in the long-term. (The title of my book reflects the same concept – *The Best Way to Rob a Bank is to Own One.*)

Akerlof & Romer's insights were based in part on research by S&L regulators. Their insights have been confirmed by white-collar criminologists. Lehman was a "control fraud." That is a criminology term that refers to situation in which the persons controlling a seemingly legitimate entity use it as a "weapon" (Wheeler & Rothman 1982) of fraud (Black 2005). Financial control frauds' "weapon of choice" for looting is accounting.

Lehman's principal source of (fictional) income and real losses was making (and selling) what the trade accurately called "liar's loans" through its subsidiary, Aurora. (The bland euphemism for liar's loans was "Alt-A.") Liar's loans are "criminogenic" (they create epidemics of mortgage fraud) because they create strong incentives to provide false information on loan applications. The FBI began warning publicly about the epidemic of mortgage fraud in 2004 (CNN). Liar's loans also produce intense "adverse selection" – even the borrowers who are not fraudulent will tend to be the least creditworthy. The combination of these two perverse incentives means that liar's loans, in economics jargon, have a deeply "negative expected value" to the lender. In English, that means that the average dollar lent on a liar's loan creates a loss ranging from 50 – 85 cents.

> The value of Lehman's Alt-A mortgage holdings fell 60 percent during the past six months to $5.9 billion, the firm reported last week.[1]

Gambling against the casino creates a negative expected value, but making liar's loans creates inevitable, catastrophic losses.

That loss, however, may not be recognized for many years – particularly if the liar's loans become so large that they help hyper-inflate a financial bubble. In the near-term, making massive amounts of liar's losses loans creates a mathematical guarantee of producing record (albeit fictional) accounting income. (As long as the bubble inflates, the liar's loans can be refinanced – creating additional fictional income and delaying (but increasing) the eventual loss. The industry saying for this during the S&L debacle was: "a rolling loan gathers no loss."

Lehman's underlying problem that doomed it was that it was insolvent because it made so many bad loans and investments. It hid its insolvency through the traditional means – it refused to

[1] http://www.denverpost.com/headlines/ci_10473057 "Local Lehman arm led in Alt-A loans." **By Greg Griffin** *The Denver Post*. Posted: 09/16/2008 12:30:00 AM MDT

recognize its losses honestly. It could not resolve its liquidity crisis because it was insolvent and its primary source of fictional accounting income collapsed with the collapse of the secondary market in nonprime loans. If Lehman sold its assets to get cash it would have to recognize these massive losses and report that it was insolvent. Investors knew that Lehman was grossly inflating its asset values, so they were generally unwilling buy stock in Lehman or acquire it.

There is no way to "manage" the "risk" of making massive amounts of liar's loans. Lehman was the world leader in making liar's loans. As the name makes clear, Lehman's top managers knew that their principal source of income was making fraudulent loans. It was necessary, therefore, that Lehman not document that its liar's loans were frequently fraudulent. Lehman, instead, classified its massively fraudulent liar's loans as "prime" loans. Its disclosures did not identify how many of the "prime" loans it held were actually liar's loans. As I will discuss in more detail in response to your final question, Lehman personnel that pointed out the fraudulent liar's loans were attacked, even fired, by Lehman's management. Honest managers, of course, would be delighted if employees identified frauds.

That same pattern of conscious managerial indifference to pervasive mortgage and accounting fraud was the norm at other nonprime mortgage participants that have been investigated. I refer to it as the financial "don't ask; don't tell" policy. Here is a classic example from Standard & Poors. The context is that the professional credit rating specialist has asked his boss for a copy of the "tapes" which contain the nonprime loan files that are the "underlying" backing a collateralized debt obligation (CDO). The professional plans to review a sample of the lender's loan files so that he can evaluate their credit quality. Here is the response he receives (the punctuation is from the original).

> Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don't have it and can't provide it. [W]e MUST produce a credit estimate. It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.[2]

Making liar's loans is not risky – it is suicidal. That is why every significant lender specializing in liar's loans failed. The pervasive fraud cannot be admitted – for Lehman's entire business model was premised on massive sales of liar's loans to others. If Lehman admitted that its liar's loans were often fraudulent it could not sell them – cutting off one of its largest sources of income. Worse, it would be stuck with a portfolio full of fraudulent loans and have to recognize (or hide through further accounting fraud) that it was insolvent. Worse still, if it admitted its liar's loans were often fraudulent it would risk having to repay past purchasers of its liar's loans and risk SEC suits and criminal prosecutions. This is why "risk management" is always a sham at firms holding liar's loans. Risk management is premised on honest operations, honest data,

[2] E-mail from Frank Raiter to Richard Gugliada et al., March 20, 2001 http://oversight.house.gov/story.asp?ID=2250

and honest managers. Honesty is fatal to entities making, or purchasing, large amounts of liar's loans.

Second, the right "tone at the top" is essential to effective corporate governance. Lehman's managers too often created an unethical tone. The Valukus Report contains an example of this problem. When SVP Lee blew the whistle on accounting abuses, as he was required to do under Lehman's employee policies, management responded by firing him.

Lehman is alleged to have treated another whistleblower in a similar fashion.

> The HR lady pulled Michael Walker into a room and told him he was fired.
> The reason: Talking to the FBI. It was a violation of the company's privacy policy.
> "I was stunned," Walker told me. "I couldn't believe it. But that's what she said."
> Walker, a "high-risk specialist," was then walked out of the building as if he were the risk. His job at Aurora Loan Services LLC, Littleton, Colo., ended on Sept. 4, 2008.
>
> Aurora was a subsidiary of Lehman Brothers, the big, failing Wall Street investment bank that didn't get a bailout. A week after Walker was fired, Lehman filed history's biggest bankruptcy.
>
> His job was to uncover mortgage fraud. But he claims he was fired for doing it. In a lawsuit recently filed in Denver District Court, he claims Lehman's mortgage subsidiary wanted to remain profitably unaware of fraud.
>
> Aurora made its loans through independent mortgage brokers, who often didn't have to meet any criteria to be brokers, not even criminal background checks in some cases. Inevitably, some percentage of the mortgage applications they took would be laced with fraud. But like everyone else, they got paid by loan volume, not by loan quality.
>
> Consequently, Walker and his fraud-seeking colleagues were always busy.
> "They just absolutely flooded us with work," he said. "There was no way we could possibly keep up with it. And that's what they wanted.
>
> "They were putting the loans into an investment trust," he explained. "When they became aware of fraud, they had to buy those loans back out of the trust. So it ended up costing them money."
>
> What were the chances that Bob's Fly-By-Night Mortgage Co. Would be able to return the funds it got from Aurora? What were the chances that the losses could be recovered through foreclosure? Better to let it ride.

> But Walker couldn't play this game. A "Suspicious Activity Report" that he filed in 2006 led to interviews with the FBI and the IRS in 2008, and then ultimately to his bizarre dismissal.[3]

Walker endangered the fraud scheme that lay at the heart of Lehman's (fictional) profitability because he violated the "don't ask; don't tell" rule and brought the FBI to Aurora's offices. Control fraud turns everything that is normally good about private markets perverse. It creates a "Gresham's dynamic" in which bad ethics drives good ethics from the marketplace.

The Walker case is stunning, but it is important to step back and see the contours of the forest. Any firm that specializes in making liar's loans that it purchases from others (who are paid on the basis of volume and conducted no meaningful underwriting prior to lending) and sells to others without any meaningful underwriting will have a pervasive corrupt tone.

Lehman's senior managers consciously chose to take the unethical path because they viewed it as extraordinarily profitable.

> Mr. Hibbert was a vice-president at Lehman Brothers and he'd been sent to meet First Alliance founder Brian Chisick to see if Lehman could form some kind of relationship with the mortgage lender.
>
> "This is a weird place," he wrote later in an internal memo. While he noted the company's "efficient use of their tools to create their own niche," he also pointed out that "there is something really unethical about the type of business in which [First Alliance] is engaged."
>
> Mr. Chisick had become one of the biggest players in subprime loans. First Alliance's annual revenue had doubled in four years to nearly $60-million (U.S.) and its profit had increased threefold to $30-million.
>
> In his detailed report, he described the marketing operation as a "work of art" and marvelled at the profit margin, cash flow, collection practices and growth prospects of First Alliance.
>
> But Mr. Hibbert also had some concerns. The company targeted too many elderly customers; he had seen several 30-year loans given to people in their 70s. "It is a sweat shop," he wrote. "High pressure sales for people who are in a weak state." First Alliance is "the used car salesperson of [subprime] lending. It is a requirement to leave your ethics at the door. ... So far there has been little official intervention into this market sector, but if one firm was to be singled out for governmental action, this may be it."

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[3] http://www.foxbusiness.com/story/markets/al-lewis-privacy-policy-hides-mortgage-fraud/ (December 31, 2009).

> Despite the warning, Lehman officials recommended a $100-million loan facility for First Alliance. Mr. Chisick turned it down, but he agreed to take a $25-million line of credit and hire Lehman to work with Prudential on several securitizations.
>
> First Alliance was now set. It went public a year later on Nasdaq at $17 a share, with Mr. Chisick keeping 75-per-cent control. The stock hit $27 by year end and peaked at $36.25 shortly afterward. Mr. Chisick opened two dozen offices across the U.S., and made other expansion plans. By 1997, First Alliance was on track to arrange more than $500-million worth of loans, up from $324-million a year earlier.

At this juncture, various state Attorneys General began to sue First Alliance for consumer fraud. Prudential terminated its ties with the lender.

> But Lehman jumped at the opportunity to move in. Senior vice-president Frank Gihool asked Mr. Hibbert to pull together a review of First Alliance for Lehman's credit risk management team. Mr. Hibbert once again marvelled at the company's operations and financial outlook. But he also said the lawsuits posed a serious problem. The allegation about deceptive practices "is now more than a legal one, it has become political, with public relations headaches to come," he wrote.
>
> Nonetheless, on Feb. 11, 1999, Lehman approved a $150-million line of credit, and became the company's sole manager of asset-backed securities offerings. The bottom line for Lehman was made clear in another internal report: The firm expected to earn at least $4.5-million in fees.
>
> But within a year, the weight of the lawsuits crippled First Alliance. On March 23, 2000, the company filed for bankruptcy protection. Mr. Chisick managed to walk away with more than $100-million in total compensation and stock sales over four years. Lehman, owed $77-million, collected the full amount, plus interest.
>
> First Alliance eventually settled the lawsuits filed by the state attorneys, agreeing to pay $60-million. In the California class-action case, a jury found Lehman partially responsible for First Alliance's conduct and ordered the firm to pay roughly $5-million.

Lehman acquired Aurora to be its liar's loan specialist. Aurora, which was inherently in the business of buying and selling often fraudulent loans, set its ethical tone at subterranean levels.

> Mark Golan was getting frustrated as he met with a group of auditors from Lehman Brothers.
>
> It was spring, 2006, and Mr. Golan was a manager at Colorado-based Aurora Loan Service LLC, which specialized in "Alt A" loans, considered a step above subprime lending. Aurora had become one of the largest players in that market, originating $25-billion worth of loans in 2006. It was also the biggest supplier of loans to Lehman for securitization.

> Lehman had acquired a stake in Aurora in 1998 and had taken control in 2003. By May, 2006, some people inside Lehman were becoming worried about Aurora's lending practices. The mortgage industry was facing scrutiny about billions of dollars worth of Alt-A mortgages, also known as "liar loans"– because they were given to people with little or no documentation. In some cases, borrowers demonstrated nothing more than "pride of ownership" to get a mortgage.
>
> That spring, according to court filings, a group of internal Lehman auditors analyzed some Aurora loans and discovered that up to half contained material misrepresentations. But the mortgage market was growing too fast and Lehman's appetite for loans was insatiable. Mr. Golan stormed out of the meeting, allegedly yelling at the lead auditor: "Your people find too much fraud."

Lehman senior management, however, responded to problems of fraud and unethical behaviour by cranking up the volume of liar's loans by Aurora and BNC Mortgage (which specialized in subprime loans).

> Lehman had become the only vertically integrated player in the industry, doing everything from making loans to securitizing them for sale to investors.
>
> ***
>
> Lehman was a dominant player on all sides of the business. Through its subsidiaries – Aurora, BNC Mortgage LLC and Finance America – it was one of the 10 largest mortgage lenders in the U.S. The subsidiaries fed nearly all their loans to Lehman, making it one of the largest issuers of mortgage-backed securities. In 2007, Lehman securitized more than $100-billion worth of residential mortgages.
>
> These demands posed a much larger problem: contagion. Because these CDOs were thinly traded, many of them did not yet reflect the loss in value implied by their crumbling mortgage holdings. If Bear Stearns or its lenders began auctioning these CDOs off, and nobody wanted to buy them, prices would plummet, requiring all banks with mortgage exposure to begin adjusting their books with massive writedowns.
>
> Lehman, despite its huge mortgage exposure, appeared less scathed than some. Mr. Fuld was awarded $35-million in total compensation at the end of the year.

http://www.theglobeandmail.com/report-on-business/article703526.ece

Volume of liar's loans and subprime was everything – as long as Lehman could sell the liar's loans to other parties. Volume created immense real losses, but it also maximized Mr. Fuld's compensation.

> Aurora was originating more than $3 billion a month of such loans in the first half of 2007.

> Lehman's real estate businesses helped sales in the capital markets unit jump 56 percent from 2004 to 2006, faster than from investment banking or asset management, the company said in a filing. Lehman reported record earnings in 2005, 2006 and 2007.

http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVZKah.at5fY

September 15, 2008

2. The role of the SEC as Lehman's primary regulator in oversight, examination and enforcement in advance of Lehman's bankruptcy filing, and the role of the other government agencies, including the Federal Reserve Bank of New York (FRBNY), that were monitoring Lehman during the crisis.

The Consolidated Supervised Entities (CSE) program never made the SEC a real "primary regulator." The SEC is incapable, as constituted, staffed, and led to be a primary regulator of anything – and that includes the rating agencies. "Safety and soundness" regulation is a completely different concept than a "disclosure" regime. The SEC's expertise, which it has allowed to rust away for a decade, is in enforcing disclosure requirements. The SEC did not have the mindset, rules, or appropriate personnel to make the CSE program a success even if the agency had been a "junk yard dog." Given the fact that the SEC was self-neutered by its leadership during the period Lehman was in crisis in 2001-2008, there was no chance that it would succeed. Its only hope was to form an effective partnership with the Fed. The Fed had unique authority under the Home Ownership and Equity Protection Act of 1994 (HOEPA) to regulate all mortgage lenders and had unprecedented practical leverage during the crisis because of its ability to lend and convert investment banks to commercial bank holding companies. The Fed is supposed to be an experienced "safety and soundness" regulator (though I will express doubts that it is effective). An SEC/Fed partnership would at least have some chance. The Valukas report reveals that the FRBNY staff at Lehman recognized that the SEC staff at Lehman's offices were not capable of understanding its financial condition.

One approach that other nations use is to combine the securities and financial regulation functions in a single Financial Services Agency (FSA).

3. The relationship and means of communication, especially formal and informal information sharing, between the SEC and FRBNY as Lehman's financial condition deteriorated as well as between Lehman, the SEC, the Treasury Department, the Board of Governors Federal Reserve, and the FRBNY.

It was a painful, as a former regulator, to read the Valukas report's discussion of the FRBNY staff's open disdain for working cooperatively with the SEC to protect the public. The Valukas

report exposes the sick relationship between the country's main regulatory bodies and the systemically dangerous institutions (SDIs) they are supposed to be policing. The FRBNY, led by President Geithner, had a clear statutory mission -- promote the safety and soundness of the banking system and compliance with the law – stood by while Lehman deceived the public through a scheme that FRBNY officials likened to a "three card monte routine" (p. 1470).

> The FRBNY discounted the value of Lehman's pool to account for these collateral transfers. However, the FRBNY did not request that Lehman exclude this collateral from its reported
>
> liquidity pool. In the words of one of the FRBNY's on-site monitors: "how Lehman reports its
>
> liquidity is between Lehman, the SEC, and the world" (p. 1472).

Translation: The FRBNY knew that Lehman was engaged in fraud designed to overstate its liquidity and, therefore, was unwilling to loan as much money to Lehman. The FRBNY did not, however, inform the SEC, the public, or the OTS (which regulated an S&L that Lehman owned) of the fraud. The Fed official doesn't even make a pretense that the Fed believes it is supposed to protect the public. The FRBNY remained willing to lend to a fraudulent systemically dangerous institution (SDI). This is an egregious violation of the public trust, and the regulatory perpetrators must be held accountable. The Fed wanted to maintain a fiction that toxic mortgage product were simply misunderstood assets, so it allowed Lehman to keep dealing the three card monte scam. We now know from Valukas and from former Treasury Secretary Paulson that the Treasury and the Fed knew that Lehman was massively overstating its on-book asset values: "According to Paulson, Lehman had liquidity problems and no hard assets against which to lend" (p. 1530). We know from Valukas' interview of Geithner (p. 1502):

> The challenge for the Government, and for troubled firms like Lehman, was to reduce risk exposure, and the act of reducing risk by selling assets could result in "collateral damage" by demonstrating weakness and exposing "air" in the marks.

Or, in plain English, the Fed didn't want Lehman and other SDIs to sell their toxic assets because the sales prices would reveal that the values Lehman (and all the other SDIs) placed on their toxic assets (the "marks") were inflated with worthless hot air. Lehman claimed its toxic assets were worth "par" (no losses) (p. 1159), but Citicorp called them "bottom of the barrel" and "junk" (p. 1218). JPMorgan concluded: "the emperor had no clothes" (p. 1140). The FRBNY acted shamefully in covering up Lehman's inflated asset values and liquidity. It constructed three, progressively weaker, stress tests – Lehman failed even the weakest test. The FRBNY then allowed Lehman to administer its own stress test. Surprise, it passed.

The Fed's defense of its disgraceful refusal to protect the public is meritless. It argues that it was not there in its regulatory capacity and that it sent only a few staffers that laced the capacity or the leverage to accomplish any supervisory goals. This is either a deliberate obfuscation or a confession of a core failure. As Senior Vice President and General Counsel of the FHLBSF I was always a regulator – even when I was providing involved in credit-side activities. As a lender, the FHLBSF often learned material information about the institutions we regulated because we engaged in effective underwriting of asset quality. My predecessor famously used the leverage of the FHLBSF as lender of last resort for the largest S&L in America, which was in a liquidity crisis, to force out the fraudulent CEO controlling the institution and to enter into a broad array of steps that greatly reduced the institution's risk exposure and frauds. At its peak, we had roughly 50 FHLBSF credit personnel resident at the S&L. The fact that the FRBNY, which had far more resources than the FHLBSF, chose to send only a token crew to be on-site at a potential global catastrophe is a demonstration of failure, not a valid excuse for their failure to act to protect the public. The FRBNY has vastly greater leverage than the FHLBSF ever had and in the context of the Lehman crisis it had the leverage to force any change it believed was necessary, including an immediate conversion of Lehman to a bank holding company and a commercial bank.

The Fed has inherent problems even in safety & soundness regulation due to its structure. First, the regional FRBs have boards of directors dominated by the industry. Congress already made the policy decision, in removing all regulatory functions from the FHLBs in the 1989 FIRREA legislation, that this is an unacceptable conflict of interest.

Second, supervision is, at best, a tertiary activity at the Fed and regional banks. Monetary policy gets all the emphasis, the credit windows come second, and economic research and safety & soundness regulation vie for a distant third place. (Consumer regulation is a bastard step child at the Fed and most agencies.)

Third, the Fed is far too close to the systemically dangerous institutions. The SDIs are in an ideal position to exploit opportunities for regulatory "capture."

Fourth, the Fed is dominated by neo-classical economists that have no theory of, experience with, or interest in the complex financial frauds that are the dominant cause of our recurring, intensifying financial crises. Bernanke appointed an economist, Patrick Parkinson, with no examination or supervision experience to head all Fed examination and supervision.

Fifth, the Fed is addicted to opaqueness and its senior ranks believe the bankers when they claim that the people must never be allowed to learn the truth about asset losses. One of the conflicts of interest that a banking regulator must never succumb to is the temptation to encourage or allow the regulated entity to lie about its financial condition for the purported purpose of preventing a run on the bank. Geithner, unfortunately, embraced that temptation and stated it

openly to the Bankruptcy Examiner. It is very easy, psychologically, to believe that you are letting a bank lie to the public for a noble reason – protecting the public. The bankers always tell the regulators that the world will end if the banks tell the truth – but that is a lie. Regulators' greatest asset is their integrity. I was one of the four FHLBSF regulators that met with the "Keating Five." To this day, I have no idea what political affiliations, if any, my three colleagues hold. We simply insisted on honest disclosures and we always made a referral to our agency to alert the SEC (and the FBI) to any efforts we found to use accounting to deceive the investors or the regulators.

4. Please reflect on the appropriateness of accounting practices such as Repo 105 or 108 and the adequacy of the disclosure of such accounting practices.

The reason accounting approaches are used to attempt to achieve GAAP treatments that are contrary to the true economic substance of the transaction is to deceive. There are no social benefits to such deception and there are enormous harms. At law, the element that distinguishes fraud from other forms of larceny is deceit. Fraudsters get the victim to trust them – then betray that trust in order to cheat them. This is why fraud is the most effective acid for destroying trust. We need trust in most areas of life, including economics and finance. When bankers no longer trust bankers, markets fail rather than "clear." This can cause global contagion. The economic substance, in every case, of Lehman's Repo transactions was a loan, not a true sale. The sole purpose of entering into the transactions was to attempt to achieve an accounting treatment directly contrary to the true nature of the transaction for the purpose of deceiving investors and regulators. If these transactions are not frauds, then accounting and accountancy have ceased to have any value or integrity. It is time for accountants, business people, and regulators to demand an end to the deliberate use of accounting to deceive.

5. The quality of Lehman's Management Discussion and Analysis disclosures in its public filings for the 2007 reporting periods.

Wholly inadequate and deceptive, but may I respectfully suggest that the question needs to be broadened to prior years. Lehman, for example, lumped fraudulent liar's loans in with prime loans and called them all "prime." This is a disgrace and an attempt to deceive. Even after multiple warnings, including the FBI in 2004, about the "epidemic" of mortgage fraud and even after the rare serious internal review was made of Aurora's liar's loan portfolio was made and revealed endemic fraud, Lehman made no meaningful disclosure of the fraud or the fatal consequences of selling fraudulent loans to other parties as a business strategy.

6. Other issues that you deem relevant to the public policy issues raised by the Lehman Report.

Lehman was an international leader in making "Alt a" loans. The trade called alt a loans "liar's loans" for the very good reason that they are liar's loans. The failure of the SEC and Fed to deal

effectively with something the trade openly called fraudulent is astonishing. Wherever we have looked we find a staggering incidence of fraud in liar's loans (often 90%). Any lender that made large amounts of liar's loans was guaranteed in the short-term (and the intermediate term given the bubble that liar's loans and subprime caused to hyper-inflate) to report record (albeit fictional) profits. The bubble leads to "refis", which mask the true loss for several years. (They can even lead to "cash out" refis through a second or third liar's loan that makes the borrower deeply underwater on his mortgage but provides him with lots of cash).

We have known for centuries that underwriting home loans is essential to avoid "adverse selection." We have known for centuries that adverse selection (1) is "criminogenic" -- it can produce widespread fraud and (2) has a "negative expected value." To put that in English, it means that, on average, you lose money by making liar's loans. That loss is inherent -- it can be masked for a time by a rapidly inflating bubble (in which case, the loss grows greatly) and it may be passed to others -- but it is inescapeable that someone will bear that loss (successful hedging, for example, simply shifts the loss to another victim). Both "principals" to the "alt a" loan generally suffer severe losses. The borrower is put into a home he cannot afford at a true market value that is significantly smaller than his mortgage. The lender (or whoever bears the loss when the loan defaults) loses. We need not have any sympathy for the fraudulent borrower, but it turns out that the fraudulent loan applications and appraisals were commonly prepared by the lender personnel or their agents. The unfaithful agents gain -- and their gains are large. The SEC's failure to take action against such blatant misrepresentations to shareholders was egregious.) Those purported profits led to very large bonuses (and stock appreciation) for Lehman's senior officers. Given Lehman's origination and sale of enormous amounts of liar's loans, I believe that the data would show that it was largely the fraudulent origination and sale of liar's loans (and mortgage paper backed by such loans) that made Lehman's officers exceptionally wealthy in 2003-2006.

Industry observers began to use the term "epidemic" to describe mortgage fraud as early as 2003. The FBI warned in Congressional testimony in 2004 of an "epidemic" of mortgage fraud. In 2005, observers released a report documenting widesrpead inflated appraisals. No honest secured lender would cause, or permit, widespread inflated appraisals, yet studies of appraisers demonstrate that the intimidation (and reprisals where intimidation failed) of appraisers grew sharply and became endemic after these warnings. The SEC took (1) no effective regulatory action against the securities firms it regulated that originated, sold, and purchased liar's loan product and (2) no effective action against firms that failed to disclose (1) the acute risk of failure that comes from originating, selling, or purchasing liar's loans or (2) the losses from making or purchasing liar's loans. (It may seem strange to talk of "risk" or "losses" from selling liar's loans, but such sales were typically made with "reps & warranties" and with "put" options where the purchaser had a right to demand that the seller repurchase bad loans. Contrary to the common refrain, the contracts were typically drawn to require that the sellers of nonprime mortgages retain some "skin in the game.")

The Fed deserves special criticism for its failure to respond to these warnings by taking any effective action to stop liar's loans. The Fed had unique authority under HOEPA to ban liar's

loans, which would have prevented the bubble from hyper-inflating and contained the rapdily growing epidemic of mortgage fraud. Most liar's loans were made by lenders that were not federally insured or regulated, so only the Fed had the power to crack down on all liar's loans. The Fed refused to use its authority under HOEPA (until mid-2008) -- a full year after the secondary market in nonprime loans collapsed. Seven years late and $2.5 trillion short (roughly the amount of nonprime loans).

Criminologists refer to entities that spread fraud epidemics as "vectors" (continuing the public health metaphor, the anopheles mosquito is a "vector" that spreads malaria and can create epidemics). Lehman was one of the largest vectors that spread the fraud epidemic. We must not focus only on what bad assets it held in portfolio at a particular time. If Lehman, for example, had sold more of its "alt a" loans earlier its losses would, of course, have been reduced but system losses on liar's loans would be unchanged. If Lehman had sold large amounts of "alt a" loans at an earlier date to Fannie and Freddie, for example, it might have caused them to collapse at an earlier date with even greater losses. This might have set off an even worse global crisis. The Fed, due to its unique HOEPA authority, and the SEC, because it has jurisdiction over every publicly traded company, were the only entities that could have shut down the vectors spreading the fraud epidemic. This should have been there most important priority. They had ample warnings of the epidemic of liar's loans and the fact that it was spreading rapidly. Lehman, Citi, WaMu, Indymac, and Bear Stearns were on everyone's list of the worst vectors, yet the Fed and the SEC took no effective action until after virtually every major originator of liar's loans had failed. It would be as if the Public Health Service waited to start killing mosquitoes until 2.5 million Americans had died of malaria over the course of a decade.

It is critical to understand that making liar's loans required multiple frauds by multiple parties. Because liar's loans create an intensely criminogenic environment, they produce fraud epidemics. Because liar's loans also create severe adverse selection, they inherently have a negative expected value. It's easy to put that in English. When Aurora (Lehman's firm that specialized in making liar's loans) made a $400,000 liar's loans they created annual (fictional) accounting income of perhaps $50,000. They also created a real loss of $200,000 - $300,000. If Lehman sold the $400,000 liar's loan to another company for $410,000, Lehman created a (real -- but likely fraudulent) gain of $10,000. This, however, simply increased the purchaser's eventual loss to $210,000 - $310,000. Whatever entity purchased the liar's loan (directly or via a CDO) owned an asset with massive real losses (50% - 85%). Assume a realistic hypothetical. Fannie purchases $60 billion in liar's loan paper from Lehman. The liar's loans are really worth $20 billion, so Fannie has just suffered a real $40 billion loss. Ask yourself: will Fannie's senior officers recognize this loss? If they do, Fannie will report that it is massively unprofitable and insolvent. The senior officers will not get their bonuses and will almost certainly be fired. Not a hard decision for Fannie's senior leadership.

Similarly, the typical Fannie purchase requires "reps and warranties" from the seller that the assets it is selling conform to higher underwriting and credit quality standards. (See Mr. Bowen's (Citi) testimony before FCIC.) Will Lehman senior managers disclose to Fannie's senior managers that the liar's loans do not conform? If they do, the deal likely dies. The typical Fannie purchase allows Fannie to "put" bad loans back to the seller. Will Fannie senior

managers, once it is "pregnant" with a portfolio filled with scores of billions of dollars of nonprime loans, choose to "put" $60 billion in liar's loan paper to Lehman in, say, June 2008? If Fannie's senior managers do so they (1) will cause Lehman to collapse and (2) will violate the key "don't ask, don't tell" rule that governed nonprime mortgages. If Fannie exercises the "put" it will be announcing to the world that (1) fraud is pervasive in liar's loans, (2) Lehman sold fraudulent liar's loans to a large number of financial firms at grossly inflated prices -- and those firms have not recognized their losses, and (3) Fannie (and presumably Freddie and other investment bankers and end purchasers) are all likely to start exercising their "put" options on liar's loan paper issues by entities other than Lehman. The (previously grossly inflated) price of liar's loans will promptly collapse to the real value (which is only 15 - 50 cents on the dollar). Among the entities that will have to report that they are massively insolvent are Fannie and Freddie. Which is to say, Fannie was not about to exercise its put on any really large block of liar's loans.

Yes, Lehman went down in a liquidity crisis, but that crisis was caused overwhelmingly by its bad assets (leverage, of course, magnifies gains and losses in asset values).
Lehman's fundamental problem was that it was insolvent and unprofitable. The operations that produced much of its fictional income produced these real losses. It could not sell enough assets to solve its liquidity problems because its assets were so bad that it would have to recognize fatal levels of losses on such sales. It could not sell enough equity (which also gives cash) to deal with its liquidity problems because everyone knew it was in desperate shape and had to (honest) means of making sufficient earnings to dig itself out of the hole. It could not find an acquirer for the same reason. Potential equity investors and acquirers could see by late 2008 that the music had stopped. House prices began to decline in late 2006. Most uninsured nonprime speciality lenders collapsed in 2007 or early 2008. The secondary market in nonprime paper collapsed in March 2007 (and there were no signs it would be recreated). Fitch (finally) went public in November 2006 with its study of CDOs backed by nonprime mortgages which found evidence of fraud in nearly every loan. Recall the repeated private efforts to create an industry fund to purchase (and hold at their inflated prices) nonprime paper -- it raised exactly $0. Bankers no longer trusted other bankers' asset valuations, which shut down a series of markets.

The relevant issue was never: can Lehman be saved? The relevant issue, one that the SEC and the Fed appear never to have even asked, was: how can we stop Lehman from serving as a vector spreading the epidemic of liar's loans? They should have asked themselves that question -- and acted -- no later than 2001. We (OTS) acted in 1991 to contain a growing problem in nonprime lending because we understood adverse selection and its role in causing fraud and negative expected value. The Fed and the SEC, therefore, had the duty, the power, the background in economics, and the example of our successful regulatory intervention that prevented an earlier nonprime crisis -- all of which should have made it far easier for them to contain the crisis. Unlike 1991, when we acted to prevent a nonprime crisis, the loans that the current "alt a" lenders made were openly called "liar's loans" by the trade. How difficult was it for the SEC and the Fed to figure out that we should end "liar's loans"? Even it you assume that the SEC and the Fed were so committed to the mantra that regulation is the source of all evil, they have no excuse for their failure to respond effectively in 2004 when the FBI warned

them that the "epidemic" of mortgage fraud would cause a crisis if it were not contained. The SEC and the Fed had the unique authority to contain the crisis. They failed to do so.

Mortgage Fraud became Endemic

Roughly 40% of U.S. mortgage lending during 2006 was nonprime, evenly split between subprime (known credit defects) and "alt-a" (purportedly high credit quality, but lacking verification of key underwriting data). "Alt-a" loans, by definition, did not conduct traditional underwriting (Bloomberg 2007; Gimein 2008). Almost half of subprime loans, by 2006, did not conduct traditional underwriting. Nearly 30% of total mortgage lending in 2006 lacked traditional underwriting. A small sample review of nonprime loan files by Fitch (2007), found that underwriting had to be eviscerated to permit the endemic fraud that came to characterize nonprime mortgage lending.

> Fitch's analysts conducted an independent analysis of these files with the benefit of the full origination and servicing files. The result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file.
>
> [F]raud was not only present, but, in most cases, could have been identified with adequate underwriting, quality control and fraud prevention tools prior to the loan funding. Fitch believes that this targeted sampling of files was sufficient to determine that inadequate underwriting controls and, therefore, fraud is a factor in the defaults and losses on recent vintage pools.

MARI, the Mortgage Bankers Association (MBA's) experts on fraud, warned that "low doc" lending caused endemic fraud.

> Stated income and reduced documentation loans … are open invitations to fraudsters. It appears that many members of the industry have little historical appreciation for the havoc created by low-doc/no-doc products that were the rage in the early 1990s. Those loans produced hundreds of millions of dollars in losses for their users.
>
> One of MARI's customers recently reviewed a sample of 100 stated income loans upon which they had IRS Forms 4506. When the stated incomes were compared to the IRS figures, the resulting differences were dramatic. Ninety percent of the stated incomes were exaggerated by 5% or more. More disturbingly, almost 60% of the stated amounts were exaggerated by more than 50%. These results suggest that the stated income loan deserves the nickname used by many in the industry, the "liar's loan."

The same obvious question (which neither Fitch nor MARI asked) arises: why did lenders fail to use well understood underwriting systems that are highly successful in preventing fraud – even when they knew that fraud was endemic and would cause massive losses? The same obvious answer exists – it was in the interests of the controlling officers to optimize short-term accounting income. Turning a blind eye to endemic fraud helped optimize reported income and their executive compensation.

MARI's reference to the "early 1990s" refers to a number of S&Ls that originated or purchased "low doc" loans in the early 1990s. These loans caused "hundreds of millions of dollars in losses." Those losses were contained because the regulators promptly used their supervisory powers to halt the practice when they realized that it was growing and becoming material. We acted because we recognized that not underwriting maximized adverse selection and guaranteed high real losses (after near-term, fictional, profits). We ordered a halt to the practice even while many of the lenders were reporting that the lending was profitable. "Hundreds of millions of dollars in losses" is serious, but if the losses are contained at that level the number of lender failures will be minimal and there will be no risk of a crisis. Unfortunately, our regulatory successors had no "historical appreciation" for successful supervisory policies or the identification of accounting control fraud. They issued ineffective "cautions" to the industry that "low doc" loans could be risky, but refused to order an end to the practice and never considered the possibility that the lenders were control frauds.

Thomas J. Miller, Attorney General of Iowa, testimony at a 2007 Federal Reserve Board hearing shows why fraud losses are enormous:

> Over the last several years, the subprime market has created a race to the bottom in which unethical actors have been handsomely rewarded for their misdeeds and ethical actors have lost market share.... The market incentives rewarded irresponsible lending and made it more difficult for responsible lenders to compete. Strong regulations will create an even playing field in which ethical actors are no longer punished.
>
> Despite the well documented performance struggles of 2006 vintage loans, originators continued to use products with the same characteristics in 2007.
>
> [M]any originators ... invent ... non-existent occupations or income sources, or simply inflat[e] income totals to support loan applications.
>
> Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer.

These risks were "layered" – interacting to produce far greater risk (IMF 2008: 4-5 & n.6). Honest nonprime lenders would have responded by establishing record high general loss reserves in accordance with generally accepted accounting principles (GAAP). Instead, A.M. Best reported in February 2006 that: "the industry's reserves-to-loan ratio has been setting new record lows for the past four years" (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). One year later, A.M. Best reported: "loan loss reserves are down to levels not seen since 1985" (roughly one percent) (A.M. Best 2007: 1). A.M. Best went on to point out that these grossly inadequate loss reserves in 1985 led to a decade-long crisis in banking and S&Ls. In 2009, IMF estimated losses on U.S. originated assets of $2.7 trillion (IMF 2009: 35 Table 1.3). Total U.S. bank and S&L general loss reserves in 2006 were under $100 billion, so

general loss reserves would have had to be roughly 30 times larger to be adequate. If the lenders had established adequate loss reserves they would have reported that they were deeply unprofitable, which was the economic reality. The banking regulatory agencies, the SEC, and "private market discipline" all failed to require even remotely adequate reserves and minimal honesty in financial reports. The current control frauds used the same optimization techniques as did the S&Ls – but they did it on steroids. The primary epidemic directly created the upstream epidemic and was a necessary, but not sufficient, cause of the upstream epidemic.

If You Don't Investigate, You Won't Find

Criminologists and financial regulators have long warned that the failure to regulate the financial sphere *de facto* decriminalizes control fraud in the industry. The FBI cannot investigate effectively more than a small number of the massive accounting control frauds. Only the regulators can have the expertise, staff, and knowledge to identify on a timely basis the markers of accounting control fraud, to prepare the detailed criminal referrals essential to serve as a roadmap for the FBI, and to "detail" (second) staff to work for the FBI and serve as their "Sherpas" during the investigation.

The agency regulating S&Ls made criminal prosecution a top priority. The result was over 1000 priority felony convictions of senior insiders and their co-conspirators. That is the most successful effort against elite white-collar criminals. The agency also brought over 1000 administrative enforcement actions and hundreds of civil lawsuits against the elite frauds. One result of this was an extensive, public record of fact that fraud was "invariably present" at the "typical large failure" (NCFIRRE 1993). The Enron-era frauds were accounting control frauds and while the effort against them was too late and weaker than the effort against the S&L frauds it involved scores of prosecutions and provided substantial public documentation.

The FBI, however, after a brilliant start in identifying the epidemic of mortgage fraud, went tragically astray and its efforts to contain the epidemic failed. The FBI suffered from a horrific systems capacity problem. It did not have the agents or expertise to deal with the concurrent control fraud epidemics it faced this decade. Its systems capacity problems became crippling when 500 white-collar specialists were transferred to national security investigations in response to the 9/11 attacks and the administration refused to allow the FBI to hire new agents to replace the lost white-collar specialists.

The most crippling limitation on the regulators', FBI's, and DOJ's efforts to contain the epidemic of mortgage fraud and the financial crisis was not understanding of the cause of the epidemic and why it would cause a catastrophic financial crisis. The mortgage banking industry controlled the framing of the issue of mortgage fraud. That industry represents the lenders that caused the epidemic of mortgage fraud. The industry's trade association is the Mortgage Bankers Association (MBA). The MBA followed the obvious strategy of portraying its members

as the victims of mortgage fraud. What it never discussed was that the officers that controlled its members were the primary beneficiaries of mortgage fraud. It is the trade association of the "perps." The MBA claimed that all mortgage fraud was divided into two categories – neither of which included accounting control fraud. The FBI, driven by acute systems incapacity, formed a "partnership" with the MBA and adopted the MBA's (facially absurd) two-part classification of mortgage fraud (FBI 2007). The result is that there has not been a single arrest, indictment, or conviction of a senior official of a nonprime lender for accounting fraud.

One of the most dramatic, and unfortunate differences between the S&L debacle and the current crisis is that the financial regulatory agencies gave the FBI no help in this crisis – even after it warned of the epidemic of mortgage fraud. The FBI does not mention the agencies in its list of sources of criminal referrals for mortgage fraud. The data on criminal referrals for mortgage fraud show that regulated financial institutions, which are required to file criminal referrals when they find "suspicious activity" indicating mortgage fraud, typically fail to do so. There is no evidence that the agencies responsible for enforcing the requirement file criminal referrals have taken any action to crack down on the widespread violations.

The crippling mischaracterization of the nature of the mortgage fraud epidemic came from the top, as the *New York Times* reported in late 2008.

> But Attorney General Michael B. Mukasey has rejected calls for the Justice Department to create the type of national task force that it did in 2002 to respond to the collapse of Enron.
>
> Mr. Mukasey said in June that the mortgage crisis was a different "type of phenomena" that was a more localized problem akin to "white-collar street crime."

The nation's top law enforcement official swallowed the MBA's mischaracterization of the mortgage fraud epidemic and economic crisis hook, line, sinker, bobber, rod, reel, and boat they rowed out into the swamp. Because Mukasey refused to investigate the elite frauds he created a self-fulfilling prophecy in which the FBI and DOJ pursued only the "white-collar street crim[inals]" (the small fry) and therefore confirmed that the problem was the small fry. The pursuit of the small fry was certain to fail.

The MBA's success in causing the FBI to ignore the control frauds reminds me of this passage in the original *Star Wars* movie where Obi-Wan uses Jedi powers to pass through an Imperial check point with two wanted droids in plain sight:

Stormtrooper: Let me see your identification.
Obi-Wan: [*with a small wave of his hand*] You don't need to see his identification.
Stormtrooper: We don't need to see his identification.
Obi-Wan: These aren't the droids you're looking for.
Stormtrooper: These aren't the droids we're looking for.
Obi-Wan: He can go about his business.

Stormtrooper: You can go about your business.
Obi-Wan: Move along.
Stormtrooper: Move along... move along.

Luke: I don't understand how we got by those troops. I thought we were dead.
Obi-Wan: The Force can have a strong influence on the weak-minded.

The FBI isn't supposed to be "weak-minded" about elite white-collar criminals. It is not supposed to be misled by "Jedi mind tricks" by the lobbyists for the "perps." It is not supposed to fail to understand the importance of endemic markers of accounting control fraud at every nonprime specialty lender where even a preliminary investigation has been made public.

The FBI, DOJ, banking regulators, SEC, and all the purported sources of "private market discipline" failed to act against (and even praised) the *perverse incentive structures* that the accounting control frauds created to cause the small fry to act fraudulently. Those incentive structures ensured that there were always far more new small fry hatched to replace the relatively few small fry that the DOJ could imprison. Accounting control frauds deliberately produce intensely criminogenic environments to recruit (typically without any need for a formal conspiracy) the fraud allies that optimize accounting fraud. They create the perverse Gresham's dynamic that means that the cheats prosper at the expense of their honest competitors. The result can be that the unethical drive the ethical from the marketplace. Had Mukasey been aware of modern white-collar criminological research he would have been forced to ask why tens of thousands of small fry were able to cause an epidemic of mortgage fraud in an industry that had historically successfully held fraud losses to well under one percent of assets. Ignoring good theory produces bad criminal justice policies.

The Size of the Mortgage Fraud Epidemic Swamps the FBI

The size of the current financial crisis and the incidence of fraud in the current crisis vastly exceed the S&L debacle. The FBI testified that it "increased the number of agents around the country who investigate mortgage fraud cases from 120 Special Agents in FY 2007 to 180 Special Agents in FY 2008...." Its testimony noted that it employed "1000 FBI agents and forensic experts" against the S&L frauds (Pistole 2009). It received over 63,000 criminal referrals for mortgage fraud in the last year for which it has full data (a figure that has risen substantially every year). The FBI, therefore, can investigate only a tiny percentage of criminal referrals for mortgage fraud. The FBI reports that 80% of mortgage fraud losses occur when "industry insiders" are involved in the fraud (FBI 2007).

Only federally insured banks and S&Ls are required to file criminal referrals. Non-insured lenders made 80% of nonprime mortgage loans (subprime and "alt-a"), and the made the worst nonprime loans that most invited fraud. These lenders can make criminal referrals and it would

be in the interests of honest lenders to do so, but they rarely do. That means that the first approximation of the true annual incidence of mortgage fraud would be to multiply 63,000 by five (315,000). That extrapolation, however, would only be sound if (A) insured lenders spotted all mortgage fraud and (B) filed criminal referrals when they spotted likely frauds. The FBI believes that insured entities identify mortgage frauds prior to lending in about 20% on "no doc" loans (known in the trade as "liar's loans") (*New York Times,* April 6, 2008). Multiplying 315,000 by five produces a product of over 1.5 million.

The data on referrals show that the typical insured lender rarely files when it finds mortgage fraud. The October 2009 FinCEN report on criminal referrals for mortgage fraud (in jargon, Suspicious Activity Reports (SARs) found:

> In the first half of 2009, approximately 735 financial institutions submitted SARs, or about 50 more filers compared to the same period in 2008. The top 50 filers submitted 93 percent of all [mortgage fraud] SARs, consistent with the same 2008 filing period. However, SARs submitted by the top 10 filers increased from 64 percent to 72 percent.

Only a small percentage of mortgage lenders, 75 in total (roughly 10% of federally-insured mortgage lenders), filed even a single criminal referral for mortgage fraud during a mortgage fraud epidemic. Of the 735 that make at least one filing, fewer than 200 file more than four referrals. A mere ten filers provide the FBI with almost three-quarters of all SARs mortgage fraud filings. We cannot form an appropriate estimate of the degree of under-filing of criminal referrals when insured banks find fraud, but we can infer that the failure to file is pervasive. The logical explanation for the widespread failure of lenders to file criminal referrals when they discover mortgage frauds is that they fear that if they file FBI would come to the lender and discover its complicity in the fraud.

To sum it up, in FY 2007 the FBI has had less than one-eighth of the resources it had to investigate the S&L frauds despite the fact that the current crisis is perhaps 30 times worse than the S&L debacle. It was facing well over a million mortgage frauds annually. It could investigate under 1000 cases per year. If every investigation was successful the FBI would be completely ineffective in preventing or even slowing materially the epidemic of mortgage fraud. Mukasey's strategy of going after the small fry gave the control frauds a free pass and had to fail to deter the small fry. Representative Kaptur's bill to fund the FBI's replacement of the reassigned agents is a necessary step that I hope will gain bipartisan support.

What if We Had Looked?

Within the last month, facts have been revealed about four massive nonprime players that show the strong evidence of elite criminality that would have been revealed – in some cases, five years ago – had there been real investigations. In addition to Lehman, there have been recent disclosures on:

WaMu

Members interested in reading the Senate Banking Committee report and the underlying documents can find them through this link:

http://levin.senate.gov/newsroom/release.cfm?id=323765

Citicorp

The full prepared statement of Mr. Richard Bowen, Former Senior Vice President and Business Chief Underwriter of CitiMortgage Inc. before the Financial Crisis Inquiry Commission on April 7, 2020 can be found here:

http://www.fcic.gov/hearings/04-07-2010.php

Mr. Bowen's testimony received far less attention because he testified on the same day as Alan Greenspan and Citi's former top officials. This is unfortunate because he was far more candid about Citi's operations than were its former senior officials. Mr. Bowen disclosed that Citi was also a massive vector, selling roughly $50 billion annually in mostly bad mortgages (primarily to Fannie and Freddie).

> The delegated flow channel purchased approximately $50 billion of prime mortgages annually. These mortgages were not underwriten by us before they were purchased. My Quality Assurance area was responsible for underwriting a small sample of the files post-purchase to ensure credit quality was maintained.
>
> These mortgages were sold to Fannie Mae, Freddie Mac and other investors. Although we did not underwrite these mortgages, Citi did rep and warrant to the investors that the mortgages were underwritten to Citi credit guidelines.
>
> In mid-2006 I discovered that over 60% of these mortgages purchased and sold were defective. Because Citi had given reps and warrants to the investors that the mortgages were not defective, the investors could force Citi to repurchase many billions of dollars of these defective assets. This situation represented a large potential risk to the shareholders of Citigroup.
>
> I started issuing warnings in June of 2006 and attempted to get management to address these critical risk issues. These warnings continued through 2007 and went to all levels of the Consumer Lending Group.
>
> We continued to purchase and sell to investors even larger volumes of mortgages through 2007. And defective mortgages increased during 2007 to over 80% of production.

Goldman Sachs

The SEC charges that Goldman Sachs should be added to the list of elite financial frauds.

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Statement By Thomas H. Cruikshank To House Financial Services Committee

I would like to thank the House Financial Services Committee for inviting me to appear at today's hearing on public policy issues raised by the Lehman Bankruptcy Examiner's Report. No one can deny that the bankruptcy of Lehman Brothers has had a disastrous impact – on the company, its employees, its investors, and even on our country and its economy. As a director of the firm, Lehman's collapse weighs on me personally each and every day. It is vital that we learn from Lehman's history so we do not repeat it. In this spirit, I applaud the Committee for holding these hearings today.

My Background

I joined Lehman Brothers Holdings Inc. ("Lehman") as a director in 1996, and have served on the Board for approximately 14 years. I have been a member of the Audit Committee of the Board since the beginning of my tenure and chairman of that Committee since 2003. I have also served on the Board's Nominating and Corporate Governance Committee.

After graduating from Rice University with a degree in Business Administration and Economics, I began my career at the accounting firm Arthur Andersen. While working, I also attended law school. I left Arthur Andersen in 1955 to serve as an officer in the Navy at the end of the Korean War. After completing my service, I rejoined Arthur Andersen for a few years until I decided to try my hand at practicing law at Vinson & Elkins. Looking for another new challenge, in 1969 I joined Halliburton. I spent the next 25 years working in a number of roles, including Chief Financial Officer, President, Chief Executive Officer and Chairman. I finally retired from Halliburton after the end of 1995.

During my career, I have had the honor of serving on a number of boards of directors, including those of Goodyear, the Williams Companies, Seagull Energy, and Central and Southwest, in addition to serving as the chairman of both National Junior Achievement and Up with People (an international education organization that addresses the need for young adults and leaders to develop global perspectives, intercultural understanding and knowledge of worldwide social issues). I joined Lehman's Board because I had been very impressed by the firm's work for Halliburton when I was CEO, and because I was interested in its aspiration to build a world-class investment banking enterprise based on the "One Firm" model. During my time on Lehman's Board, I saw the company grow from a modest niche player, specializing in corporate finance and trading, into a global powerhouse that was the fourth largest investment bank in America.

Over the years, I attended dozens upon dozens of Board and Committee meetings. I also got to know a number of incredibly talented and dedicated employees (not to mention my fellow directors for whom I have an enormous amount of admiration). I developed a great respect for and strong attachment to Lehman. All of this made it so much harder to see the company collapse during the early morning hours of September 15, 2008. Indeed, that Monday was the darkest day of my professional career.

Lehman's Fall

I, along with my fellow directors, know all too well that Lehman's fall has had drastic consequences. Thousands of employees lost their jobs and much, if not all, of their savings. Investors, including me and my fellow directors, collectively lost billions of dollars. Notably, consistent with the Board's view of proper compensation practices, Lehman's employees owned approximately one quarter of the company's common shares.

Lehman's bankruptcy has had a ripple effect on America's economy – the Dow Jones index plunged 500 points on the day of the bankruptcy, and, just weeks later, Congress stepped in and passed a $700 billion rescue program for the economy (now commonly known as TARP). The collapse of Lehman, a company to which I have been devoted for nearly fifteen years, troubles me very deeply and will always continue to do so.

The Examiner's Report

Given the staggering impact that Lehman's bankruptcy has had not only on the company, but our country, it is critical that we explore the reasons behind the firm's failure so that we can learn from it and do our best to make sure something like this does not happen again. I want to thank Anton Valukas, Lehman's Bankruptcy Examiner, for all the hard work that went into producing his report. It is important to study, analyze, assess, debate and learn from it. Indeed, the Examiner, his attorneys, and his accountants spent tens of thousands of hours investigating and chronicling their understanding of Lehman and the events leading up to its bankruptcy – reviewing millions of pages of documents and interviewing more than 250 witnesses. The resulting 2200 page report (before even counting its 34 separate appendices) is a testament to the complexity of the myriad issues that Lehman faced over its last two years.

Looking back, I am sure that there are things Lehman could have done differently. But, as has often been pointed out, hindsight is twenty-twenty. And what may seem crystal clear today in 2010 was much less so back in 2007 and 2008. As you may recall, in the spring of 2007, Benjamin Bernanke, the Chairman of the Federal Reserve, advised that "the effect of the troubles in the subprime sector on the broader housing market [would] likely be limited," and that there should not be "significant spillovers from the subprime market to the rest of the economy or to the financial system."[1] Indeed, even after Bear Stearns nearly collapsed in March 2008, then Treasury Secretary Henry Paulson stated that the "worst [was] likely behind us,"[2] and that "[t]his

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1 Ben Bernanke, Chairman, Fed. Reserve, Speech at Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007).

2 Michael M. Phillips & Damian Paletta, *Paulson Sees Credit Crisis Waning*, Wall Street Journal (May 7, 2008), available at, http://online.wsj.com/article/SB121011652297872261.html (last visited Apr. 19, 2010).

[was] a very manageable situation . . . ."[3] If only they, and many other leaders in the financial world, had been right.

Still, even in retrospect, the Examiner found that there are absolutely no colorable claims against the independent directors in connection with our work on behalf of the company. The Examiner carefully reviewed the facts and circumstances regarding, among other things, Lehman's: (1) risk-taking and risk-management activities; (2) efforts to raise capital, attract strategic investors, and spin off its commercial real estate assets; (3) purported use and disclosure of "Repo 105" transactions; and (4) disclosure of its liquidity pool. His conclusion, that there are no claims against the outside directors for breaching their duties,[4] comports with my own belief and the belief of my fellow directors that we did our absolute best in exercising our business judgment to try and help navigate Lehman through what was the greatest financial tsunami since the Great Depression.

The Role of Lehman's Board of Directors

Going forward, as Congress continues to consider corporate governance issues, it is important to remember the role of a board of directors. It is not to manage, or micromanage, a corporation. That is the province of the company's officers and senior management who devote their careers to the corporation – 60, 80, 100 hours a week, 52 weeks a year. A board of directors, on the other hand, brings its collective wisdom, experience, and outside perspective to bear in "thoughtfully appointing officers, establishing or approving goals and plans and monitoring [a company's] performance."[5] And that is exactly what we, as Lehman's outside directors, worked extremely hard to do.[6]

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3 "Paulson braces public for months of tough times," Associated Press Online (July 21, 2008).

4 *See, e.g.,* Report of Anton R. Valukas, Examiner ("Examiner's Report"), at 188-95, 611, 992, 1479-80, Case No. 08-13555 (JMP) (Bankr. S.D.N.Y. Mar. 11, 2010) [Docket No. 7531].

5 R. Franklin Balotti & Jesse A. Finkelstein, *Balotti and Finkelstein's Delaware Law of Corporations and Business Organizations*, DELCBO 4.10, 2006 WL 2450219, *1 (2009) (internal citations omitted).

6 Courts have recognized that "[b]usiness decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future," and that imposing "liability on directors for making a 'wrong' business decision," would be bad public policy and "cripple their ability to earn returns for investors by taking business risks." *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009).

Since the beginning of 2007 through Lehman's bankruptcy filing in September 2008, our Board and its committees convened on more than 80 occasions in that less than 21 month span. I still remember one week in July 2008, when we were examining and analyzing the company's strategic options, meeting every day for six days in a row.

At just about every Board meeting, we received detailed reports from management on Lehman's financial performance and other important issues. These reports were made by various groups and individuals at Lehman and included, where appropriate, consultation with outside experts. We reviewed numerous metrics including the firm's balance sheet, leverage, average risk appetite usage, long term capital, as well as comparative competitive information such as ten-year debt spreads and long-term debt credit ratings. We also looked into the firm's monthly financial results and the key initiatives in each division, including fixed income, equities, banking, investment management and principal investments.

Moreover, management regularly made presentations to the Board and its committees on key topics. Such presentations included updates on:

- Lehman's Subprime Mortgage Origination Business (March 20, 2007);
- Lehman's Liquidity, Leveraged Loan Commitments and Mortgage Positions (September 11, 2007);
- Lehman's ABS CDO Exposure (November 8, 2007);
- Lehman's 2008 Financial Plan Summary (January 29, 2008);
- Liquidity and the Market (March 25, 2008);
- Lehman's Commercial Real Estate (March 25, 2008);
- Lehman's Risk Management (April 15, 2008);
- Lehman's Fixed Income Division (May 7, 2008);
- Concerns Raised Regarding Balance Sheet and Legal Entity Controls (July 22, 2008);
- Lehman's Strategic Alternatives (July 22, 2008);
- Risk Issues Facing Lehman (June 19, 2008 and August 13, 2008); and
- Lehman's Valuations (July 22, 2008).

Board meetings were an active and dynamic affair. Board members probed management, asked numerous questions and demanded and received detailed, cogent answers. In my entire career, I have never seen officers and employees who were more responsive to answering questions from its Board members. I still recall, after seeing Lehman's second quarter 2008 results, asking management for a full presentation on the company's valuations. In response, at the July Audit Committee meeting, two members of senior management presented a 23-page report, which provided an in-depth discussion and analysis of Lehman's valuation adjustments, mark downs, processes and procedures.

Risk Management

One issue that management spent a great deal of time discussing with the Board was risk. Risk-related issues were addressed by the full Board at nearly every regularly scheduled meeting. They were analyzed at the meetings of the Finance and Risk Committee. And risk issues were also addressed by other committees as well – such as the Audit Committee. Thus, as the Examiner himself noted, Lehman's Board "plainly implemented a sufficient reporting system and controls."[7]

As directors, we took great comfort from management's reports regarding Lehman's extensive risk management system, which was widely regarded as being among the best in the business. Indeed, management described in detail how risk management was at the heart of the culture of the firm; how the firm's CEO, President and entire Executive Committee took an active leadership role in key risk decisions and oversight; and how the Risk Committee, which included members of the Executive Committee and heads of key trading businesses, met weekly to discuss such topics as risk appetite, counterparty risks, market risks, and event risks. In addition, we were told about how Lehman made decisions on large risk exposures by committee; how frequently those decisions included the full Executive Committee of the firm; and how there were more than 20 different committees that served as a check on Lehman's risk taking activities. Management also informed the Board that Lehman's internal control environment had multiple overlapping and reinforcing elements. And, the Board was further reassured by the size, structure and expertise of Lehman's Global Risk Management Group, which employed industry-leading quantitative approaches to risk management and qualitative approaches to risk evaluation. This group, which had approximately 250 employees, plus more than 200 technologists (two thirds of whom had advanced degrees), was organizationally independent of the business, but had risk managers placed in the business units they covered so that they were a part of what was happening real time, day-to-day. The Board took additional comfort from management's reports regarding Lehman's extensive Valuation and Control group, which consisted of a technical staff well-versed in the products they covered.

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[7] Examiner's Report at 194.

Reliance on Professionals

In performing its oversight role, Lehman's Board of Directors – like boards at companies across the country – relied upon the expertise of a variety of professionals, both inside and outside the firm. For example, the Audit Committee worked closely with Lehman's Corporate Audit Group, which employed more than 140 people and allocated its resources to address key risks across the firm, including financial, compliance, and operational risks.

We also retained Ernst & Young ("E&Y"), one of the most highly-regarded accounting firms in the world, as the company's auditors. E&Y performed reviews on a quarterly basis by applying analytical review procedures and making inquiries of persons responsible for financial and accounting matters. They further conducted a robust annual audit of the firm's financial statements. E&Y regularly attended Audit Committee meetings, met in private sessions with the Audit Committee members and certified Lehman's financial disclosures. While E&Y regularly had substantive discussions with the Audit Committee about Lehman's audited financial statements, at no time in 2007 or 2008 did E&Y raise any red flags regarding Lehman's risk management, valuation, or the firm's certified filings.

In addition to E&Y, in early 2007, Lehman retained another world-renowned accounting firm – PricewaterhouseCoopers – to support the more quantitative aspects of risk testing by evaluating the completeness of the supporting documentation for the firm's risk models, assessing the adequacy of the methodology and testing to ensure that the models were implemented appropriately. Lehman also worked intimately with one of the most well-respected law firms in the nation, which advised it on public disclosure issues.

Interaction with Government Regulators

As a Board of Directors, we had confidence in what we understood to be Lehman's close working relationship with government regulators. Even before the financial crisis, Lehman voluntarily subjected itself to the scrutiny of the Securities and Exchange Commission ("SEC") as a part of that agency's consolidated supervised entity ("CSE") program. The purpose of this program was to give global investment banks a way to submit voluntarily to regulation that was not required by law. Under the CSE program, which provided the SEC with new and far greater transparency into Lehman's financial information, not only did Lehman meet with regulators from the SEC on at least a quarterly basis, but Lehman's Corporate Audit group also implemented systems to verify the operating effectiveness of controls supporting Lehman's capital calculation and other CSE activities and adopted a testing framework to meet the SEC's expectations. The Board understood that the SEC's CSE reviews covered corporate governance, functional risk management activities, business specific products, and capital calculation and reporting. And, we were told by management that the SEC considered Lehman a model member of the CSE program.

In addition, as the financial crisis deepened, both the SEC and the Federal Reserve Bank of New York ("FRBNY") worked intimately with Lehman to monitor and assess the firm's liquidity.

The weekend after Bear Stearns's near collapse, Lehman, together with the SEC and the FRBNY, collaborated to identify all refinancing risk. By that time, both the FRBNY and SEC had installed teams of monitors at Lehman's offices. Thereafter, management maintained a constant dialogue with the SEC and the FRBNY regarding liquidity issues.

Lehman's Efforts to Respond to the Worsening Financial Crisis

Notwithstanding the start of what became the subprime crisis, Lehman's year-end 2007 financial results reached record levels.[8] Still, in 2007 and 2008, the firm took numerous steps to adjust to the worsening economic climate. For example, by August of 2007, Lehman had shut down its subprime mortgage lending unit. The firm reduced its mortgage and asset-backed securities exposure by many billions of dollars between the fourth quarter of 2007 and third quarter of 2008. Indeed, during this period, both residential mortgage exposure and commercial real estate exposure were substantially reduced.[9] We also discussed what had appeared to have gone wrong at Bear Stearns, how Lehman was different, and what we should nonetheless do to strengthen Lehman in light of Bear Stearns's collapse. In response, through the spring of 2008, Lehman raised more than $15 billion in new capital.

Throughout 2008, Lehman also explored and pursued a number of strategic alternatives in an effort to strengthen the firm as the financial crisis deepened. Such initiatives included selling some or all of its highly lucrative investment management division, spinning off commercial real estate assets into a new company, lowering costs, reducing its dividend, decreasing leverage, and searching for strategic partners and for buyers of the entire business. While times remained troubling, a number of Lehman's efforts appeared to pay off. The Board was told how Lehman's liquidity had, between the second quarter of 2007 and the second quarter of 2008, nearly doubled to a record high.

Repo 105

The Examiner's Report has raised questions about certain transactions now known as "Repo 105." While the Examiner does not claim that Lehman's accounting for these transactions was wrong, his report suggests that these transactions should have been better disclosed.

As the Examiner has concluded, this Repo 105 issue was never brought to the attention of the Board by anyone.[10] During 2007 and 2008, the Audit Committee discussed a broad array of

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8 Press Release, *Lehman Brothers Reports Record Net Revenues, Net Income and Earnings Per Share for Fiscal 2007* (Dec. 13, 2007).

9 Press Release, *Lehman Brothers Announces Preliminary Third Quarter Results and Strategic Restructuring* (Sept. 10, 2008) (Attachments II - V).

10 Examiner's Report at 945.

financial matters with E&Y on an average of once a month. In order to ensure that the Audit Committee obtained unfettered information from our respected independent auditors, we routinely met with E&Y outside the presence of any management representatives as part of our regular process. If they had any question whatsoever about Lehman's accounting or disclosure regarding Repo 105's or any other issue, I believe that E&Y would have promptly raised the issue with the Audit Committee and I would have expected them to do so. They did not.

Still, I think it is clear that Repo 105 is not the reason Lehman failed. According to the Examiner's Report, without the use of Repo 105, Lehman's net leverage was still substantially reduced from the fourth quarter of 2007 to the second quarter of 2008.[11] And, as I have now learned, Repo 105 generally involved highly liquid government bonds that constituted a small percentage of Lehman's balance sheet.

Lehman's Bankruptcy

So, if Repo 105 was not the culprit, why did Lehman collapse into bankruptcy? I am not so presumptuous as to say that I know the definitive answer to this question. I believe that there were many factors that contributed to this failure – including, among other things, the firm's real estate exposure (which was exacerbated by the rules for applying mark-to-market accounting), the numerous short-sellers who were capitalizing on and fueling rumors about Lehman's troubles, the tightening of the short-term credit market, and perhaps most of all, a loss of confidence in Lehman in the financial world that led to a run on the bank. Since Lehman, like all investment banks, relied on a sizable amount of short-term refinancing for its survival, loss of confidence and a market-wide panic was a fatal combination.

That said, I was dismayed when, on the evening of Sunday, September 14, 2008, the Chairman of the SEC and the general counsel of the FRBNY essentially told the Board that Lehman needed to file for bankruptcy before the Asian markets opened. I do not purport to be an expert on what would have been best for our national economy, nor do I generally have a view on bailouts and the like as policy matters. Nonetheless, to this day I wonder whether more could have been done to save Lehman and stabilize the financial system. While there may be good reasons that I do not comprehend, I still do not understand why the government did not help finance a sale of Lehman to Barclays (which was on the verge of buying our company), like it did to facilitate JP Morgan's purchase of Bear Stearns. I still do not know why, the same day Lehman was told to file for bankruptcy, the Fed expanded access to its Primary Dealer Credit Facility for other major investment banks. Nor do I understand why the government did not expedite Lehman's conversion to a bank holding company, as was done for Goldman Sachs and Morgan Stanley within a week of Lehman's bankruptcy, granting those investment banks long-term access to the Fed's discount window. I still do not know why Lehman was allowed to fail after the government had saved Fannie Mae and Freddie Mac by injecting billions of dollars into them. And, I remain at a loss as to why AIG was given a $85 billion bailout on September 16, 2008,

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[11] Examiner's Report at 748.

when Lehman was given nothing. There may be good and reasonable reasons for all of these distinctions, but as a director of Lehman I do not know them.

The drastic impact of Lehman's bankruptcy on the wider economy was swift and severe. The Dow Jones dropped more than 500 points the day Lehman declared bankruptcy – at the time the largest single-day drop by points since the days following the terrorist attacks on September 11, 2001. The commercial paper market dried up. And relentless pressure was put on other major financial institutions who themselves teetered on the edge of ruin. As a result, the government stepped in with the TARP program. While we cannot rewrite history, had the government acted to stabilize Lehman so that it could have been sold or unwound, it is quite possible our country's financial crisis would not have been nearly as severe and widespread.

My Fellow Directors

Before concluding my remarks, I would like to take a moment to recognize and thank my fellow Board members for their hard work and dedication to Lehman. Lehman had a practice of selecting directors who had a history of successfully managing major companies and who had the wisdom, experience, talent and mettle to provide oversight and guidance to management and the corporation. My fellow directors have held CEO positions at such esteemed companies as I.B.M., the U.S. Export-Import Bank, Vodafone, Sotheby's, Celanese, Telemundo, U.S. Bancorp, and a large brokerage firm. The Lehman directors have also sat on various other boards of well run, successful companies. One director, a former executive committee member and chief economist at Salomon Brothers, is a world-renowned luminary in the field of economics. And yet another was a Rear Admiral in the United States Navy, the first woman to command a U.S. naval station, and the head of the American Red Cross. They truly are a remarkable group of people and it has been an honor and a privilege to serve alongside them.

My thanks to Chairman Frank, Ranking Member Bachus, and the rest of the House Financial Services Committee for the opportunity to speak with you today. While I may not have the knowledge and expertise of my fellow panelists appearing before this Committee, I am happy to address any questions you may have.

STATEMENT OF RICHARD S. FULD, JR.
BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

APRIL 20, 2010

Mr. Chairman, Ranking Member Bachus, and Members of the House Committee on Financial Services, you have invited me here today to address a number of public policy issues raised by the Lehman Brothers bankruptcy report filed by the Examiner.

Since September of 2008, I have given much thought to the financial crisis and the perfect storm of events that forced Lehman into bankruptcy. Everyone's focus is now on how to prevent another crisis. The key is how regulation and governance should be deployed going forward to better protect the financial markets and the entire system.

The idea of a "super regulator" that monitors the financial markets for systemic risk, I believe, is a good one. To be successful in today's challenging environment, this new regulator should have actual experience and a true understanding of the business of financial institutions, the capital markets and risk management and must be given the resources sufficient to accomplish its important mission.

My view is that the new regulator also should have access, on a real-time basis, to all information and data regarding transactions, assets and liabilities, as

well as current and future commitments. In addition, we should put in place established and effective methods of communication between the regulator and the firms being regulated, all of whom should be guided by clear standards for capital requirements, liquidity and other risk management metrics.

The job of the new regulator can only be done, in my opinion, with the creation and utilization of a master mark-to-market capability that determines valuations and capital haircuts on all assets, commitments, loans and structures.

In short, to have a fair and orderly market, I believe we need a single set of transparent rules for all of the participants.

You have asked specifically about the role of the SEC and the Federal Reserve Bank of New York. Beginning in March of 2008, the SEC and the Fed conducted regular, at times daily, oversight of Lehman. SEC and Fed officials were physically present in our offices monitoring our daily activities. The SEC and the Fed saw what we saw, in real time, as they reviewed our liquidity, funding, capital, risk management and mark-to-market processes. The SEC and the Fed were privy to everything as it was happening. I am not aware that any data was ever withheld from them, or that either of them ever asked for any information that was not promptly provided.

After an extended investigation into Lehman's bankruptcy, the Examiner recently published a lengthy report stating his views. Despite popular and press

misconceptions about Lehman's valuations of mortgage and real estate assets, liquidity, and risk management, the Examiner found no breach of duty by anyone at Lehman with respect to any of these.

Speaking of asset valuations, the world still is being told that Lehman had a huge capital hole. It did not. The Examiner concluded that Lehman's valuations were reasonable, with a net immaterial variation of between $500 million and $2.0 billion. Using the Examiner's analysis, as of August 31, 2008 Lehman therefore had a remaining equity base of at least $26 billion. That conclusion is totally inconsistent with the capital hole arguments that were used by many to undermine Lehman's bid for support on that fateful weekend of September 12, 2008.

The Examiner did take issue, though, with Lehman's "Repo 105" sale transactions.

As to that, I believe that the Examiner's report distorted the relevant facts, and the press, in turn, distorted the Examiner's report. The result is that Lehman and its people have been unfairly vilified.

Let me start by saying that I have absolutely no recollection whatsoever of hearing anything about Repo 105 transactions while I was CEO of Lehman. Nor do I have any recollection of seeing documents that related to Repo 105 transactions. The first time I recall ever hearing the term "Repo 105" was a year after the bankruptcy filing, in connection with questions raised by the Examiner.

My knowledge, therefore, about Lehman's Repo 105 transactions, and what I will say about them today, is based upon my understanding of what I have recently learned.

As CEO, I oversaw a global organization of more than 28,000 people with hundreds of business lines and products and with operations in more than forty countries spread over five continents. My responsibility as the CEO was to create an infrastructure of people, systems and processes, all designed to ensure that the firm's business was properly conducted in compliance with the applicable standards, rules and regulations.

There has been a lot of misinformation about Repo 105. Among the worst were the completely erroneous reports on the front pages of major newspapers claiming that Lehman used Repo 105 transactions to remove toxic assets from its balance sheet. That simply was not true. According to the Examiner, virtually all of the Repo 105 transactions involved highly liquid investment grade securities, most of them government securities. Some of the newspapers that got it wrong were fair-minded enough to print a correction.

Another piece of misinformation was that Repo 105 transactions were used to hide Lehman's assets. That also was not true. Repo 105 transactions were sales, as mandated by the accounting rule, FAS 140.

Another misperception was that the Repo 105 transactions contributed to Lehman's bankruptcy. That was not true either. Lehman was forced into bankruptcy amid one of the most turbulent periods in our economic history, which culminated in a catastrophic crisis of confidence and a run on the bank. That crisis almost brought down a large number of other financial institutions, but those institutions were saved because of government support in the form of additional capital and fundamental changes to the rules and regulations governing banks and investment banks.

The Examiner himself acknowledged that the Repo 105 transactions were not inherently improper and that Lehman vetted those transactions with its outside auditor. He also does not dispute that Lehman appropriately accounted for those transactions as required by Generally Accepted Accounting Principles.

I have recently learned that, in 2000, the Financial Accounting Standards Board published detailed accounting rules for transactions of this very type, described them and dictated how they should be accounted for. In 2001, Lehman adopted a written accounting policy for Repo 105 transactions that incorporated those accounting rules. E&Y, the firm's independent outside auditor, reviewed that policy and supported the firm's approach and application of the relevant rule, FAS 140.

As I now understand it, because Lehman's Repo 105 transactions met the FAS 140 requirements, that accounting rule mandated that those transactions be accounted for as a sale. That was exactly what I believe Lehman did. Lehman should not be criticized for complying with the applicable accounting standards.

In other words, those transactions were modeled on FAS 140. The accounting authorities wrote the rule that expressly provided for those transactions and how they should be accounted for. To the best of my knowledge, Lehman followed those rules and requirements.

My job as the CEO was also to put in place a robust process to ensure that Lehman complied with all of its obligations to make accurate public disclosures. I had hundreds of people in the internal audit, finance, risk management and legal functions to ensure that we did, in fact, comply with all of our obligations.

Part of that process was E&Y's role in auditing our financial statements and reviewing our quarterly and annual SEC filings. Each year, E&Y issued formal opinions that Lehman's audited financial statements were fairly presented in accordance with GAAP, and they were.

We also had in place a rigorous certification process that was carried out in advance of every annual and quarterly SEC filing. That bottom-up process involved hundreds of people who had first-hand knowledge of the firm's day-to-

day business and the responsibility to review for accuracy and compliance the firm's SEC disclosures before they were filed.

Before we made any annual or quarterly filing, the key people who were involved in this process signed certifications confirming that, to their knowledge, the filing did not contain any untrue statement of a material fact or any material omission and that it fairly presented Lehman's financial position.

Our certification process culminated, every quarter, with a mandatory, all-hands, in-person meeting, which was chaired by Lehman's Chief Legal Officer. In addition to me, that meeting was attended by the firm's President, Chief Financial Officer, Financial Controller, Executive Committee members, business heads, the principal internal audit, finance and risk managers, legal counsel and our outside auditors.

After we had reviewed the draft annual or quarterly filing in detail, the Chief Legal Officer and I would each ask everyone present to speak up if there was anything in the document that caused them concern, or if anything had been omitted that they thought should be included. Attendees were also told that they should speak separately with the Chief Legal Officer if they had an issue that they did not want to raise at the meeting. To my knowledge, no one ever, at any of those meetings, raised any issue about Repo 105 transactions.

I relied on this certification process because it showed that those with granular knowledge believed the SEC filings were complete and accurate. I never signed an SEC filing unless it was first approved by the Chief Legal Officer.

Mr. Chairman, I thank you for allowing me to speak on these issues and I will be pleased to answer any questions this Committee may have.

EMBARGOED UNTIL DELIVERY

Statement of Treasury Secretary Timothy F. Geithner
Committee on Financial Services
U.S. House of Representatives
April 20, 2010

Chairman Frank, Ranking Member Bachus, Members of the Committee, thank you for the opportunity to testify before you today.

The failure of Lehman Brothers in September 2008 was a key inflection point during the most critical phase of the recent financial crisis. Lehman's bankruptcy accelerated a classic "run" on our financial system—a phenomenon not witnessed in this country since the 1930s. In the face of this run, the U.S. government, together with governments from around the world, had no choice but to intervene aggressively, on an unprecedented scale, to prevent an economic catastrophe.

The Lehman episode was not just a disaster for Lehman. It was a disaster for our country. And like any calamity, it should be subjected to careful, independent scrutiny. Whenever an airline tragedy occurs, our National Transportation Safety Board conducts a detailed examination of the causes of the accident. Financial disasters should receive similar examinations.

The Valukas Report is a great example of such an inquiry. The authors of that report have done an important service not only to the Lehman bankruptcy proceedings, but also to current and future students of the recent financial crisis.

As this Committee knows, detailed, independent inquiries are a part of what makes our system strong and resilient. Today's hearings are an important part of this process. I welcome the opportunity to participate.

While the causes of the financial crisis extend far beyond any single firm, Lehman Brothers illustrates many of the failures that brought our financial system to the edge of the abyss. The financial reforms proposed by the Administration, and passed by this Committee, are designed to address these failures in a comprehensive fashion.

No regulatory regime will be able to prevent major financial firms from reaching the point of insolvency. But a well-designed regulatory framework must put in place shock absorbers to contain the damage caused by a major firm's default. And it must provide the government with tools to manage the orderly dismantling and liquidation of firms that mismanage themselves into insolvency.

Lehman Brothers: A Case Study in Our System's Failures

Lehman caused Lehman's insolvency. But in many ways, Lehman Brothers serves as an iconic example of what went wrong with our financial system in the years leading up to the crisis. These deficiencies were not limited to Lehman. Rather, they were widespread and far-reaching problems in the basic structure of our financial system. I want to begin by briefly reviewing several of these critical failures.

EMBARGOED UNTIL DELIVERY

The Shadow Banking System. Lehman Brothers operated with very high levels of leverage, and it financed itself to a large extent through the issuance of short-term debt. These factors, combined with a high-risk business model, made Lehman vulnerable to collapse.

Of course, leverage and maturity transformation (the use of short-term liabilities to finance longer-duration assets) are inherent in banking. But unlike regulated banking institutions, Lehman conducted its activities largely free from the important prudential constraints that come with banking regulation. In this regard, Lehman Brothers was part of a broader pattern.

In the run-up to the recent crisis, we witnessed a period of explosive growth in leverage and maturity transformation *outside* the perimeter of prudential banking regulation. This parallel, lightly regulated system has come to be known as the "shadow banking system." Large dealer firms like Lehman were a key part of this system—but they were just one part. At its peak, the shadow banking system financed about $8 trillion in assets with short-term obligations, making it almost as large as the real banking system.

The rapid growth of this system was fueled by light regulation and weak or nonexistent capital requirements. It was also driven by cheap funding from large institutional investors, such as money market mutual funds and securities lenders, which furnished a ready supply of short-term financing.

Financing long-term, risky assets with short-term debt was a reliable formula for rapid growth and robust earnings during the boom. But these activities were vulnerable to fragility and rapid deleveraging when conditions deteriorated, as they inevitably did.

The emergence of shadow banking represented a failure of regulation to keep pace with developments in the financial sector. As much as any other factor, this fundamental regulatory failure set the stage for the crisis.

Market Structures: Tri-Party Repo and Money Market Mutual Funds. Like other dealer firms, Lehman Brothers relied heavily on a critical funding market called the repurchase agreement, or "repo," market. This market proved to be a major source of liquidity risk and instability in the crisis—for Lehman as well as other firms. This portion of the shadow banking system merits particular attention.

Repos are essentially loans that financial institutions use to finance securities inventories—typically on an overnight basis. Repos are collateralized by assets on dealers' balance sheets, in the same way that a mortgage is secured by a home.

One particularly large and important segment of the repo market is called "tri-party" repo. In this $2 trillion market, repo lenders (usually money market mutual funds) extend loans overnight to dealers. During the trading day, credit is provided by big banks that act as repo "clearing banks." Through this process, individual dealer firms typically borrow hundreds of billions of dollars each day.

While tri-party repo has been effective in providing liquidity to securities markets during normal times, under stress conditions these arrangements proved to be a source of liquidity risk for important parts of the financial sector. During the recent crisis, there was significant uncertainty in the markets about whether money funds would maintain their investments and whether repo

clearing banks might refuse to provide intraday credit. Uncertainty in this area contributed to "flight" risk in the tri-party repo market.

These structural issues were exacerbated by tri-party lenders' concerns around collateral quality. Traditionally, tri-party repo funding had been limited to the safest collateral classes, such as Treasury and agency securities. During the credit boom, however, tri-party repo lenders began to fund riskier collateral—most notably, various forms of complex structured mortgage products. Tri-party repo lenders extended this credit without requiring sufficient haircuts to reflect the risk of the underlying collateral. Not surprisingly, when the value of this lower-quality collateral became uncertain, tri-party lenders became less willing to continue funding.

As a consequence of these issues, the tri-party repo market was a critical source of liquidity strain on dealer firms during the financial crisis. And money market mutual funds, which provide a large portion of tri-party repo funding, made these liquidity problems even more acute. Money funds were themselves shown to be sources of instability during market stress. In a chaotic and uncertain financial environment, savers who parked cash in money funds became concerned that those assets might not have been as safe as they had anticipated. These concerns intensified after Lehman's bankruptcy, when one large money fund "broke the buck," meaning that its net asset value fell below $1 per share. The money fund industry experienced a modern-day bank run in September 2008. This run accelerated dramatically following Lehman's collapse.

Aggressive policy action was required to stabilize the money funds, including a temporary government guarantee of this $3 trillion industry. Although this program was successful and resulted in positive returns to taxpayers through guarantee fees, the money fund guarantee exposed taxpayers to substantial risks.

Tri-party repo and money funds are prominent examples of market structures and practices that were not robust enough to withstand a major disruption.

Derivatives. Lehman was a major participant in the over-the-counter (OTC) derivatives markets. As of August 2008, Lehman held over 900,000 derivatives positions worldwide. The market turmoil following Lehman's bankruptcy was in part attributable to uncertainty surrounding the exposure of Lehman's derivatives counterparties.

In this regard, Lehman's bankruptcy highlights another flaw in our financial infrastructure: the opacity and complexity of the OTC derivatives markets. These products grew exponentially in the run-up to the crisis. The notional amount of outstanding credit default swaps grew from about $2 trillion in 2002 to over $60 trillion at year-end 2007. Because these trades are conducted on a bilateral basis, the market has very little visibility into the magnitude of derivatives exposures between firms.

Before the crisis, regulatory efforts were underway to reduce the risks in this system. The New York Fed played a leading role in improving the OTC derivatives markets infrastructure from 2005 to 2008. Huge backlogs of unconfirmed trades were eliminated. A central repository for credit derivatives trades was established. And, in 2008, the notional amount of aggregate credit default swaps was reduced substantially through regulatory portfolio compression requirements, which caused dealers to collapse superfluous positions. These initiatives were necessary

predicates to further reform in the OTC derivatives markets, including central clearing. As a result of these initiatives, the market uncertainty surrounding derivatives exposures in the crisis was substantially less than it might otherwise have been.

Despite this progress, the basic infrastructure of the OTC derivatives markets makes them a dangerous transmission vehicle for instability during periods of market turmoil. When a major derivatives market participant fails, uncertainty around derivatives exposures undermines confidence in other institutions. OTC derivatives markets, in their current form, significantly increase the risk of financial contagion.

Breakdown in Basic Checks and Balances. Lehman's plunge into high-risk businesses in the years before its bankruptcy has become a familiar story. During this period of aggressive growth, Lehman developed significant exposures to risky subprime lending, commercial real estate, structured products, and high-risk lending for leveraged buyouts. Importantly, the Valukas Report indicates that Lehman repeatedly breached its own risk concentration limits in pursuit of higher earnings.

These types of risk management failures were widespread in the financial sector. Sound risk management practices were in many cases disregarded in favor of concentrated, directional bets. AIG, Bear Stearns, and Lehman Brothers, not to mention scores of mortgage lenders, all allowed fundamental breakdowns in risk management.

Our financial system relies on a set of complementary institutional controls to prevent such unsound practices from emerging. Boards of directors, ratings agencies, and audit and disclosure functions are essential checks and balances against risk management failures.

These mechanisms provide an important level of redundancy in oversight. When effective, they identify material business risks and act as independent referees on firms' internal risk management processes. Major risk management failures require multiple failures to take place within this system of checks and balances.

Before and during the crisis, weaknesses in these checks and balances were prevalent. Boards of directors failed to exercise critical judgment and address critical weaknesses in risk management. Ratings agencies failed to do an adequate job of assessing the risks in structured credit products and disclosing their ratings methodologies. Auditors failed to identify practices that may have crossed the line from an accounting perspective. And the existing accounting and disclosure regime did not adequately apprise investors of material risks in a timely fashion.

Pervasive Opportunities for Regulatory and Accounting Arbitrage. Lehman provides a stark example of how gaps in our system have allowed financial firms to maneuver their operations to "optimize" regulatory and accounting treatment.

Our regulatory system has given firms too much leeway to structure their activities for favorable tax, accounting, and regulatory treatment. For internationally active firms, differences between U.S. and foreign tax, accounting, and capital regimes have prompted firms to structure their activities to minimize these constraints.

EMBARGOED UNTIL DELIVERY

Our system in many cases allowed risks to migrate to where regulation was weakest. As the SEC has acknowledged, its voluntary oversight regime allowed Lehman and other investment banks to operate with too much leverage and risk.

Accounting arbitrage has also been widespread. The Valukas Report describes how Lehman appears to have moved certain assets off-balance sheet through repo transactions executed in its London broker-dealer subsidiary. According to the Report, these transactions were designed to reduce the firm's reported leverage at quarter-end.

Importantly, regulatory and accounting arbitrage makes institutions far more complex than they need to be. Complexity poses serious challenges to an effective audit and disclosure regime. Readers of the financial reports of major financial institutions know that they are highly opaque and difficult to understand. Indeed, disclosure documents of complex financial firms are often indecipherable even to experienced analysts.

Without transparency and comparability, market discipline cannot operate effectively. The system we have is not tenable in this regard. Financial reporting must be simpler and easier to understand, and must facilitate meaningful comparisons across institutions.

Of course, none of our government's financial supervisors did an adequate job. But the most dangerous practices that precipitated the crisis were heavily concentrated in the most lightly regulated parts of the financial industry. Regulatory arbitrage is not a formula for financial stability.

Flawed Compensation Practices. Compensation structures at Lehman allowed top executives to realize substantial gains without suffering the downside if their business decisions proved unwise. Lehman's top executives received substantial cash compensation during the boom. And they were able to cash out significant amounts from stock compensation they received in the years prior to the crisis.

This phenomenon was not isolated to Lehman. At many financial firms, compensation structures were misaligned with the time horizons of risk: executives were rewarded for short-term performance, with little attention to the risk of future losses. These practices did not incentivize prudent risk-management and long-term value creation. Instead, they encouraged high-risk activities that were designed to achieve short-term profitability.

As I described earlier, our system has checks and balances that are meant to limit such practices. But, in many cases, these checks and balances did not work. Professionals whose jobs were to monitor and constrain risk-taking were generally paid substantially less than those who made investment decisions. Compensation committees gave little attention to the risk-taking implications of pay-setting decisions. And directors charged with making those decisions lacked the sophisticated, independent advice they needed to assess critically the complex relationship between compensation and risk-taking.

No Tools to Wind Down Large Financial Firms. Lehman's bankruptcy in September 2008 helped to turn an intensifying global financial crisis into a classic financial panic. Fearing further defaults, investors declined to renew funding to all types of financial institutions. Money fund

investors redeemed their shares and redeployed funds from the private sector to Treasury securities, driving yields into negative territory. Credit markets froze, and corporate America found itself unable to access short-term credit through the commercial paper markets. Without forceful government intervention, the financial system would have collapsed.

These circumstances demonstrated a critical shortcoming in our system. In that moment of historic stress, the government lacked any means to wind-down and liquidate a complex, interconnected financial firm in an orderly way.

After the near-failure of Bear Stearns, it was apparent to informed observers that Lehman Brothers was the weakest of the remaining independent investment banking firms. And we knew that a disorderly bankruptcy of Lehman Brothers, if it occurred, would have damaging consequences for the financial system. With the limited powers that we had, we worked diligently to avoid an outcome that would destabilize the financial system and damage the broader economy. But our tools were insufficient.

The stability of the U.S. financial system cannot be left vulnerable to the reckless choices of individual firms. Lehman's disorderly bankruptcy was profoundly disruptive. It magnified the dimensions of the financial crisis, requiring a greater commitment of government resources than might otherwise have been required. Without better tools to wind down firms in an orderly manner, we are left with no good options.

Actions Taken by the FRBNY

Lehman Brothers was symptomatic of many of the deep structural flaws in our financial system. These flaws did not emerge overnight. Rather, they were a product of developments in the financial system that unfolded over the course of many years.

I was President of the Federal Reserve Bank of New York at the time of Lehman's bankruptcy filing and during the period leading up to it.

As an independent investment bank, Lehman was supervised not by the Federal Reserve, but by the SEC. The Federal Reserve had no regulatory authority over the firm—no authority over its capital, no authority over its liquidity, and no oversight over its audit and accounting control functions. The Federal Reserve was not engaged in supervision of Lehman Brothers. It did not have the legal authority to do so. These roles and responsibilities remained with the SEC. As I mentioned earlier, the failure to subject all large, interconnected financial firms to robust oversight was a major flaw in our system.

Although the New York Fed was not Lehman's supervisor, it did establish an onsite presence at Lehman in March 2008, after the fall of Bear Stearns.

On the day of the Bear Stearns sale in March 2008, the Federal Reserve announced the creation of the Primary Dealer Credit Facility ("PDCF")—a collateralized lending facility to provide liquidity to primary dealers. The creation of the PDCF meant that the Federal Reserve was a potential lender to the major dealer firms. To manage the risks associated with this facility, the New York Fed immediately installed a small number of analysts at each of the major independent dealer firms, including Lehman Brothers.

After creating the PDCF monitoring program, the Federal Reserve entered into a Memorandum of Understanding ("MOU") with the SEC, which was formalized in July. The MOU was designed to facilitate information-sharing and cooperation. It established a clear division of responsibilities between the SEC and the Federal Reserve. It explicitly affirmed the SEC's role as the supervisor of the independent investment banks.

The PDCF monitoring program did *not* establish the full panoply of supervisory oversight powers that the Federal Reserve exercises with respect to bank holding companies. That regime entails large examination teams, with oversight of the firm's audit and control functions.

In accordance with the MOU, the Federal Reserve worked closely with SEC on a number of important initiatives after the near-failure of Bear Stearns in March. The SEC and the Federal Reserve jointly worked to encourage improvements in the capital and liquidity positions of the investment banks. Simultaneously, the SEC and the Federal Reserve cooperated on a range of other priorities, including taking steps to address risks associated with the derivatives and repo markets.

With respect to Lehman Brothers, between March and September, the New York Fed worked closely with Treasury and the SEC to encourage the firm to raise capital, reduce balance sheet risk, find a strategic buyer, and take other actions to survive the storm. Lehman was unsuccessful in these efforts. The global financial crisis had escalated significantly by the fall of 2008, limiting the available options to stabilize the firm.

The Federal Reserve's powers were limited: it could lend on a short-term basis against good collateral, but it could not safely put a failing investment bank out of existence.

In the absence of a willing buyer, the U.S. government did not have the authority to take the steps that would have been necessary to prevent Lehman's disorderly failure. Lehman lacked sufficient high-quality collateral to permit the Federal Reserve to extend a loan large enough to prevent the firm from defaulting. Given the magnitude of the firm's liquidity issues, stabilizing Lehman would have required a buyer that was willing to guarantee its trading obligations during the period between the signing and closing of the acquisition transaction. No such buyer materialized.

Some have asked why Lehman went bankrupt, while AIG received extraordinary assistance that prevented default. The answer is that AIG presented a very different case. AIG had enough high-quality collateral to permit the Federal Reserve to extend a loan sufficient to stabilize the firm—largely the profitable insurance businesses that were relatively insulated from the firm's losses on complex financial transactions.

In the end, in the absence of a willing buyer, bankruptcy was the only option for Lehman Brothers. The government had neither the authority nor the tools to prevent Lehman's failure from imperiling the financial system.

Financial Reform

Lehman Brothers illustrates many of the key deficiencies of our current regulatory regime—a regime that simply is not equipped to effectively monitor, constrain or respond to risks in our financial system.

EMBARGOED UNTIL DELIVERY

The Administration's reform proposals—which are broadly consistent with the reform bill that passed the House in December and the bill currently working its way through the Senate—have been crafted to address precisely these failures.

If these reforms become law, we will be far better situated to avoid the abuses that led to the crisis. In particular:

- *Any* major financial firm whose failure could pose a risk to the financial system will be subject to robust, comprehensive supervision, with clear regulatory accountability. An insurance company like AIG that operates with massive derivatives exposure, or an investment bank like Lehman Brothers, will not be able to escape robust consolidated supervision by virtue of its corporate form. These regulatory loopholes will be closed, and opting out will not be an option.
- Major financial firms will be subject to *more stringent* prudential requirements than other financial firms—higher capital, higher liquidity, and more exacting oversight. These higher requirements will reflect the fact that major firms pose greater risks to the financial system. So not only would firms like Lehman, Bear Stearns, and AIG be subject to consolidated supervision, but they also would be subject to substantially higher standards than other firms, due to their size and interconnectedness.
- Better disclosure and transparency will reduce opportunities for accounting arbitrage. We have committed to improving accounting standards and moving forward with international accounting convergence. At the Pittsburgh summit last year, the G-20 leaders called on international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards. These initiatives are currently underway, and they will greatly improve the transparency and comparability of financial statements.
- Regulators are taking action to address the unstable aspects of the repo and money fund industries. Under the auspices of the Federal Reserve, an industry-led task force has been working to develop enhancements to the policies, procedures and systems supporting the tri-party repo market. This initiative is designed to ensure that the structure of the tri-party repo market will not amplify systemic risk during future periods of market stress. And the SEC recently enacted new rules to strengthen liquidity and disclosure in the money fund industry. More work remains to be done in this area, and the President's Working Group on Financial Markets is preparing a report setting forth options to address systemic risk and to reduce the susceptibility of money funds to runs.
- Reform will bring comprehensive oversight and transparency to the OTC derivatives markets. These markets have proved to be a major source of uncertainty and risk during periods of financial disruption. The proposed reforms will bring the bulk of these trades into central clearing arrangements, ensuring full transparency and reducing the degree to which financial contagion can spread due to real or perceived counterparty credit exposures. All dealers and major market participants will be subject to tough prudential standards, including margin and capital requirements. And the SEC and CFTC will have full enforcement authority to set position limits and address fraud, manipulation, and

abuse. These reforms will make the system far more resistant to the types of disruption we saw when Lehman failed.

- Important standards will be put in place regarding disclosure and accountability for executive compensation. In particular, companies will be required to hold an annual, non-binding shareholder vote to approve executive compensation. And compensation committees will be given the independence and tools they need to drive a harder bargain over executive pay. These reforms will help to ensure that compensation practices are aligned with the long-term interests of shareholders. They will complement other initiatives relating to compensation in the United States and abroad, including the compensation standards agreed upon by the G-20 for financial institutions around the world; new SEC disclosure rules that will give shareholders critical information on the relationship between pay practices and risk-taking; and recent Federal Reserve guidance on compensation principles that will be incorporated into the supervisory process.
- Finally, we will have a resolution regime that will give the government the necessary tools to safely put failing financial institutions out of existence. The pending bills would establish a bankruptcy-like regime for large financial institutions that mismanage themselves into failure. Under the proposed resolution authority, major financial firms facing insolvency will be dismantled, sold, or liquidated in an orderly fashion. Culpable management will be replaced, equity will be extinguished, and creditors will be exposed to losses. Any costs incurred through this wind-down process will be recouped from large financial institutions—not covered by taxpayers. Resolution authority was the critical tool we needed to deal with Lehman, Bear, and AIG. We must have it when the next big financial firm gets into trouble.

Conclusion

There are few better examples of why we need comprehensive financial reform than Lehman Brothers. No financial regulatory system will ever be perfect. Financial firms will always overreach and get into trouble. But it is clear that good financial regulation can mean the difference between a fundamentally sound and resilient financial system, and one that is built on an unstable foundation.

The path we choose will have significant implications for the future of our economy. Like the President, I am confident that our country will once again choose to tackle these tough problems and enact meaningful reform.

Thank you.

STATEMENT OF MATTHEW LEE,

FORMER SENIOR VICE PRESIDENT, LEHMAN BROTHERS

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

HEARING REGARDING "PUBLIC POLICY ISSUES RAISED BY THE REPORT OF THE LEHMAN BANKRUPTCY EXAMINER"

APRIL 20, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for the Committee's invitation to appear here today. As you may know, I was employed by Lehman Brothers for 14 years, ultimately as Senior Vice President, Global Financial Control. In 2008, I identified several accounting and corporate governance issues that caused me considerable and growing concern both from an accounting and a corporate governance perspective. On multiple occasions, I attempted to bring these issues to the attention of Lehman Brothers' executive management, and on one occasion to the attention of Lehman's outside auditors. Within days of first raising issues, I was terminated.

I was born, raised and educated in the United Kingdom, and I am an adopted citizen of the United States. I received a Bachelor of Commerce degree (1981), and a Master of Arts (Honors) degree in Economics (1976), both from the University of Edinburgh, Scotland. In the field of accounting, I am a member of the Institute of Chartered Accountants of Scotland, an Associate of the Institute of Cost and Management Accountants, and a Certified Public Accountant registered in the State of New York.

In 1977, I joined the London office of Arthur Young, McClelland, Moores & Co as an auditor. In 1981, I transferred to the New York office of Arthur Young & Company, which later

became Ernst & Young. I specialized in auditing financial services clients and I was eventually promoted to the position of Principal, as a global technical expert in Financing Products, International Securities and Trust Banking. In that capacity, I was asked to identify potential client accounting control issues, bring them to the attention of client management, and to assist our clients in resolving them.

In 1994, Lehman Brothers recruited me to work as the Global Product Controller of its Equity Finance Division. I learned that Lehman had sought me out based on my reputation as an auditor with a keen ability to identify and resolve complex internal accounting control issues. In 2005, I was promoted to Senior Vice President, Global Financial Control, head of consolidated legal entities and consolidated and unconsolidated daily and monthly balance sheets. In that capacity, I oversaw Lehman's global balance sheet production, and supervised approximately 150 employees worldwide. During the last year of my employment, I reported directly to Martin Kelly, Managing Director & Global Financial Controller.

During my fourteen years working at Lehman, I periodically identified problematic issues with Lehman's internal accounting control practices, including the validity of the assets and liabilities represented on Lehman's balance sheets. I typically reported my findings to management orally, and in my experience my concerns were usually addressed and appropriately resolved. Over the course of my employment, I received positive performance evaluations, as well as promotion in title and responsibilities, and I was compensated commensurate with my positions and duties.

During late 2007 and early 2008, several accounting control issues (some longstanding, others new) that I believed were material to Lehman's financial condition, were causing me

increasing concern, including Lehman's use of so-called "Repo 105" transactions to temporarily remove debt and assets from its balance sheet, evidently to coincide with public financial reporting dates. These issues were discussed on numerous occasions among my peers, most of whom shared my concerns; these discussions often included my direct supervisor, Martin Kelly. However, I became increasingly concerned that management was not responding to these concerns and that indeed the problems were getting worse.

On May 16, 2008, I sent a letter raising certain of these accounting and balance sheet issues – essentially, those which were most directly within my scope of responsibility -- to the senior financial management of Lehman, which included the Global Financial Controller (Martin Kelly), the Head of Capital Markets Product Control (Gerard Reilly), and the Chief Financial Officer (Erin Callan). Because I felt that these issues created operational risk for Lehman, I also sent the letter to the Chief Risk Officer (Christopher J. O'Meara). Subsequently, I prepared another writing addressing additional accounting-control issues of significant concern existing outside my immediate scope of responsibility, including the "Repo 105" transactions. That communication was sent to Jack Johnson, a Managing Director in Lehman corporate compliance. In both communications, I outlined what I believed to be the critical issues, as was my obligation as an employee of Lehman and consistent with Lehman's Code of Ethics.

Shortly after sending my first letter, I was interviewed by Joseph Polizzotto, Lehman's General Counsel, and Elizabeth Rudofker, Head of Corporate Audit. On May 22, 2008, the day after that interview, I was terminated without warning. Approximately two weeks after my termination, notably *after* I had communicated additional concerns including Repo 105, I was interviewed by Ernst & Young auditors. I later learned that in July 2008, a detailed presentation regarding issues I had raised was made to the Audit Committee of Lehman's Board of Directors,

(Examiner's Report at p. 960) but I was not informed of the presentation nor asked to participate. Subsequently, associates of Mr. Valukas, Lehman's bankruptcy examiner, interviewed me. I cooperated fully with each and every one of these inquiries, both internal and external.

Based on what I observed during my employment, I believe that there were serious, material accounting control and corporate governance issues at Lehman. I am here today to answer any questions that the committee may have regarding those issues.

Testimony Concerning the Lehman Brothers Examiner's Report
by Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission
Before the House Financial Services Committee

April 20, 2010

Introduction

Chairman Frank, Ranking Member Bachus, members of the Committee, I appreciate the opportunity to testify regarding the failure of Lehman Brothers and the Lehman Brothers Examiner's Report (Examiner's Report). I should say at the outset that this testimony is on my own behalf as Chairman of the SEC, and does not necessarily represent the views of the Commission or individual Commissioners.

When I became Chairman of the SEC in late January 2009, the agency and financial markets were still reeling from the events of the fall of 2008. Since that time, the SEC has worked tirelessly to review its policies, improve its operations and address the legal and regulatory gaps that came to light during the crisis.

The Lehman failure, both individually and within the context of the broader financial crisis, sheds light on many interconnected and mutually reinforcing causes that contributed to the failure of many major financial institutions, both bank and non-bank, including:

- Irresponsible lending practices, which were facilitated by a securitization process that originally was viewed as a risk reduction mechanism;
- Excessive reliance on credit ratings by investors;
- A wide-spread view that markets were almost always self-correcting and an inadequate appreciation of the risks of deregulation that, in some areas, resulted in weaker standards and regulatory gaps;
- The proliferation of complex financial products, including derivatives, with illiquidity and other risk characteristics that were not fully transparent or understood;
- Perverse incentives and asymmetric compensation arrangements that encouraged excessive risk-taking;
- Insufficient risk management and risk oversight by companies involved in marketing and purchasing complex financial products;
- A siloed financial regulatory framework that lacked the ability to monitor and reduce risks flowing across regulated entities and markets; and

- The lack of an adequate statutory framework for the oversight of large investment bank holding companies on a consolidated basis.

My testimony will describe the SEC structure for the supervision of investment banks and their holding companies, the failure of Lehman, the lessons learned from the Consolidated Supervised Entity program, and the legislative and regulatory initiatives necessary to address the supervision and resolution of systemic entities in the future.

The Consolidated Supervised Entity Program

Beginning in 2004[1] through September 2008, the SEC was recognized as the consolidated supervisor for the five large independent investment banks – including Lehman Brothers – under its Consolidated Supervised Entity (CSE) program. The CSE program was created, in part, as a way for U.S. global investment banks that lacked a consolidated holding company supervisor to voluntarily submit to consolidated regulation by the SEC.[2] The SEC had no statutory authority to regulate these holding companies, and thus prior to the CSE program they were not subject to any consolidated supervision or capital requirements.

The CSE program was viewed as an effort to fill a significant gap in the U.S. regulatory structure that was left when the Gramm-Leach-Bliley Act failed to require investment bank holding companies to be regulated at the holding company level and to improve the Commission's oversight of broker-dealers. In retrospect, the program created classic regulatory arbitrage – a system in which a regulated entity was permitted to select its regulator. The arbitrage was facilitated by a prevailing regulatory consensus at the time of the program's inception that focused on meeting regulatory objectives while being careful not to undermine the competitiveness of American financial institutions and capital markets vis-à-vis their overseas, more lightly regulated, counterparts.

In addition, the program was implemented at a time when many believed that the inherently self-correcting nature of markets would prevent institutions from taking on excessive risk, including in the origination or trading of exotic financial instruments.

Under the CSE regime, the holding company was required to provide the Commission with information concerning its activities and risk exposures on a consolidated basis; submit its non-regulated affiliates to SEC examinations; and compute on a monthly basis, risk-based consolidated holding company capital in general accordance with the Basel Capital Accord, an internationally recognized method for computing regulatory capital at the holding company level. In connection with the

[1] The SEC was recognized as the consolidated supervisor of Merrill Lynch in 2004. The other investment banks came into the CSE program beginning in 2005.

[2] Exchange Act Rel. 34-49830, 69 Fed Reg 34428, June 21, 2004.

establishment of the CSE program, the largest U.S. broker-dealer subsidiaries of these entities were permitted to utilize an alternate net capital (ANC) computation.[3] Other large broker-dealers, whose holding companies were subject to consolidated supervision by banking authorities, also were permitted to use this ANC approach.[4]

Under the CSE program, the SEC undertook for the first time the consolidated oversight of the five largest U.S. investment banks, whose operations were global in scope and extended well beyond the types of products and business lines typically found in a registered broker-dealer. Participation by the CSE firms in this regime was voluntary, and the consolidated oversight of these holding companies was more prudential in nature than the SEC's traditional rule-based approach for broker-dealer regulation. In brief, this program reflected a profoundly different approach to oversight and supervision for the Commission. Properly executing the program called for a correspondingly significant expansion in human, financial, managerial, technological and other resources devoted to the oversight and examination of CSE holding companies and their subsidiaries.

The SEC believed at the time that it was stepping in to address an existing gap in the oversight of these entities. Once, the agency took on that responsibility, however, it had to follow through effectively. Notwithstanding the hard work of its staff, in hindsight it is clear that the program lacked sufficient resources and staffing, was under-managed, and at least in certain respects lacked a clear vision as to its scope and mandate.

During 2008, the CSE institutions failed, were acquired, or converted to bank holding companies which enabled them to access government support. The CSE program was discontinued in September 2008 by former Chairman Christopher Cox.

The Failure of Lehman Brothers

Events leading up to the failure of Lehman. In retrospect, the seeds of Lehman's failure were sown well before 2008. Key risk-taking activities that eventually contributed to Lehman's collapse began when the firm embarked in 2006 on an aggressive growth strategy. As part of this strategy, Lehman invested its own capital in assets such as subprime and Alt-A residential mortgages and mortgage-backed securities, commercial real estate, and leveraged lending commitments. After the subprime

[3] In 2004, the SEC amended its net capital rule to permit certain broker-dealers subject to consolidated supervision to use their internal mathematical models to calculate net capital requirements for the market risks of certain positions and the credit risk for OTC derivatives-related positions rather than the prescribed charges in the net capital rule, subject to specified conditions. These models were thought to more accurately reflect the risks posed by these activities, but were expected to reduce the capital charges by the broker-dealer subsidiaries. Accordingly, the SEC required that these broker-dealers have, at the time of their ANC approval, at least $5 billion in tentative net capital (i.e., "net liquid assets"), and thereafter to provide an early warning notice to the SEC if that capital fell below $5 billion. This level was considered an effective minimum capital requirement.

[4] Currently six broker-dealers utilize the ANC regime and all are subject to consolidated supervision by banking authorities.

mortgage crisis emerged, Lehman scaled back exposures in this area, but continued its growth strategy and increased its exposures to leveraged finance and to commercial real estate before liquidity dried up in these markets beginning in August 2007.

During this time, Lehman reported its risk-taking activities under the CSE program. The program's oversight of Lehman's risk-taking focused on whether Lehman had an appropriate system of controls designed to ensure that the risk tolerance of Lehman's management and Board was effectively communicated to Lehman staff and that the risks assumed by the firm were appropriately captured and communicated to senior management. The CSE program also was focused on whether the firm had sufficient capital, under then-current standards, and liquidity, to support these activities. Clearly, the firm and the SEC did not anticipate the extent of the coming market dislocation and the issues that the dislocation would create for the firm.

The near collapse of Bear Stearns in March 2008, which was averted only through a government assisted sale to JPMorgan Chase, resulted in a heightened focus on Lehman. Of the four remaining CSE holding companies then supervised by the SEC, Lehman was considered to have the business model closest to Bear Stearns in that it was heavily dependent on fixed income securitization revenues. In March, however, Lehman reported a first quarter profit and a $34 billion liquidity pool.

In April 2008, Lehman issued approximately $4 billion in preferred securities. In June 2008, Lehman posted its first quarterly loss as a public company. Lehman attributed this $2.8 billion loss primarily to write-downs on residential and commercial mortgage securities and hedges related to these securities. Even though the firm reported that its liquidity pool had grown to $45 billion, it still had significant amounts of illiquid assets, consisting primarily of commercial and residential loans and securities.

Throughout the summer, Lehman embarked on various strategies to raise capital and to reduce the size of its exposure to mortgage-related and other illiquid assets. In June 2008, Lehman issued $4 billion in common stock and $2 billion in mandatory convertible debt. Management sought to raise additional capital through direct equity investments in the firm and by selling a stake in its investment management division. They also sought to spin off the bulk of the firm's commercial real estate assets. By the end of August, these additional efforts failed and the firm's write-downs continued to grow, while the sale of illiquid assets slowed.

The immediate causes of failure. The immediate cause of Lehman's bankruptcy filing on September 15, 2008 stemmed from a loss of confidence in the firm's continued viability resulting from concerns regarding its significant holdings of illiquid assets and questions regarding the valuation of those assets. The loss of confidence resulted in counterparties and clearing entities demanding increasing amounts of collateral and margin, such that eventually Lehman was unable to obtain routine financing from certain of its lenders and counterparties.

Several key events in early September contributed to this loss of confidence. On September 9, the Korean Development Bank, which had been in talks to acquire a stake in Lehman, announced that it would not be doing so. In addition, although Lehman retained most of its secured funding lines, its clearing banks demanded more collateral as a condition to continuing their clearing relationship.

According to information provided by Lehman to the SEC, Lehman claimed its liquidity pool was $41.5 billion at the beginning of the week of September 8, and ended the week at $1.4 billion. The largest drains on the liquidity pool included an increase in the amount of clearing deposits required by the firm's lenders and a decline in the amount of secured funding provided by the firm's counterparties.

Over the weekend of September 12th – 14th, representatives from the Treasury, the Federal Reserve Bank of New York and the Commission met with management from Lehman and other major financial firms in an effort to address the situation. According to the Examiner's Report, the government's analysis was that it did not have the legal authority to make a direct capital investment in Lehman, and Lehman's assets were insufficient to support a loan large enough to avoid Lehman's collapse.[5] On September 15th, Lehman's U.K. broker-dealer filed for administration and Lehman's holding company filed for bankruptcy.

On September 19, 2008 a district judge in the Southern District of New York entered an order commencing the liquidation of the Lehman broker-dealer under the Securities Investor Protection Act.

The CSE program's supervision of Lehman. As noted above, under the CSE regime, Lehman's holding company was required to provide the Commission with information concerning its activities and exposures on a consolidated basis, submit its non-regulated affiliates to SEC examinations, and compute on a monthly basis risk-based consolidated holding company capital in general accordance with the Basel Capital Accord. As with all CSE firms, SEC staff had a core set of monthly meetings with Lehman's market and credit risk groups and regular quarterly meetings with other internal control functions, including treasury, internal audit, and financial controllers. Beyond this core set of meetings, SEC staff had frequent conversations with the Lehman staff as questions and issues arose.

As noted above, supervision of Lehman was increased in March 2008 after Bear Stearns nearly collapsed. SEC staff had more frequent interaction with the firm, either through on-site visits or telephone calls, with a focus on the firm's liquidity and funding. Lehman also began submitting more frequent reports to the SEC, including reports on the liquidity pool on a daily basis. SEC staff monitoring Lehman also began to have more frequent communications with the staff of the Federal Reserve Bank of New York regarding Lehman's financial position.

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[5] See Examiner's Report at 11-12.

As others have noted, once the markets turned, and particularly once Bear Stearns averted collapse only through a government-assisted sale, it is not clear that anything the SEC could have done would have prevented Lehman's bankruptcy. It is also clear that the SEC did not do enough as consolidated supervisor to identify certain risks and require additional capital and liquidity commensurate with the risks. As stated previously, the program was in my view insufficiently resourced, staffed, and managed from its inception. At the time the program was terminated in September 2008, it had approximately 21 staff, including 10 monitoring staff. Further, in light of the prudential nature of the program, it was a substantial departure from the agency's traditional approach of establishing clear rules and enforcing compliance with them. The Examiner's Report appears to confirm these and other shortcomings and the need to continue our reforms to breakdown stovepipes and instill a culture of collaboration.

Lehman's Repo 105 transactions. Lehman funded itself in large part through short term repurchase transactions, borrowing tens of billions of dollars on a daily basis. In a repurchase transaction, or repo, a company sells securities in exchange for cash with a simultaneous agreement for the purchaser to return the same or similar securities for a fixed price at a later date, generally a short period of time. Accounting standards establish guidance for whether a repurchase transaction should be reported as a financing transaction (debt) or a sale based in part on whether the reporting entity has surrendered control over the asset. Typically, repos are accounted for as financings (debt) as control over the assets is not fully surrendered.

The availability of repo funding was highly dependent upon the confidence of counterparties, rating agencies and the market in general. Beginning in late 2007 and throughout 2008, amidst increase concern about Lehman's leverage, Lehman significantly increased their reliance on repurchase agreements that Lehman referred to as "Repo 105s." Unlike typical repo transactions, Lehman treated Repo 105 transactions as sales for accounting purposes. The Examiner's Report concluded that the motive for the transactions was ultimately to reduce its leverage: to temporarily remove tens of billions of dollars in assets from its balance sheet at the end of financial reporting periods and use the cash to pay down liabilities as a means to reduce its reported leverage.[6] Lehman did not disclose that it accounted for its repurchase transactions as sales. Instead, it reported that it accounted for its repo transactions as financings, the common accounting treatment for repurchase transactions.

As discussed in the Examiner's Report, regulators (including Commission staff), rating agencies and the Lehman Board, were unaware of Lehman's use of Repo 105 transactions.[7] For purposes of the CSE program, the Commission did not perform an audit of Lehman's balance sheet. Instead, the Commission depended on the integrity of the balance sheet information provided by Lehman's management which was audited or, in the case of quarterly reports, reviewed, by Lehman's auditors. Lehman did not disclose in its audited financials that it was undertaking repos as sales – on the contrary,

[6] See, e.g., Examiner's Report at 732-4.
[7] See id. at 739.

Lehman's disclosure would lead one to believe that it accounted for all of its repos as financings and that the repos were properly reported as such on the balance sheet.

The findings of the Examiner's Report raise critical and legitimate questions about the use of these transactions to manage Lehman's balance sheet at the close of financial reporting periods, and also raise questions as to how widespread this practice may be. Last month our Division of Corporation Finance issued letters to various public companies requesting detailed information about their use of repurchase agreements or similar transactions involving the transfer of assets where they have an obligation to repurchase them. Among other things, these letters instruct companies to (1) describe their accounting for these transactions, their business purpose for engaging in them, and their impact upon liquidity; (2) provide detailed information about the financial statement impact of these transactions throughout each quarter; and (3) discuss how that impact differed from that presented at each quarter end. Not only will this information enable us to better evaluate each company's disclosure, it will help us understand whether companies are complying with our current requirements, and whether changes to current requirements should be made. Where we find that companies are engaging in financial transactions that are inconsistent with their publicly reported financial condition, we will take appropriate action.

Concerns Identified in the Examiner's Report. The Examiner's Report also raised concerns about the SEC's oversight of Lehman's liquidity pool. Ensuring adequate liquidity was a key part of the CSE program's stated objectives, but the Examiner's Report identified a number of issues with how this objective was implemented.

Each CSE firm was expected to maintain a liquidity pool consisting of cash or highly liquid and highly rated unencumbered debt instruments. However, the standards regarding the types of assets that could be included in this liquidity pool, and the manner in which those assets could be held, were not set forth in a Commission regulation and were otherwise unclear. In fact, practices varied across CSE firms. Though the CSE program began an inspection in early 2008 to gain a better understanding of liquidity practices across the CSE firms, the inspection was not completed prior to the termination of the CSE program. In my view, consolidated supervision requires detailed and clearly stated criteria for what assets are eligible for inclusion in a liquidity pool, meaningful verification efforts and established procedures for addressing concerns that are identified.

In addition, the CSE program appears to have been insufficiently skeptical about the information provided by the firm regarding its liquidity or other risk indicators. As discussed in the Examiner's Report, it appears that Lehman did not fully report to the Commission significant changes affecting assets in its liquidity pool in the period leading up to Lehman's bankruptcy. Although each firm is fully responsible for providing accurate information to its regulators, in certain instances it appears there was insufficient follow-up on issues that should have raised potential concerns.

The Examiner's Report concludes that the SEC did not aggressively restrain Lehman's appetite for taking on increasing risk between 2005 and 2008.[8] The requirement of having sound internal risk management controls was a key element of the CSE regime. However, in practice, the firm apparently treated risk limits not as requirements, but as softer guidelines or thresholds that would trigger necessary internal management approvals when exceeded. The philosophy of the CSE program and its management was that regulators should avoid substituting their views for the business judgment of the firm's management and its Board, as long as the firm continued to satisfy applicable capital requirements and was following its internal controls and escalation processes around increasing risk limits.

While it may be true that ultimate responsibility for the management of financial institutions rest with their management and boards of directors, it is necessary that regulators of large interconnected financial institutions demand more of a firm's management. In the Lehman case, management should have been challenged more forcefully with respect to the types of risks they were taking and, where necessary, had meaningful requirements or limitations imposed.

Finally, the Examiner's Report expresses concerns about a lack of information sharing among the federal regulators involved in Lehman. Effective information sharing by regulators is critical to fulfilling our regulatory obligations, and it is something that the American public has every right to expect. Cooperation and coordination with other financial institution regulators is essential. I expect SEC staff to work closely with our colleagues in other agencies. In addition, I am demanding full information sharing within the SEC – without silos that undermine our effectiveness.

Incorporating Lessons Learned from the CSE Program

The CSE program was terminated in September 2008, and the SEC is no longer the consolidated supervisor of these firms.[9] However, the SEC is taking steps to incorporate the lessons learned from the CSE experience into its ongoing role as primary functional regulator of broker-dealers. Lessons learned include the following.

Capital Adequacy Rules Were Flawed and Assumptions Regarding Liquidity Risk Proved Overly Optimistic. The applicable Basel capital adequacy standards depended heavily on the models developed by the financial institutions themselves. All models depend on assumptions. Assumptions about such matters as correlations, volatility, and market behavior developed during the years before the financial crisis were

[8] In addition, the Examiner's Report notes that Lehman management excluded some of Lehman's riskiest assets from its stress testing, thereby substantially limiting the usefulness of these tests. See Examiner's Report at 67-9. While Commission staff believed Lehman had other ways of measuring these risks, those procedures plainly were insufficient.

[9] The Gramm-Leach-Bliley Act had created a voluntary program for the oversight of certain investment bank holding companies (i.e., those that did not have a U.S. insured depository institution affiliate). The firms participating in the CSE program did not qualify for that program or did not opt into that program. Only one firm (Lazard Ltd.) has ever opted for this statutory program and remains in the program today.

not necessarily applicable for the market conditions leading up to the crisis, nor during the crisis itself.

The capital adequacy rules did not sufficiently consider the possibility or impact of modeling failures or the limits of such models. Indeed, regulators worldwide are reconsidering how to address such issues in the context of strengthening the Basel regime. Going forward, risk managers and regulators must recognize the inherent limitations of these (and any) models and assumptions – and regularly challenge models and their underlying assumptions to consider more fully low probability, extreme events.

While capital adequacy is important, it was the related, but distinct, matter of liquidity that proved especially troublesome with respect to CSE holding companies. Prior to the crisis, the SEC recognized that liquidity and liquidity risk management were critically important for investment banks because of their reliance on private sources of short-term funding.

To address these liquidity concerns, the SEC imposed two requirements. First, a CSE holding company was expected to maintain funding procedures designed to ensure that it had sufficient liquidity to withstand the complete loss of all short term sources of unsecured funding for at least one year. In addition, with respect to secured funding, these procedures incorporated a stress test that estimated what a prudent lender would lend on an asset under stressed market conditions (a haircut). Second, each CSE holding company was expected to maintain a substantial "liquidity pool" that was composed of unencumbered highly liquid and creditworthy assets that could be used by the holding company or moved to any subsidiary experiencing financial stress.

The SEC assumed that these institutions, even in stressed environments, would continue to be able to finance their high-quality assets in the secured funding markets (albeit perhaps on less favorable terms than normal). In times of stress, if the business were sound, there might be a number of possible outcomes. For example, the firm might simply suffer a loss in capital or profitability, receive new investment injections, or be acquired by another firm. If not, the sale of high quality assets would at least slow the path to bankruptcy or allow for self-liquidation.

As we now know, these assumptions proved much too optimistic. Some assets that were considered liquid prior to the crisis proved not to be so under duress, hampering their ability to be financed in the repo markets. Moreover, during the height of the crisis, it was very difficult for some firms to obtain secured funding even when using assets that had been considered highly liquid.

Thus, the financial institutions, the Basel regime, and the CSE regulatory approach did not sufficiently recognize the willingness of counterparties to simply stop doing business with well-capitalized institutions or to refuse to lend to CSE holding companies even against high-quality collateral. Runs could sometimes be stopped only with significant government intervention, such as through institutions agreeing to become

bank holding companies and obtaining access to government liquidity facilities or through other forms of support.

Consolidated Supervision is Necessary but Not a Panacea. Although large interconnected institutions should be supervised on a consolidated basis, policymakers should remain aware of the limits of such oversight and regulation. This is particularly the case for institutions with many subsidiaries engaging in different, often unregulated, businesses in multiple countries.

Before the crisis, there were many different types of large interconnected institutions subject to consolidated supervision by different regulators. During the crisis, many consolidated supervisors, including the SEC, saw large interconnected, supervised entities fail, merge, or seek government liquidity or direct assistance.

Systemic Risk Management Requires Meaningful Functional Regulation, Active Enforcement & Transparent Markets. While a consolidated regulator of large interconnected firms is an essential component to identifying and addressing systemic risk, a number of other tools must also be employed. These include more effective capital requirements, strong enforcement, functional regulation, and transparent markets that enable investors and other counterparties to better understand the risks associated with particular investment decisions. Given the complexity of modern financial institutions, it is essential to have strong, consistent functional regulation of individual types of institutions, along with a broader view of the risks building within the financial system.

Steps the SEC is taking to incorporate lessons learned from the CSE experience into its ongoing role as primary functional regulator of broker-dealers are as follows:

- ***Improvements to Broker-Dealer Reporting and Monitoring.*** With respect to the SEC's ongoing monitoring of certain large broker-dealers, the staff has developed enhanced reporting requirements for the firms, including information regarding balance sheet composition to monitor for the build-up of positions in particular asset classes. In addition, the SEC's 17-h Risk Assessment Program, under which it monitors for potential risks posed to broker-dealers by their affiliates, is in the process of being improved and upgraded.

- ***Improved Coordination.*** There must be full information sharing within the SEC. I have directed senior staff across all divisions to establish dedicated teams – including staff from the Division of Trading and Markets, Division of Risk, Strategy, and Financial Innovation, Division of Investment Management, and the Office of Compliance, Inspections and Oversight – with responsibility for key financial institutions for which the Commission is the primary functional regulator. We also will be seeking additional opportunities to coordinate more effectively with our fellow regulators.

In addition, we have created and staffed a new division – the Division of Risk, Strategy, and Financial Innovation (Risk Fin) – to develop and expand our institutional expertise. Risk Fin will re-focus the agency's attention on and response to new products, trading practices, and risks. Already, this new division has attracted renowned experts in the financial, economic, and legal implications of the financial innovations being crafted on Wall Street.

- ***Improved Examination, Oversight and Enforcement.*** The SEC's Office of Compliance Inspections and Oversight and our Division of Trading and Markets will be working together with Risk Fin to review and improve our broker-dealer oversight and examination program, initially starting with our ANC firms. This collaboration will address key supervision functions, including risk assessment, exam planning, information gathering and analysis, policy-making, interpretive guidance, monitoring, and reporting. A key theme will be to act in a more coordinated and integrated manner, improving information sharing on a Commission-wide basis and better realizing the potential synergies among our examination, supervision and rule-making functions. Another objective is to better enhance and deploy our expertise, particularly in connection with the planning and analysis of our supervision and examination programs. These programs must be aggressive in their execution, and possible violations of the securities laws and regulations will be vigorously investigated and enforced.

- ***Further Improvements to Rules and Requirements.*** Effective January 2010, the SEC staff instructed the ANC firms to take standardized net capital charges on certain less liquid mortgage and other asset-backed securities positions rather than using financial models to calculate net capital requirements. In addition to increasing the capital required to be held for these positions, this approach will reduce reliance on value-at-risk models.

  The SEC also is reviewing other ways to further enhance and strengthen our financial responsibility requirements for broker-dealers. With respect to ANC firms in particular, we are taking a fresh look at our rules with a view to determining whether the entire ANC approach should be substantially modified.

  With respect to all broker-dealers, some steps the staff is reviewing include: (1) raising minimum net capital requirements for broker-dealers; (2) enhancing the requirements for treating securities as liquid for purposes of the Commission's net capital rule; (3) limiting circumstances when clearing deposits would be allowable for net capital purposes; (4) narrowing the types of unsecured receivables that would be allowable for net capital purposes; and (5) imposing certain explicit leverage-based requirements, such as requiring broker-dealers to provide "early warning" notice to regulators if their leverage exceeds certain levels.

Regulatory Reform

The failure of Lehman demonstrates the need for important legislative changes in supervisory and resolution structures for large financial entities that can have a systemic impact on the financial system. The bills passed in the House and being considered in the Senate, although different in many details, are designed to address key issues raised by the financial crisis.

Regulation of Systemic Risk. The financial crisis demonstrated the need to watch for, warn about, and eliminate conditions that could cause a sudden shock and lead to a market seizure or cascade of failures that put the entire financial system at risk. While traditional financial oversight and regulation can help prevent systemic risks from developing, it is clear that this regulatory structure failed to identify and address systemic risks that were developing over recent years. The current structure was hampered by regulatory gaps that permitted regulatory arbitrage and failed to ensure adequate transparency. This contributed to the excessive risk-taking by market participants, insufficient oversight by regulators, and uninformed decisions by investors that were key to the crisis.

Given the shortcomings of the current regulatory structure, I believe there is a need to establish a framework for macro-prudential oversight that looks across markets and avoids the silos that exist today. Within that framework, I believe a hybrid approach consisting of a single systemic risk regulator and an empowered council of regulators is most appropriate. Such an approach would provide the best structure to ensure clear accountability for systemic risk, enable a strong, nimble response should adverse circumstances arise, and benefit from the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences. This should be a mechanism for providing a second set of eyes over large interconnected firms and ensuring that standards and investor protections are *raised* so that there is no regulatory benefit to being large and interconnected.

End Too-Big-To Fail. One of most important regulatory arbitrage risks is the potential perception that large interconnected financial institutions are "too-big-to fail" and will therefore benefit from government intervention in times of crisis. This perception can lead market participants to favor large interconnected firms over smaller firms of equivalent creditworthiness, fueling greater risk.

In addition to establishing a strong Systemic Risk Council and higher standards, a key element to ending "too-big-to-fail" is the creation of a credible resolution regime to unwind and liquidate institutions of any size. In times of crisis when a systemically important institution may be teetering on the brink of failure, policymakers currently must immediately choose between two highly unappealing options: (1) providing government assistance to a failing institution (or an acquirer of a failing institution), thereby allowing markets to continue functioning but creating moral hazard; or (2) not providing government assistance but running the risk of market collapses and greater costs in the future. Markets recognize this dilemma and can fuel more systemic risk by

"pricing in" the possibility of a government backstop of large interconnected institutions. This can give such institutions an advantage over their smaller competitors and make them even larger and more interconnected.

A credible resolution regime can help address these risks by giving policy makers a third option: a controlled unwinding of a large, interconnected institution over time. Structured correctly, such a regime could force market participants to realize the full costs of their decisions and help reduce the "too-big-to-fail" dilemma. Structured poorly, such a regime could strengthen market expectations of government support, thereby fueling "too-big-to-fail" risks.

Insuring Independence and Resources for Market Regulation. Although traditionally independent of the executive branch, the SEC lacks an independent source of funding like most financial regulators. Most financial regulators have been established as independent entities with bipartisan management and dedicated funding sources. Unlike its regulatory counterparts, however, the SEC's funding is subject to the budget and appropriations process. As a result, the SEC has been unable to maintain stable, sufficient long-term funding necessary to conduct long-term planning and lacks the flexibility to apply resources rapidly to developing areas of concern.

Despite the damage done by the financial crisis, trading volume has more than doubled since 2003, the number of investment advisers has grown by roughly 50 percent, and the assets they manage have increased nearly 120 percent, to $46 trillion. The SEC's 3,800 employees oversee approximately 35,000 entities – including 11,500 investment advisers, 7,800 mutual funds, 5,400 broker-dealers, and more than 10,000 public companies – a nearly 10 to 1 ratio that is only growing larger. These numbers do not include the many unregulated entities that our enforcement staff must pursue to protect investors.

By guaranteeing independence, facilitating long-term planning, and closing the resource gap between the agency and the entities it regulates, independent funding will allow the SEC to better protect millions of investors. In addition, independent funding will ensure an SEC that is more effective at identifying and addressing the kinds of risk that dealt a significant blow to the American economy. An independently funded SEC will be better able to take strong action to prevent future risky activities by the entities under its supervision and to fulfill the important new responsibilities assigned to it under any future legislation.

Conclusion

In conclusion, there are many lessons to be learned from both the Lehman failure and the larger financial crisis. The enormity and worldwide scope of the crisis, and the unprecedented government response required to stabilize the system, demands a full and careful evaluation of every aspect of our financial system. As I have said in previous testimony, we cannot hesitate to admit mistakes, learn from them and make the changes needed to address the identified shortcomings and reduce the likelihood that such crises

reoccur. More vigorous regulation and a new culture and approach are essential, and I look forward to continuing to work with you as you consider ways to strengthen our financial system. Thank you again for the opportunity to discuss these important issues with you today, and I look forward to answering your questions.

Statement by

Anton R. Valukas

Examiner, Lehman Brothers Bankruptcy

before the

Committee on Financial Services

United States House of Representatives

regarding

"Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner"

April 20, 2010

Dear Chairman Frank, Ranking Member Bachus and Members of the Committee:

I appreciate this opportunity to appear before you in connection with my role as the Examiner in the Lehman bankruptcy – the largest bankruptcy proceeding ever filed.

As you know, on February 8, 2010, I filed my Final Report with the Court under seal. On March 11, 2010, a redacted version was publicly released; and on April 14, the entire, unredacted Report was made public. The Report is 2209 pages exclusive of appendices and details my findings – formed from interviews of more than 250 persons and review of approximately 35 million pages of documents.

Your letter dated April 14, 2010, inviting me to appear before the Committee, requests that I address five specific bulleted topics, with a sixth bullet inviting me to comment on other issues I deem relevant to public policy issues raised by my Report. I will address each bullet in the order listed in your letter.

Bullet one: The extent to which corporate governance should be enhanced to appropriately manage firm risk.

We conducted an extensive investigation to learn how Lehman managed, monitored and limited its exposure to risk. Lehman had adequate corporate governance procedures in place. It had quantitative risk models that accurately calculated risk and that accurately warned that Lehman was taking on significant levels of risk in excess of the limits generated by the models. Lehman's procedures included reporting of the limits, and exceedances of the limits, to senior management and the Board.

But we found that Lehman was significantly and persistently in excess of its own risk limits. Lehman management decided to disregard the guidance provided by Lehman's risk management systems. Rather than adjust business decisions to adapt to risk limit excesses, management decided to adjust the risk limits to adapt to business goals.

We found that the SEC was aware of these excesses and simply acquiesced. With no regulator in place that required Lehman to adhere to its risk limits (I will

discuss that issue further in bullet two below), Lehman's risk limits became meaningless.

To be sure, Lehman's corporate governance procedure could have been better. A proper system should have had an independent risk management function that reported directly to senior management, to the Board of Directors, and to the regulators, rather than to a business unit; indeed that is a regulatory requirement (SEC Reg 15c3-4); but in 2006-2007, the Lehman risk function reported to the head of a business line rather than directly to senior management.

Lehman was unique among the investment banks in measuring "risk appetite" – the amount of loss it could expect to incur from market risk, credit risk, and event risk and still return a minimal level of profitability. Lehman had in place a series of risk appetite limits, including a firm-wide limit. Every day, Lehman measured its risk usage and compared the usage to see if it was under or over the risk limit.

Lehman represented to the SEC in writing that its firm-wide risk appetite limit was a *"binding constraint on its risk-taking"* that *"could not be exceeded under any circumstances."* Lehman repeatedly represented to the SEC that this firm-wide risk appetite limit was a hard limit – a meaningful constraint on Lehman's risk taking. Lehman advised the SEC that the limits were set by senior management and the Board. Excesses of limits were reported to the Board.

So an appropriate governance plan was in place to set risk limits. But management did not observe the limits. For example, Lehman committed to what was its largest single investment – Archstone – in May 2007, with closing to occur later. It was clear prior to the commitment that the Archstone transaction would put Lehman over its then existing risk limits, but the deal was committed anyway. With the inclusion of Archstone, Lehman was clearly in excess of its established risk limits. But in the face of exceeding its risk limits, Lehman did not take steps to reduce risk; rather, it simply raised the risk limits.

Lehman ultimately took writedowns on its investment in Archstone of hundreds of millions of dollars; our retrospective analysis was that the writedowns should have been significantly higher. Archstone was one of the investments that put Lehman on or over the brink; yet it was a transaction that would not have been made had Lehman adhered to its own risk limits.

I ultimately concluded that there were no colorable claims arising from investment decisions such as Archstone. Senior management made the conscious decisions to exceed risk limits and complete the Archstone and other deals because they believed, erroneously, that those deals would be profitable. Likewise the decisions to exceed risk limits were flawed but made in the expectation of profit, not loss.

Archstone was the largest, but not the only instance in which risk management's view was overruled or disregarded. Lehman was in breach of its established risk appetite limits on a persistent basis during the second half of 2007. Lehman ultimately cured the breaches at the end of the year, not by reducing risk, but by raising risk appetite limits again.

To be fair, Lehman made some efforts to reduce some risks during this period, but we found that Lehman did not make a systematic effort to reduce its overall commercial real estate risks, the major factor in the breach, until some time in the spring of 2008.

Lehman also had in place a "single transaction limit" framework to limit the size of individual transactions as a risk control. But in late 2006, Lehman management made the affirmative decision to disregard the single transaction limit because it had cost Lehman significant profit-making opportunities. As a result, Lehman committed to and closed dozens of transactions that were vastly in excess of that business unit's risk limits.

The decision not to enforce these limits had consequences for Lehman in the summer of 2007 when certain Lehman executives became concerned whether Lehman would be able to fund all of its outstanding commitments. At that time, a senior Lehman officer, Ian Lowitt, observed: "In case we ever forget; this is why one has concentration limits and overall portfolio limits. Markets do seize up."

By 2008, Lehman had in place a stress testing program, designed to assess whether Lehman could survive a series of both hypothetical and historical stress scenarios. But Lehman did not include many of its riskiest assets in its stress testing, such as commercial real estate. Without including these investments, the stress testing was – at best – meaningless, because a large proportion – perhaps the majority – of Lehman's risk lay with those business lines. And at worst the stress testing was affirmatively misleading, because it provided false comfort. Because the stress testing was not meaningful, Lehman's management and Board

were deprived of information that would have more accurately described Lehman's true risk picture and that might have led to more decisive action to reduce risk.

Lehman had in place a system for reporting risk issues and breaches of limits to its Board. The reports to the Board were not always timely or in adequate detail. But in sum, Lehman had in place an appropriate set of procedures to track and set limits to control risk, procedures for management review of the limits and compliance with the limits, and procedures for Board reporting and oversight. Lehman had the procedures; it simply chose to ignore them when it reached established limits. And with no effective external regulation, there was no one to require that Lehman stay within limits. Which brings me to the second bullet:

Bullet two: The role of the SEC and other agencies in oversight, examination and enforcement.

By at least 2007, various agencies of the US government were concerned – at the highest levels – with the prospects for Lehman's survival. Former Treasury Secretary Paulson, Fed Chairman Bernanke, then President of the Federal Reserve Bank of New York (FRBNY) Geithner, and Former SEC Chairman Cox each told us that they were concerned about Lehman's future and the effect of Lehman's possible demise on the US economy. That concern intensified after Bear Stearns' near collapse in March 2008. Indeed, on June 13, 2008 - three months before Lehman's bankruptcy - Donald L. Kohn, Vice Chairman of the Federal Reserve, sent an email to Chairman Bernanke stating that "the question is when and how [Lehman] go[es] out of business not whether." The concern at the top was reflected in the personal role each of the individuals assumed in staying abreast of Lehman's situation.

After the near-collapse of Bear Stearns in March 2008, the SEC and FRBNY placed embedded teams at Lehman to gather information and monitor Lehman's condition. Then-FRBNY President Geithner spoke regularly with Lehman's CEO, Richard Fuld and advised him that Lehman needed to raise more capital and / or form a strategic alliance with an entity with a stronger balance sheet.

Secretary Paulson spoke to Mr. Fuld regularly and repeatedly urged that Lehman raise capital, find a strategic partner, or sell Lehman. Beginning in March 2008, Chairman Cox had direct calls with Mr. Fuld every few weeks. Chairman Bernanke spoke infrequently to Mr. Fuld but frequently with Geithner and Paulson about Lehman. Chairman Bernanke observed that Secretary

Paulson was frustrated by Mr. Fuld's "more inertial behavior" to raise capital or find a strategic partner. The Fed was trying to pressure Lehman to be more aggressive, but was conscious of its "appropriate role" as a lender, not a regulator, given that the SEC was the regulator.

So the agencies were concerned. They gathered information. They monitored. *But no agency regulated.*

The Fed and Treasury took pains to tell us that the SEC was Lehman's regulator, and that they therefore deferred to the SEC. For its part, the FRBNY viewed its role as a potential lender, not as a regulator. Secretary Geithner viewed the SEC, not the FRBNY, as Lehman's primary regulator; he told us that the FRBNY had "no knowledge, reach or capacity to affect [Lehman's] behavior." Secretary Geithner stated that the FRBNY had authority to obtain information from Lehman solely from the FRBNY's status as a "rather late, reluctant creditor" to Lehman through the Fed's discount window.

But former SEC Chairman Cox took equal pains to say, during our interview with him on January 8, 2010, that the SEC's statutory jurisdiction was limited to Lehman's broker-dealer subsidiary and that it was not the regulator of Lehman itself.

Despite Chairman Cox's statement, we believe it is clear that the SEC was Lehman's primary regulator. In 2005, the European Union ("EU") announced that it would regulate global financial institutions unless they were regulated by an equivalent domestic agency. In response, all of the major investment banks – Lehman, Bear Stearns, Goldman Sachs, Morgan Stanley and Merrill Lynch – voluntarily submitted to regulation under the SEC's Consolidated Supervised Entity ("CSE") program. Lehman was free to withdraw, but if it had done so, it would have become subject to EU supervision; so the SEC thus had *de facto* supervisory authority; the SEC's General Counsel's office has acknowledged that it had that authority, stating that "CSE staff thus had broad authority in its supervision of Lehman Brothers."

The SEC Rule governing the CSE program, 69 Fed. Reg. 34.428, mandates that, in order to participate in the CSE program, the broker-dealer must submit a written undertaking by the ultimate holding company - LBHI - that "[a]cknowledge[s] that the [SEC] may implement *additional supervisory conditions* if the ultimate holding company fails to comply in a material manner with any provision of its undertaking" which requires the holding company to provide the SEC with information about the company's capital and other specified financial,

operational and risk management information on a monthly, quarterly and annual basis, as well as to "implement and maintain a consolidated internal risk management control system . . . ." The SEC rule expressly contemplates SEC regulatory authority over the holding company.

Perhaps most significant, in February 2008 testimony to the Senate Banking Committee, Chairman Cox acknowledged that, through the CSE Program, the SEC had authority to "monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities . . . or the broader financial system, at risk."

We believe it clear, then, that the SEC was in fact Lehman's primary regulator. The SEC told us that were constantly monitoring Lehman's risk and liquidity. But there was little if any actual regulation; we observed no instance in which the SEC did anything, in Chairman Cox's words, to "act quickly in response to financial or operational weaknesses" at Lehman.

The SEC made a few recommendations or directions here and there, but in general it simply collected data; it did not direct action, it did not regulate.

It is one thing for Lehman to have exercised the business judgment, although in retrospect clearly bad judgment, to forge ahead and take on excessive risk. But it was quite another for the supposed regulator – a regulator who had been told by Lehman that its risk controls were binding and not meant to be exceeded under any circumstances – to stand by idly and simply acquiesce to management's decision. The SEC's mission – clearly stated on its own website – is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." The SEC's role was not to simply absorb and acquiesce to Lehman's decisions; the SEC's role was to supervise and regulate to protect investors and the markets.

I will briefly address three critical areas, which are described in complete detail in my Report, in which the SEC had actual knowledge – or could have, with minimal effort, obtained that knowledge – of significant issues that, if they had been the subject of regulation, might have altered the outcome.

The SEC *knew* that Lehman was reporting sums in its reported liquidity pool that the SEC did not believe were in fact liquid; the SEC *knew* that Lehman was exceeding its risk control limits; and the SEC *should have known* that Lehman was manipulating its balance sheet to make its leverage appear better than it was. Yet even in the face of actual knowledge of critical shortcomings, and after Bear

Stearns' near collapse in March 2008 following a liquidity crisis, the SEC did not take decisive action.

> *Liquidity.* The SEC and the FRBNY each told us that Lehman's liquidity was of critical importance. But Lehman included in its reported liquidity pool assets that both the SEC and the FRBNY concluded, when they were advised of the facts, were not proper components of liquidity because they were not readily monetizable.
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> Lehman publicly disclosed its liquidity pool – the amount supposedly available to Lehman to satisfy its short-term obligations – because liquidity was essential to maintain the confidence of Lehman's trading partners. On June 9, 2008 - just three months before declaring bankruptcy - Lehman announced its liquidity pool was at $45 billion, its "largest ever."
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> On September 10, 2008 - five days before it filed for bankruptcy - Lehman publicly announced that its liquidity pool was holding steady at approximately $41 billion. By Friday, September 12, however, Lehman had less than $2 billion of assets that could readily be turned into cash; it literally did not have sufficient cash to open for business on Monday, and it filed for bankruptcy protection on September 15.
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> We know in retrospect that Lehman's report of a $41 billion liquidity pool on September 10 was off by tens of billions of dollars. In the course of my investigation, we discovered an internal Lehman document that lists Lehman's actual liquidity during Lehman's final week, categorizing the assets as "High," Mid" and "Low" "Ability to Monetize." On September 9, the day before the announcement of the $41 billion pool, Lehman had $40.6 billion of assets in its supposed pool. But the internal document shows that only $24.7 billion of that amount was in the "High" category; there was $0.9 billion in "Mid" category; and $15 billion of the $41 billion liquidity pool was in fact not liquid at all, because those amounts were pledged to the clearing banks. On September 10, after the announcement of a $41 billion pool, the "High" ability to monetize assets plummeted from $24.7 to 9.4 billion; on September 11 the amount fell further to $7 billion; and by September 12 it was a mere $1.4 billion.
>
> The SEC did not learn all of these precise facts until September 12 or later. But months earlier, it *had* learned critical information that put it on notice

that Lehman's liquidity was not as was portrayed to the investing public. But the SEC did not act on its knowledge, it simply acquiesced.

In June 2008, one of Lehman's clearing banks, Citibank, required that Lehman post $2 billion as a "comfort deposit" as a condition for Citi's continued willingness to clear Lehman's trades. Lehman was technically free to withdraw the deposit, but it could not do so as a practical matter without shutting down or disrupting the business it ran through Citi. Later in June, Lehman posted $5 billion of collateral to JPMorgan, Lehman's main clearing bank, in response to an earlier demand by JPMorgan. Lehman continued to count virtually all of these deposits in its reported liquidity pool – nearly $7 billion of a reported $40 billion, 17.5% of the total.

The SEC had actual knowledge, in June 2008, of the Citi deposit. The SEC believed that it was not proper to include such deposits in a reported liquidity pool. The FRBNY, when it ultimately learned about the deposit months later, likewise agreed that it was improper to include such deposits in a liquidity pool. But while the SEC disapproved of Lehman's inclusion of that amount in its liquidity pool, it took no action to require that Lehman not do so. The SEC did not direct that Lehman publicly disclose the facts so that no one was misled about Lehman's liquidity. And, remarkably, the SEC did not ask the logical question "Are there other deposits like this one?" so they did not learn – until September 12 – that virtually all of the $5 billion JPMorgan deposit was also included in the reported liquidity pool, as well as more than $9 billion Lehman posted to JPMorgan after September 8.

On September 12, 2008, the significance of Lehman's collateral postings became clear to the SEC's Michael Hsu. Mr. Hsu connected the dots in an email that day that "lehman's liquidity pool is almost totally locked up with clearing banks to cover intraiday [sic] credit []. This is a really big problem." But even then, with Lehman shares being actively traded, the SEC did not require Lehman to make any announcements about its severely depleted liquidity.

Risk. The SEC knew that Lehman was in repeated and persistent breach of its own risk limits, yet the SEC simply acquiesced; it took no action either to get Lehman back into control or to require that Lehman publicly disclose the full extent of its risk-taking.

When Lehman applied for and was granted CSE status, it advised the SEC that it had a robust procedure to calculate and set risk limits as a *"binding constraint on its risk-taking"* that *"could not be exceeded under any circumstances."*

The SEC received monthly information about Lehman's risk limits and risk usage from Lehman. In October 2007, the CSE staff learned that Lehman was more than 20% over its recently increased risk appetite limit amount. But the SEC simply acquiesced; it did nothing with that information other than to ask whether the limit breaches had been properly escalated within Lehman. It did not direct compliance with risk limits. It did not direct public disclosure that Lehman failed to stay within its limits.

Lehman's CSE application also advised the SEC that Lehman was "in the process of developing single transaction limits," but that the businesses were "currently operating as if the limits [were] in place." But by July 2007, Lehman had committed to approximately 30 deals that exceeded its then existing limit. The SEC simply acquiesced; it did nothing to require adherence to single transaction limits; it did not require public disclosure of management's decision not to apply those limits.

Under the CSE Program, Lehman was required to develop and maintain a market-based stress testing program, under which the firm's portfolio would be tested against a series of both hypothetical and historical stress scenarios. Lehman did test, but it did not include many of its riskiest assets – such as commercial real estate – in the testing models. For example, the SEC knew that Lehman's internal stress test excluded untraded positions, including commercial real estate. The SEC simply acquiesced; it did nothing to require adjustment to the tests. When Lehman did experimental testing in 2008 with those excluded assets added into the tests, the results were stunning: The tests that were shared with the SEC showed potential losses in all cases of less than $4 billion; but with the excluded assets factored in, the losses soared to $9.4 billion in one instance, $13.4 billion in another.

Balance Sheet Manipulation. I will address this point in a bit more detail below as an independent bullet point, but it is pertinent here. My Report details Lehman's use of an accounting device known as Repo 105 – a device which was described in contemporaneous e-mails from Lehman executives as a "gimmick" and a "drug we r on" whose only purpose was

> to "manage" the balance sheet – to temporarily move $50 billion of assets of balance sheet at quarter end reporting periods. The effect of these transactions was to allow Lehman to report significantly lower leverage numbers at a time when the rating agencies and business parties viewed leverage as a critical metric.
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> The SEC did not know about the practice. But it is difficult to understand why not. In the post-Enron world, it would be logical, if not obvious, to ask public companies to explain their off-balance sheet transactions. I saw nothing in my investigation to suggest that the SEC asked even the most fundamental questions that might have uncovered this practice early on, before Lehman escalated it to a $50 billion issue.

I must emphasize, as I attempted to set out in my Report, that Lehman's failure was the result of many factors; there is no single cause or actor. I do not view my appearance today as an occasion to assign blame but rather as an opportunity to offer insights that might enhance the government's ability to protect the nation's financial infrastructure from another Lehman.

But it is my conclusion that the SEC did not effectively regulate. The SEC even had the benefit of its own Inspector General's draft report regarding Bear Stearns during the summer before Lehman failed – a report that highlighted, in the context of Bear, the SEC's failures to effectively regulate Bear's risk, leverage, capital and liquidity. And still the SEC failed to act with respect to Lehman.

Recently, current SEC Chairman Mary Schapiro came to Chicago with her senior staff to meet with me and my partners to discuss the Report. We sincerely appreciate the SEC's efforts to follow up on issues raised by the Report. I did not suggest to her, and I am not here today to suggest, any specifics for what regulations there should be or what agency should enforce those regulations. But as someone who has spent considerable time investigating the facts which preceded Lehman's failure, I have views on what was *not* done – there was a void that I believe merits additional attention and action, by this Committee or by others.

Bullet three: The relationship and means of communication between the SEC, FRBNY and other agencies.

Like most Americans, I was disturbed to learn after 9/11 that various intelligence agencies did not always share information with one another. I thought we learned something from that, but apparently not.

Lehman's collapse was not unanticipated. After Bear Stearns -- a firm whose business model was nearly identical to Lehman's -- almost collapsed, the SEC and the FRBNY assigned dedicated teams to Lehman to monitor its affairs in real time. One would expect that both agencies would work together to avert Lehman's failure. And for the most part, they did. But there were serious lapses.

Both the SEC and the FRBNY focused much of their attention on Lehman's liquidity, but neither agency directed Lehman to take any action. Both agencies had access to daily liquidity reports from Lehman soon after Bear Stearns' near collapse in March 2008. And both agencies monitored Lehman on site beginning in March 2008. On occasion, the SEC deferred to the FRBNY to develop stress test parameters to determine Lehman's vulnerability to a bank run. But we found little evidence that the two agencies pooled their resources as a team to maximize their ability to regulate Lehman. For example, after Lehman failed several stress tests in May and June 2008, neither the SEC nor the FRBNY directed Lehman to take corrective action to strengthen its liquidity position.

Significantly, the SEC and the FRBNY failed to share information about Lehman's liquidity and Lehman's inclusion of encumbered collateral in its liquidity pool. The SEC knew in June 2008 about the $2 billion Citi deposit and that it was included by Lehman in its reported liquidity pool. It did not share that information with the FRBNY, which did not learn those facts until late August 2008. Additionally, the SEC prepared liquidity analyses of the CSE firms, including Lehman, but the SEC affirmatively declined to share these with the FRBNY because, they explained to us, the analyses were in draft form and never finalized.

The FRBNY knew by at least July 2008 about the $5 billion JPMorgan collateral pledge which had been made in June 2008. The FRBNY did not pass on that information to the SEC. By August 20, 2008, the FRBNY realized that Lehman was including virtually all of the $5 billion collateral pledge to JPMorgan in Lehman's reported liquidity pool, but - again - the FRBNY did not share this with the SEC.

So as of August 20, the combined knowledge of the government was that at least $7 billion of Lehman's supposed liquidity – a significant portion of the total – was not liquid because it was pledged. But there was no combined knowledge because the SEC and FRBNY had not shared their individual knowledge.

The FRBNY knew about agreements that Lehman executed with its clearing banks on August 26 and September 9, 2008 that significantly increased the

clearing banks' rights with respect to Lehman collateral. It did not share that information with the SEC. In sum, the FRBNY did not *volunteer* information regarding the CSEs. Instead, the FRBNY only shared information specifically *requested* by the SEC.

The failure to share was not a top down decision. At the top, Chairman Bernanke and Chairman Cox were personally involved in the negotiation and execution of a Memorandum of Understanding between the Fed and the SEC that provided for the exchange of information. The failure was at a staff level, but it was a genuine failure.

The FRBNY and Fed witnesses we spoke to, from Chairman Bernanke and Secretary Geithner down to their staffs, indicated to us that they had some question with the competence of the SEC personnel who were supposedly regulating Lehman. These comments were not a reflection on the competence of particular individuals, but rather on the culture of the SEC. As Chairman Bernanke put it, with due deference to the lawyers he was speaking to, the SEC has a lawyer, enforcement mentality rather than a banker, regulator point of view. The SEC is competent to enforce rules, but it may lack the experience and skill sets possessed by bank regulators to evaluate financial risks of particular loans and other investments.

The agency with the skill sets to regulate a financial institution like Lehman – the Fed – did not have the authority; and the agency with the authority – the SEC – may not have had the skills. And the two agencies were unable to smooth out the gaps because they failed to have full and open sharing of information.

Bullet four: The appropriateness of accounting practices such as Repo 105.

I devote 320 pages of my Report to Lehman's Repo 105 practices, detailing Lehman's use of an accounting technicality to temporarily remove significant amounts of assets off balance sheet for no apparent reason other than to artificially and deceptively reduce Lehman's reported net leverage and, therefore, the market perception of Lehman's viability.

I express no view on whether, as a technical matter of GAAP accounting, it is permissible to treat transactions as sales which are by all other measures financings. But I have a definite view that it is *not* appropriate to engage in significant amounts of such transactions without disclosure.

Lehman did not disclose that it used $50 billion of these transactions. To the contrary, it affirmatively and erroneously stated in its public filings that it used repo transactions solely as financings. The effect of these transaction was to reduce its net leverage by nearly two full points – when Lehman itself defined a material transaction as one which affected net leverage by one tenth of one point. The failure to disclose the facts was not appropriate.

Bullet five: The quality of Lehman's Management Discussion and Analysis Disclosures.

I found that there are colorable claims that the Management Discussion and Analysis ("MD&A") sections of Lehman's Form 10-K for 2007 and Form 10-Q filings in 2008 were misleading.

Lehman emphasized to the investing public that it had worked to lower its net leverage ratio, and stated in its MD&A that net leverage is "more meaningful" than a simple leverage ratio. But Lehman did not disclose that it had only temporarily reduced its net leverage ratio through Repo 105 transactions. Consequently, Lehman's statement that the net leverage ratio was a "more meaningful" measurement of leverage was rendered misleading because that ratio – as reported by Lehman – was not an accurate indicator of Lehman's actual leverage, and in fact, understated Lehman's leverage significantly. In light of the market's focus on the leverage of investment banks in late 2007 and 2008, I found that sufficient evidence exists for a judge or jury to find that Lehman's reported net leverage ratio was materially misleading during that period.

An MD&A should include an "analysis" of known material trends, events, demands, commitments, and uncertainties – not simply a restatement of financial statement information. For example, an MD&A should provide information about the *quality* of, and potential variability of, a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance. Regulation S-K requires a registrant to discuss known trends involving its capital resources, *specifically including off-balance sheet financing arrangements.* The same regulation specifies that a registrant should discuss, among other things, the "nature and business purpose to the registrant of such off-balance sheet arrangements" and "[t]he importance to the registrant of such off - balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits." My report details statements, in both interviews and in contemporaneous e-mails, by senior

Lehman employees that the Repo 105 transactions had no business purpose at all, but did have a marked effect on Lehman's reported net leverage ratio.

SEC guidance also states that an MD&A should describe "unusual events and transactions" to help identify apparent trends. Lehman did not disclose the unusual nature of the Repo 105 transactions or the trend of the temporary reduction of Lehman's reported net leverage ratio at the end of reporting periods.

Lehman's obligation to repurchase $50 billion of Repo 105 transactions should have been disclosed in its MD&A. That obligation was a known event that was reasonably likely to occur and would have had a material effect on the company's financial condition or results of operations. In addition, in the Liquidity and Capital Resources section of Lehman's MD&A's, Lehman should have included a discussion of the timing and/or amounts of the cash flow created by the repayment of the Repo 105 cash borrowing in the first seven to ten days after the end of the reporting period.

Bullet six: Other relevant issues.

Because neither the SEC nor any other agency directed Lehman to correct its misleading and incomplete public statements, the public did not know there were holes in the reported liquidity pool, nor did it know that Lehman's risk controls were being ignored, or that reported leverage numbers were artificially deflated. Billions of Lehman shares traded on misinformation.

Lehman officers emphasized to us that they freely and fully provided information to various government agencies. I found no evidence to suggest that Lehman withheld any information requested by any agency. But it is my conclusion that the government simply acquiesced to the information it was given; it took no regulatory action, it did not ask hard questions.

It is difficult to speculate on what might have happened in the past had the SEC or the Fed or the Treasury taken more decisive action. We cannot say with certainty what might have worked, but we do know what did not work. If Lehman had been directed to follow its risk controls, it presumably would have taken on less risk. If Lehman had been required to disclose its true liquidity when its pool was first depleted with the $2 billion Citi deposit in June 2008, when the depletion was not terribly material, it presumably could not have

continued to count increasingly large amounts of encumbered assets as liquidity as it was required over the summer to pledge more assets with its clearing banks.

I have to state the obvious. There is no bright line action that can be said in retrospect "had the government done this, Lehman would not have failed." It is far from clear that the most engaged regulator could have saved Lehman from its fate. But what is clear is that had the government acted sooner on what it did or should have known, there would have been more opportunities for a soft landing. The markets might have been spared the turmoil of Lehman's abrupt failure.

What is clear is that the regulators were not fully engaged and did not direct Lehman to alter the conduct we know in retrospect led Lehman to ruin. Someone must be in charge. And the agency in charge must have the will to act.

Statement

of

Christopher Cox

Former Chairman, U.S. Securities and Exchange Commission

before the

Committee on Financial Services

U.S. House of Representatives

April 20, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee: Thank you for the opportunity to submit views on the bankruptcy of Lehman Brothers and the lessons learned from the perspective of federal regulators that can help inform the Committee in your important ongoing work to reform the regulation of financial services.

The federal government faced novel challenges during the height of the financial crisis, and regulators took extraordinary actions to meet them. In particular, the Securities and Exchange Commission, with statutory responsibility for the regulation of broker-dealers, worked closely with the Federal Reserve and other banking regulators whose mission is not investor protection but the safety and soundness of the banking system. While the Federal Reserve and the Department of the Treasury played direct roles in negotiating not only loans but equity investments and strategic transactions to rescue both regulated and unregulated institutions, including commercial and investment banks, GSEs, insurers, and even automotive companies, the SEC maintained its role as an arm's length regulator and law enforcement agency. Maintaining this independent but complementary role has ultimately proved important to the vindication of important national interests, as the SEC has been able to bring subsequent enforcement actions arising out of several of these transactions. The Examiner's report of evidence that Lehman filed misleading financial reports and failed to disclose material accounting information to the SEC, the Fed, and the public may provide the basis for SEC law enforcement action in that case, as well.

The lessons learned from the collaboration of federal regulators both before and after the Lehman Brothers bankruptcy can be of particular importance in identifying regulatory gaps and statutory shortcomings that should be addressed in legislation to modernize the existing regulatory framework.

Lehman Brothers was one of several financial institutions that experienced significant stress or collapsed during 2008, including Bear Stearns, Wachovia, Washington Mutual, AIG, Citigroup, Fannie Mae and Freddie Mac. Its Chapter 11 bankruptcy filing on September 15, 2008, was the largest in U.S. history. Lehman was also unique in that, unlike Bear Stearns, Fannie Mae, Freddie Mac, AIG, Citigroup, and hundreds of other financial institutions that would receive taxpayer support through the TARP program and other specially designed facilities, it did not receive such support.

After the near-collapse and emergency sale of Bear Stearns to JPMorgan Chase in March 2008, the condition of Lehman Brothers became the number one focus for the SEC Division of Trading and Markets. It was viewed as the next most vulnerable of the investment banks. Because Lehman's management also knew that its survival was at stake, the SEC, Federal Reserve, and Treasury focused on providing regulatory and other support for the firm's efforts to raise capital, secure a strategic partner or acquiror, restructure itself, lengthen the maturities of its funding, and shed its troubled assets.

The rapid collapse of Bear Stearns had challenged the fundamental assumptions behind the Basel standards, an internationally recognized method for computing

regulatory capital at the holding company level, and the other metrics that had been built into the SEC's Consolidated Supervised Entities program. This voluntary regulatory regime for large investment bank holding companies with SEC-regulated broker-dealer subsidiaries had been put in place by rule in the year prior to my joining the Commission, and represented the best thinking of the agency's professional staff. In addition to relying upon the internationally-accepted Basel standards for computing bank capital, it also adopted the Federal Reserve's standard of what constitutes a "well-capitalized" bank, and required the CSE firms to maintain capital in excess of this 10% ratio. Indeed, the CSE program went beyond the Fed's requirements in several respects, including adding a liquidity requirement, and requiring firms to compute their Basel capital 12 times a year, instead of the four times a year that the Fed requires for commercial banks.

During the unprecedented stress of the financial crisis, however, these borrowed approaches from commercial bank regulation had unfortunate results similar to those that were eventually experienced throughout the commercial bank sector in 2008. The creators of the Consolidated Supervised Entity program in 2004 had designed it to operate on the well-established bank holding company model used by regulators not only in the United States but around the globe. But the market-wide failure to appreciate and measure the risk of mortgage-related assets, including structured credit products, demonstrated that neither the Basel I nor Basel II standards as then in force were adequate. Each had serious need of improvement.

The fact that these standards did not provide adequate warning of the near-collapse of Bear Stearns, and indeed the fact that the Basel I standards used by the Federal Reserve and other U.S. banking regulators did not prevent the exceptionally costly failures and taxpayer-funded rescues of many other large commercial banks and financial institutions, is now obvious. But even in March 2008, after the Bear experience, it had become clear that the regulatory metrics used by the SEC, the Federal Reserve, and other commercial or investment bank regulators in the U.S. and throughout the world had not used risk scenarios based on a total meltdown of the U.S. mortgage market.

That is why, in March 2008, I formally requested that the Basel Committee address the inadequacy of the Basel capital and liquidity standards in light of this experience. The SEC immediately commenced to help lead this revision of international standards through our work with the Basel Committee on Banking Supervision, the Senior Supervisors Group, the Financial Stability Forum, and the International Organization of Securities Commissions. As of April 2010, however, that work has yet to be completed. In my view, it remains a matter of the utmost urgency, in particular for commercial bank holding companies, whose ranks now include not only such large and systemically important entities as Citigroup and Bank of America, but also the nation's largest investment banks.

The determination in early 2008 that existing supervisory metrics did not provide an adequate early warning mechanism led the SEC and the Federal Reserve to work closely together on the development of more stringent and varied measures for Lehman and the other large investment banks, including stress tests based on scenarios of much

shorter duration and that were much more severe, such as denial of access to secured as well as unsecured funding. Those more stringent scenarios assumed no access to the Fed's discount window or other liquidity facilities, although in fact such facilities were then available to the major investment banks. The SEC also worked closely with the Federal Reserve in directing this additional stress testing. Not only Lehman but all of the investment banks were urged to maintain capital and liquidity at levels far above what would be required under the standards in the SEC rules. The SEC and the Federal Reserve also directed Lehman and other investment banking firms to strengthen their balance sheets, in part by shedding or marking down illiquid assets.

As part of this scrutinizing of Lehman's secured funding activities, the SEC and the Fed encouraged the establishment of additional term funding arrangements and a reduced dependence on "open" transactions, which must be renewed as often as daily. This process also focused on the so-called matched book, a significant locus of secured funding activities within Lehman and other investment banks, to guard against potential mismatches between the "asset side," where positions were financed for customers, and the "liability side," where positions were financed by other financial institutions and investors. The SEC staff obtained expanded funding and liquidity information for Lehman on a continual basis, and monitored the amount of excess secured funding capacity for less-liquid positions. The additional stress scenarios that were developed with the Federal Reserve were layered on top of the existing scenarios as a basis for sizing more stringent liquidity pool requirements. Also, the SEC discussed with Lehman's senior management their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets. Since Lehman's management had by this time been made fully aware of their need for more capital, greater liquidity, and reduced leverage, the focus of both the SEC and Fed staff was on Lehman's working toward these objectives more deliberately and urgently. These strong messages were presented jointly by the SEC and the Fed to Lehman's management.

Beyond highlighting the inadequacy of the pre-Bear Stearns CSE program capital and liquidity requirements, the early experience during the credit crisis also highlighted the importance of closer collaboration between the SEC and the Federal Reserve to close the regulatory gap that existed for investment bank holding companies. That is because there was then (and is now) no provision in the law giving the SEC, the Fed, or any federal agency the authority to regulate investment bank holding companies -- whether by requiring them to compute capital measures, or to maintain liquidity on a consolidated basis, or to submit to limits regarding leverage. This is attributable to the failure of the Gramm-Leach-Bliley Act to give regulatory authority over investment bank holding companies to any agency of government.

Notwithstanding the lack of statutory authorization, the SEC had taken the lead in creating its voluntary program, stretching rather dramatically its authority over the broker-dealer subsidiaries of investment bank holding companies that the SEC then did regulate, to cover the entire global conglomerate. Congress also gave the SEC authority to regulate the investment companies and investment adviser subsidiaries within the investment bank holding company structure. But this still left a gaping hole in regulatory coverage. Lehman Brothers, for example, consisted of over 200 significant subsidiaries;

the SEC was not the statutory regulator for 193 of them. Among the vast portions of unregulated terrain were some of Lehman's riskiest areas -- including over-the-counter derivatives businesses, trust companies, mortgage companies, and offshore banks, broker-dealers, and reinsurance companies. Lehman was effectively outside of the regulatory jurisdiction of any individual federal department or agency. This was a fundamental flaw in the statutory scheme that had to be addressed -- but in the meantime, it was up to the SEC, the Fed, the Treasury and other regulators to improvise solutions.

To ensure close coordination between the Fed and the SEC, Chairman Bernanke and I negotiated a detailed Memorandum of Understanding aimed at better information flows between regulators, including the communication of market surveillance information, position reporting, and current economic data, so that both agencies could get a more comprehensive picture of capital flows, liquidity, and risk not only at individual firms but throughout the system. The MOU did not open up entirely new territory, but formalized and strengthened the ongoing cooperation between the SEC and the Fed. One reason the MOU was needed was that the Fed was reluctant to share supervisory information with the SEC, out of concern that banks would not be forthcoming with information if they thought it would be referred to the SEC for enforcement.

Both before and after the execution of the MOU, the SEC and the Fed worked closely together in addressing many aspects of the crisis. Chairman Bernanke and I endeavored to set that tone through the MOU and through our own regular consultations. And while staff level cooperation was not always perfect, each agency shared its expertise and the effort was improved because of it. SEC and Fed staff worked together inside Lehman and saw the same information. SEC staff were of course more expert in the securities industry, and Fed staff were more expert in banking supervision, and safety and soundness regulation. Because of the Fed's need for this complementary expertise, both the New York Fed and the Federal Reserve Board in Washington sought to hire SEC staff as they took on responsibility for investment bank oversight; at one point, in order to tamp down these recruitment efforts, the SEC negotiated a "no-poaching" agreement with the New York Fed. That agreement was subsequently abandoned at the request of the New York Fed, and the Fed did hire key SEC personnel. Such cross-pollination, while temporarily disruptive to the agency whose employees are recruited away, will undoubtedly improve regulatory quality and SEC-Fed cooperation in the long run.

Lehman's failure to raise sufficient capital and improve its liquidity pool during this period was not the result of government insistence and direction that it do so, but rather its inability to follow those joint SEC-Fed directives to meet established financial objectives in the face of rapidly deteriorating market conditions. In June 2008, Lehman did raise approximately $6 billion in capital. And throughout the summer, it took steps to improve its liquidity. But the deepening subprime crisis -- including the July 11, 2008 FDIC receivership of Indymac Bank, the fourth-largest bank failure in United States history, and the September 7, 2008 announcement by the Treasury and the Federal Housing Finance Agency of the federal government's conservatorship for Fannie Mae and Freddie Mac -- only worsened the conditions in which Lehman was operating.

The SEC joined the Federal Reserve and the Treasury over the weekend of September 12-14, 2008, in a final collaborative effort to save Lehman Brothers. Treasury Secretary Paulson, New York Fed President Geithner, and I met with the chief executives of financial institutions at the New York Fed headquarters. The board's decision to file for Chapter 11 bankruptcy that weekend, while setting in train a series of negative reactions and market impacts, immediately clarified the responsibilities of the SEC and other departments and agencies of government, restoring each to its accustomed role. With regulatory improvisation at that point brought to an end, the SEC immediately set to work assisting with and overseeing the sale of the significant assets of Lehman Brothers, Inc., prioritizing the protection of Lehman's brokerage customers and ensuring that the hundreds of thousands of Lehman's customer accounts had access to their cash and securities.

As this Committee infers lessons from the regulators' experiences surrounding the bankruptcy of Lehman Brothers, it is important to focus on the dramatic departure from the statutory norms that the events of 2008 represented. Prior to the Federal Reserve's unprecedented decision to provide funding for the acquisition of Bear Stearns, neither the Fed, the SEC, nor any agency had as its mission the protection of the viability or profitability of a particular investment bank holding company. Indeed, it has been a fact of life in Wall Street's history that investment banks can and will fail. Wall Street is littered with the names of distinguished institutions — E.F. Hutton, Drexel Burnham Lambert, Kidder Peabody, Salomon Brothers, Bankers Trust, to name just a few — which placed big bets and lost, and as a result ended up either in bankruptcy or being sold to save themselves. Not only is it not a traditional mission of the SEC to regulate the safety and soundness of diversified financial conglomerates whose activities range far beyond the securities realm, but Congress has given this mission to no agency of government. In the future, the roles and the powers of regulators must be clearly defined, their responsibility to intervene to save specific institutions or to let them fail must be clearly delineated, and regulatory gaps such as those that existed for investment bank holding companies must be closed. Neither the SEC

nor the Federal Reserve learned that Lehman used Repo 105 transactions to artificially reduce its apparent leverage, as described in the Examiner's report.

Much speculation has focused on whether the government's extraordinary financial interventions, beginning with the relatively smaller Bear Stearns and ultimately extending to such enormous firms as Citigroup, Bank of America, and AIG, were on balance ameliorative or disruptive. And in the case of Lehman Brothers, the question has often been asked whether there was a legally available option to save the firm. The discrepancy between the rescue of the smaller Bear Stearns, avowedly on systemic grounds, and the abandonment of Lehman Brothers to bankruptcy is usually raised in this connection. In attempting to answer such questions, it is important to bear in mind that the impact from a regulatory action or inaction can have unintended consequences.

Many analysts have wondered why, following the collapse of Bear Stearns and the alarms that set off for every investment bank, Lehman's management did not agree to sell the firm at a lower price, or take other actions to save Lehman earlier during 2008. One possible reason is that Lehman -- inspired by the fact that the much smaller Bear Stearns had been rescued on the grounds of its systemic significance -- was expecting that the federal government would financially participate in any such transaction. As late as the weekend of September 12-14, 2008, when Treasury Secretary Paulson, New York Fed President Geithner, and I met with the chief executives of financial institutions concerning Lehman, the attendees at that meeting themselves appeared uncertain, at least initially, whether the announcement that there would be no federal help for Lehman was ironclad or negotiable.

Likewise, the U.K. government's unwillingness to support a Barclays-Lehman deal may have been influenced by the lack of such U.S. government participation. These expectations may well have been created by the earlier public announcement that Bear Stearns was too systemically important and interconnected to be allowed to fail. Not unreasonably, this could be taken to

establish the proposition that larger investment banks would also be deemed too systemically important and interconnected to fail. Individuals and firms may have behaved differently if they had not been expecting the government to intervene.

For legislators, the lesson is that clarity and consistency in policy making are often as important as the rules themselves. Individuals and firms can best order their affairs if they know what rules will apply. The lack of such clarity may have contributed to the demise of Lehman in September 2008.

A final lesson from the Lehman experience is that statutory reform is necessary to close the regulatory gap that the SEC and the Fed attempted to fill through an ongoing, ad hoc collaboration. In this connection, current SEC Chairman Mary Schapiro has endorsed an Oversight Council that would be responsible for identifying risk across the system. Among her reasons for favoring this approach are that multiple sets of eyes would ensure that different perspectives are brought to bear on systemic risk analysis, that the inclusion of multiple agencies will reduce conflicts of interest, and that tapping the expertise of several regulators will ensure a higher level of sophistication in evaluating risks posed by different kinds of institutions. These are all sound reasons for favoring such an approach. But as the Lehman experience has shown, the mere existence of a collaborative forum will not necessarily produce a high level of information sharing, without more. Clear lines of authority and responsibility, drawn in statute, will be important, as will clear mandates for deeper inter-regulatory collaboration and timely access to information.

Throughout the worst of the financial crisis to the present day, the professional staff of the SEC has steadfastly worked for the protection of investors. At the same time, the agency has consistently used its regulatory powers in support of other agencies and regulators, including the Federal Reserve and the Treasury, whose missions have led them to act in extraordinary ways that have (one hopes temporarily) blurred the distinction between what is government and what is private. I am pleased that the legislative proposals you are now considering will serve to strengthen the SEC in its fundamental mission of investor protection. If we take care to heed the lessons learned in the recent financial crisis, I am confident that the financial regulatory system of the future will provide a bulwark for investor confidence and a more transparent and flexible set of authorities for the federal government to help restore and sustain American prosperity.

Thank you for the opportunity to discuss the experience of the SEC in the Lehman crisis, and the lessons it holds for fundamental regulatory reform in the future.

Financial Accounting Standards Board
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ROBERT H. HERZ
Chairman

April 19, 2010

The Honorable Barney Frank, Chairman
The Honorable Spencer T. Bachus III, Ranking Minority Member
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Re: Discussion of Selected Accounting Guidance Relevant to Lehman Accounting Practices

Dear Chairman Frank and Ranking Minority Member Bachus:

Thank you for the opportunity to submit an explanation of the accounting standards and relevant guidance relating to repurchase agreements for your April 20, 2010 hearing "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner." In order to focus my response on the most relevant financial accounting guidance, I have referred to certain matters discussed in the report of the Lehman Bankruptcy Examiner.[1] Additionally, I have also provided a brief discussion of the relevant accounting guidance relating to consolidation of special-purpose entities, which I believe may be helpful to the Members of the Committee as they deliberate the public policy issues relating to Lehman's bankruptcy.

The FASB does not have regulatory or enforcement powers. However, whenever there are reports of significant accounting or financial reporting issues, we monitor developments closely to assess whether standard-setting actions by us may be needed. In some cases, a misreporting is due to outright fraud and/or violation of our standards, in which case accounting standard-setting action is not necessarily the remedy. Other cases reveal weaknesses in current standards or inappropriate structuring to circumvent the standards, in which case revision of the standards may be appropriate. In some cases, there are elements of both.

At this point in time, while we have read the report of the Lehman Bankruptcy Examiner, press accounts, and other reports, we do not have sufficient information to assess whether Lehman complied with or violated particular standards relating to accounting for repurchase agreements or consolidation of special-purpose entities. Furthermore, we do not know whether other major financial institutions may have engaged in accounting and reporting practices similar to those apparently employed by Lehman.

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[1] Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010.

In that regard, we work closely with the SEC. We understand that the SEC staff is in the process of obtaining information directly from a number of financial institutions relating to their practices in these areas. As they obtain and evaluate that information, we will continue to work closely with them to discuss and consider whether any standard-setting actions by us may be warranted.

However, in the meantime, this letter and its attachments summarize the current accounting and reporting standards relating to repurchase agreements and consolidation of special-purpose entities, including some of the recent changes the FASB has put in place.

Accounting and Reporting Standards for Repurchase Agreements

In a typical repurchase (repo) transaction, a bank transfers securities to a counterparty in exchange for cash with a simultaneous agreement for the counterparty to return the same or equivalent securities for a fixed price at a later date, usually a few days or weeks. Accounting standards prescribe when a company can and cannot recognize a sale of a financial asset based on whether it has surrendered control over the asset. In this context, two of the criteria key in determining whether a sale has occurred are:

(a) The transferred financial assets must be *legally isolated* from the company that transferred the assets. In other words, Lehman or its creditors would not be able to reclaim the transferred securities during the term of the repo, even in the event of Lehman's bankruptcy.[2]
(b) The company that transferred the assets does not maintain *effective control* over those assets. Specific tests relate to whether the company has maintained effective control, which are described below.

If both of these criteria are met (among other criteria), the repo would be accounted for as a sale. If either of these criteria is not met, the repo would be accounted for as a secured borrowing. As a general matter, most standard repo transactions fail one or both of these criteria and, therefore, are accounted for as financings.

In the case of repos, one of the relevant tests for assessing effective control relates to the amount of cash collateral that has been provided, relative to the value of the securities transferred. The rationale behind this condition is that the counterparty has promised to return the securities, but even if it defaults, the arrangement provides for sufficient cash collateral at all times, so that the company could buy replacement securities in the market.

My understanding of Lehman's Repo 105 and 108 transactions is based on what I have read in the Examiner's report, press accounts, and other reports. Lehman apparently engaged in

[2] The Audit Issues Task Force Working Group of the AICPA issued an Auditing Interpretation, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 140," to assist auditors in their analysis. I have separately provided a copy to the Committee staff.

structured transactions, known within Lehman as "Repo 105" and "Repo 108" transactions, to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days. Lehman reported its Repo 105 and Repo 108 transfers as sales rather than secured borrowings. The cash received in the transfers was used to pay down liabilities.

Lehman reported its Repo 105 and Repo 108 transactions as sales rather than secured borrowings, apparently by attempting to structure the transactions so as to try to support the following conclusions:

(a) That the transferred securities had been legally isolated from Lehman (based on a true sale opinion from a U.K. law firm), and
(b) That the collateralization in the transactions did not provide Lehman with effective control over the transferred securities.

Based on the Examiner's report, Lehman's Repo 105 and Repo 108 transactions were structurally similar to ordinary repo transactions. The transactions were conducted with the same collateral and with substantially the same counterparties.[3]

Additionally, the following two points may be relevant to the analysis of Lehman's accounting for Repo 105 and Repo 108 transactions.

First, the assessment of legal isolation may have only considered whether the securities were isolated from a U.K. subsidiary, as opposed to the consolidated U.S. entity. We understand that, at least in some cases, the securities were first transferred from a U.S.-based entity to a U.K. subsidiary, and were then repoed with a counterparty in the U.K. Attorneys have told us that there are significant legal differences in how repo transactions are viewed in the event of the insolvency of a repo seller under U.S. and English laws. In the United States, case law related to repurchase transactions has been varied enough that most attorneys generally would not provide a true sale opinion. In England, there is apparently significantly less uncertainty about how a transfer related to a repo would be viewed by a court of law in the event of the insolvency of the repo seller (transferor). Under English law, a transfer in which the documents clearly demonstrate a seller intends to transfer outright to the buyer his entire proprietary interest in an asset apparently would be considered a true sale.

We understand that the opinion prepared by the English law firm may have limited applicability and pertains only to the portion of the transaction executed by the U.K. subsidiary with the repo counterparty. It is not clear that claims could not be pressed in another jurisdiction such as the U.S., since the securities were registered in the U.S. and it is not clear whether the transfer from Lehman to its U.K. subsidiary would be deemed to be a true sale under U.S. law. It is also not clear that the transfers would have resulted in isolation (including in bankruptcy) of the transferred assets from the consolidated Lehman entity, not

[3] Report of Anton R. Valukas, Examiner, United States Bankruptcy Court Southern District of New York, In re Lehman Brothers Holdings Inc., et al., Debtors, March 11, 2010, v3, pg. 746.

just the U.K. subsidiary, and thus any legal analysis would likely need to address all relevant jurisdictions including U.K. and U.S. law.

Second, with respect to the level of collateralization in the arrangement, Lehman apparently took a discount on the face value of the transferred assets (known as a "haircut") offered to the counterparty. Instead of transferring approximately $100 worth of securities for every $100 of cash received, Lehman transferred $105 worth of debt securities or $108 of equity securities for every $100 in cash received (hence, the names Repo 105 and Repo 108). It appears that Lehman structured the transactions in an attempt to support a conclusion that there was inadequate cash collateral to ensure the repurchase of the securities in the event of a default by the counterparty, and, on that basis, Lehman determined that sale accounting was appropriate. Under sale accounting, Lehman

(a) Removed the transferred securities from its balance sheet,
(b) Recognized the cash received, and
(c) Recognized the difference ($105 or $108 securities derecognized less $100 cash received) as a forward purchase commitment.

When developing the guidance for determining whether a company maintains effective control over transferred assets, the FASB noted that repo transactions have attributes of both sales and secured borrowings. On one hand, having a forward purchase contract—a right and obligation to buy an asset—is not the same as owning the asset. On the other hand, the contemporaneous transfer and repurchase commitment entered into in a repo transaction raises questions about whether control actually has been relinquished. To differentiate between the two, the FASB developed criteria for determining whether a company maintains effective control over securities transferred in a repo transaction.

As noted above, one of those criteria requires a company to obtain adequate cash or collateral during the contract term to be able to purchase replacement securities from others if the counterparty defaults on its obligation to return the transferred securities ("collateral maintenance requirement"). The accounting guidance provides the following example of a collateral maintenance requirement that does maintain effective control:

> Arrangements to repurchase securities typically with as much as 98–102% collateralization, valued daily and adjusted up or down frequently for changes in market prices, and with clear powers to use that collateral quickly in the event of the counterparty's default, typically fall clearly within that guideline.

The accounting guidance emphasizes the need for understanding the terms of a repo agreement and applying judgment in other situations to determine whether a company maintains effective control over the transferred securities. That example was not intended to, nor does it, create a "bright-line" for making that determination. Rather, the example describes typical collateral arrangements in repurchase agreements involving marketable securities indicating that these typical arrangements clearly result in the transferor maintaining effective control over the transferred securities.

The accounting guidance for repos has been in place since 1997 and has not been changed significantly over the years.

When there are material structured or unusual transactions, disclosure is also very important. The Examiner's report indicates that Lehman's disclosure was incorrect and misleading. According to the Examiner's report, Lehman disclosed that it accounted for all repos as secured borrowings.

Accounting and Reporting Standards for Consolidation of Special-Purpose Entities

A recent press account indicates that Lehman used a small company run by former Lehman employees apparently to shift investments off its books.[4] Based on that press account, it is not possible to determine whether that company was an operating business or a special-purpose entity (SPE). Although the press account does not describe whether and how the presence of related parties may have affected Lehman's consolidation analysis, consolidation accounting standards require consideration of related parties and de-facto agents in the consolidation analysis. In addition, accounting standards require companies to disclose significant related party transactions and de-facto agent arrangements.

The financial crisis revealed that accounting standards governing which entity must recognize and report interests in SPEs were inadequate to protect against "surprise" risks to institutions that had treated these entities as "off balance sheet." Before the recent changes to the accounting standards on consolidation described below, certain entities were exempt from consolidation requirements. Those exemptions assumed that some SPEs (including mortgage trusts) could function on "autopilot," in which no entity was deemed to be in control of such SPEs. This assumption has not been borne out in the recent period of severe stress in the mortgage market. Consolidation requirements before the recent changes had a simple concept that a company should consolidate an SPE if it has the majority of risks and/or rewards of that entity. However, the implementation of this concept was effected through complex mathematical calculations that often excluded the effect of key risks such as liquidity risk. With the benefit of hindsight, it seems that judgments were made based on overly optimistic forecasts of returns and risk, enabling companies to avoid consolidating entities in which they retained significant continuing risks and obligations. While there were numerous required disclosures under generally accepted accounting principles and SEC rules, many financial companies failed to clearly disclose retained risks, obligations, and involvements with SPEs.

Also, with the benefit of hindsight, it appears that arrangements were structured to achieve the desired outcomes of removing financial assets and obligations from balance sheets and reporting lower ongoing risk and leverage. From an investor's viewpoint, this obfuscated important risks and obligations.

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[4] Article in New York Times on April 13, 2010, titled *Lehman Channeled Risks Through "Alter Ego" Firm.*

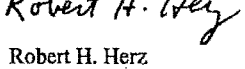
To address this, the FASB, at the request of the SEC, completed targeted projects that resulted in removing the exemption for certain entities from consolidation requirements (FAS 166 on transfer of financial assets) and in tightening the requirements governing when such entities should be consolidated (FAS 167 on consolidation of variable interest entities). In addition, the FASB enhanced disclosure requirements to improve disclosure of a company's involvements with transferred financial assets and SPEs. FAS 166 and 167 were issued in June 2009 and became effective in January 2010.[5] The enhanced disclosure requirements became effective in December 2008.

Under FAS 167, entities with the power to control key decisions and the exposure to risks and rewards will more likely report the assets and liabilities on their financial statements. FAS 167 requires an entity to provide enhanced disclosures about its continuing involvement with an SPE, regardless of whether that SPE is on- or off-balance sheet. Along with disclosures about the judgments used in assessing control and evaluating ongoing returns and risk, the revised accounting will put investors in a better position to determine who will ultimately bear the losses and reap the rewards of SPEs.

We are currently working with the International Accounting Standards Board (IASB), which promulgates International Financial Reporting Standards that are used in a number of other jurisdictions, to develop a joint standard on derecognition of financial assets, and the accounting for repurchase agreements is being considered. We are also working with the IASB to develop a joint standard relating to consolidation policy that would apply to traditional operating entities as well as SPEs. We stand ready to consider any further standard-setting actions that may be necessary.

Thank you for the opportunity to provide information on these important issues. FASB members and members of our technical staff would be pleased to respond to further inquiries or to discuss these matters further with you and your staff.

Sincerely,



Robert H. Herz
Chairman

[5] I have separately provided a copy to the Committee staff.

Testimony by Henry M. Paulson, Jr.
Before the House Committee on
Financial Services
April 20, 2010

Chairman Frank, Ranking Member Bachus, and distinguished Members of the Committee, thank you for inviting me to provide written testimony to the Committee in connection with today's hearing on "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner."

I was Secretary of the Treasury in 2008 when our nation suffered one of the most profound economic crises in history. No analysis of the crisis, no review of the government's response, and no planning for future financial reform can omit a study of one of the most significant events of that crisis—the failure of Lehman Brothers. That pivotal event highlighted the problems that plagued our financial system, demonstrated the inadequacies of our regulatory structure, and pointed the way to long term financial reform. This Committee's study of the public policy issues raised by the events surrounding Lehman's failure is, therefore, quite important and should substantially aid reform efforts.

The details of Lehman's collapse have been set forth at length in several places, including the bankruptcy examiner's report, and I will not attempt to repeat them here. Instead, I will set forth the difficulties that Treasury faced in dealing with Lehman's failure, and the policy lessons I think we learned from those circumstances. I hope this perspective will assist the Committee's examination.

* * *

As Bear Stearns faced collapse in March of 2008, I and others in government discovered what little authority the federal government had to prevent the failure of a non-FDIC insured bank or to limit the effect of such a failure on the broader financial system. Indeed, if J.P. Morgan had not been willing to enter into an agreement to buy Bear Stearns with the assistance of the Federal Reserve and to guarantee Bear Stearn's trading book pending the shareholder vote, the firm would have failed. Realizing this, we immediately began to worry about the other investment banks, over which our authorities were similarly limited. I focused particular attention on Lehman, as the markets were losing confidence that Lehman had enough capital and liquidity to manage potentially significant embedded losses. The possibility of a Lehman failure especially concerned me because I knew it would have significant negative systemic consequences given how deeply interconnected the firm was with various other parts of our financial system. Among other things, Lehman's derivative contracts, secured funding, and triparty repo transactions touched numerous financial institutions across the country and around the globe. As we examined the potential problem presented by Lehman, however, we again realized just how limited our options were.

One option—an option I exercised early on—was to encourage Lehman to take preemptive action on its own to stave off collapse. Specifically, I strongly encouraged

the firm's management to raise capital and increase its liquidity positions. In response, Lehman raised approximately $6 billion in new capital in the second quarter. As the situation deteriorated further, I also encouraged Lehman to seek a buyer or strategic partner. Lehman pursued this option as well and approached numerous financial firms and other investors about a potential acquisition or equity investment. None of these efforts were ultimately successful.

In addition to encouraging Lehman to take action on its own, I had my staff at Treasury—along with personnel from the Federal Reserve and SEC—evaluate our legal options for preventing, or mitigating the fallout from, a possible failure. The result of this analysis was disheartening. There were some limited powers that could be brought to bear in the event of the failure of a non-bank institution like Lehman. For example, the SEC might be able to ring-fence certain broker-dealer transactions to ensure that collateral was returned to customers, and the Fed might be able to take over certain triparty repo obligations. But, on the whole, there were significant shortcomings in our regulatory authorities. We had no ability to wind-down Lehman because it was not a bank. We had no sure mechanism for resolving Lehman's outstanding derivative contracts. And we had no authority to inject capital into the institution and thus had no way to resolve its balance sheet problems without a buyer. In short, the only mechanism for handling failure was the bankruptcy system, a process that was designed to resolve creditor claims, not reduce systemic risk, and was therefore inadequate to address all our concerns.

Ultimately, the only possibility for averting Lehman's collapse was to try to find a buyer. To increase the likelihood of doing so, we tried to affect a private industry-based solution to finance enough of the bad assets on Lehman's books to make an acquisition of the firm a possibility. In the days before Lehman's collapse, members of the government and private sector aggressively pursued this potential solution, but, in the end, were simply not able to arrive at a resolution that would prevent the firm's failure. On September 15, 2008, Lehman filed for Chapter 11 bankruptcy, and many of the consequences we had feared began to unfold.

* * *

The difficulties we faced in trying to protect the financial system from the result of a Lehman failure underscore the reforms that our financial regulatory system badly needs. In my view the Lehman failure highlighted three particular types of reform that are critical.

First, capital and liquidity requirements for financial institutions must be increased to reduce the chances of financial institutions operating with the high leverage and low liquidity that we saw at Lehman and others. Of these two requirements, I think it is now generally understood that financial firms need more capital than they have held historically. Less well understood, but in my view more important, is the need for bigger liquidity cushions for those institutions which are more dependent on short term credit, which, as we have seen, can be quite unstable. There is no easy way to set these liquidity

thresholds—they will vary institution by institution depending on the nature of their business and their liquidity demands under adverse conditions—but it is critical that regulators set them sufficiently high.

Second, we need a government regulator with responsibility for evaluating systemic risk. With access to all necessary information to monitor the markets, this regulator would have a better chance of identifying and limiting the impact of future speculative bubbles. Such a regulator would have the authority to design and implement appropriate systemic risk metrics, monitor the stability of the markets, and restrain activity at any financial firm that threatens the system. This authority is critical to reducing the chances of having an institution that is interconnected with the financial system to an extent that it cannot fail without harming the greater economy.

Third, no regulator can foresee all areas of potential systemic risk, and consequently the government must have the authority to wind-down, and eventually liquidate, nonbank financial institutions in a manner that prevents harm to the system as a whole. We sorely felt the need for this authority at the time of Lehman's failure, and, had we had it, I think the situation would have ended quite differently. This authority should include a number of tools, including the ability to provide emergency loans to enable an orderly liquidation. In addition, to facilitate these wind-downs all large firms should be required to develop a road map for their liquidation well ahead of any failure. These wind-down powers will ensure that future administrations do not find themselves hampered by the constraints we faced in 2008. Moreover, the existence of such authority will address the concerns of "moral hazard," by sending a clear signal to market participants that the government will not bail out failing firms—it will liquidate them.

* * *

My time in government convinced me that reform is difficult unless prompted by a crisis. As it turns out, even a crisis does not make the path to reform simple. We must not lose our sense of urgency to make the necessary reforms to ensure our long-term prosperity. I look forward to seeing this Committee's work move us along the road to such reform.

Exhibit #11

MEMORANDUM OF UNDERSTANDING
BETWEEN
THE U.S. SECURITIES AND EXCHANGE COMMISSION
AND
THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
REGARDING
COORDINATION AND INFORMATION SHARING IN AREAS OF COMMON REGULATORY AND SUPERVISORY INTEREST

The mission of the Commission is to protect investors, maintain fair, orderly, and efficient securities markets, and facilitate capital formation. The mission of the Board is to, among other things, conduct monetary policy, protect the safety and soundness of banking organizations, and

The MOU between the Board and Commission reflects the Board's and the Commission's intent to collaborate, cooperate and share information in areas of common regulatory and supervisory interest to facilitate their oversight of financial services firms.

state member banks and their subsidiaries, bank holding companies and their subsidiaries, financial holding companies and their subsidiaries, foreign banking organizations with U.S. banking operations, Edge Corporations, and Agreement Corporations. The Commission has regulatory and supervisory responsibility over securities companies, including securities broker-

C. Coordination Regarding Capital, Liquidity and Funding

17. The Commission and Federal Reserve will collaborate and cooperate with each other in—

a. Obtaining (including through visitations, reports and other means), analyzing and evaluating information regarding the capital, liquidity and funding position and resources, and associated risk management systems and controls, of CSEs and Primary Dealers;

"Agreement Corporation" shall mean a corporation that is chartered by a state to engage in international banking operations and that has an agreement or undertaking with the Board under section 25 of the Federal Reserve Act.

markets, that may materially affect the operations or financial condition of the CSEs and ANCHCs.

13. As the primary supervisor of ANCHCs, the Federal Reserve will provide the Commission, on an ongoing basis to the extent requested, information and analysis about the financial condition, risk management systems, internal controls and capital, liquidity and funding resources of the ANCHCs that affect the company's broker or dealer subsidiaries or the compliance by such subsidiaries with the conditions of eligibility to compute net capital under the alternative method in Appendix E of the Net Capital Rule.

B. Coordination Regarding Primary Dealers and Their Holding Companies

systems, internal controls, and capital, liquidity and funding resources of any Primary Dealer Bank Holding Company that affects the Primary Dealer.

6. Setting supervisory and regulatory expectations, guidelines or rules concerning the capital, liquidity and funding position and resources, and associated risk management systems and controls, of CSEs and Primary Dealers, and such expectations, guidelines or rules of application generally to broker-dealers when the principal parties affected are Primary Dealers; and

Exhibit #7

From: McDade, Bart [bmcdade@lehman.com]
Sent: Thursday, April 3, 2008 10:18 AM (GMT)
To: Lee, Hyung S [hyung.lee@lehman.com]
Subject: Re: Repo 105

I am very aware...it is another drug we r on

----- Original Message -----
From: Lee, Hyung S
To: McDade, Bart
Sent: Wed Apr 02 23:49:55 2008
Subject: RE: Repo 105

Bart,
Not sure you are familiar with Repo 105 but it is used to reduce net balance sheet in our governments businesses around the world. If for example UBS does not roll their repo 105, then Asia would go up 20bn in net balance sheet in quarter end

Bart,
Not sure you are familiar with Repo 105 but it is used to reduce net balance sheet in our governments businesses around the world.

business dramatically given their problems. This could force the whole street to deleverage their cash positions around the world. I spoke to Thomas to make sure we got in front of this, not sure what our global considerations would be.
Regards
Hyung

I am very aware...it is another drug we r on

FOIA CONFIDENTIAL TREATMENT REQUESTED BY
LEHMAN BROTHERS HOLDINGS, INC.

QFR from Congressman McHenry

Q: **There was an editorial in the Wall Street Journal this morning titled "The SEC's Impeccable Timing" on how the Goldman suit helped to hide the IG report on the Stanford debacle.**

Ms. Shapiro, as this editorial points out, the IG report is downright damning for an SEC that wants the public to believe that it has turned a corner after the Bernie Madoff disaster. We now know that at almost every turn the SEC staff failed to act on Stanford.

Recently, I was contacted by constituents in my district who were Stanford CD holders. They were sold the CD's by Stanford Group Company, a FINRA member broker, and they are seeking an extension of SIPC coverage for the losses they suffered. I understand you recently met with a group from the Stanford Victims Coalition. What was is your response to these defrauded investors?

A: I can assure you that we are taking the situation of the Stanford Victims Coalition ("SVC") members, and all other Stanford victims, very seriously, and are investigating closely their status under SIPA. In particular, Commission staff is completing its study of all the facts relating to the Stanford case with respect to whether SIPA would authorize a liquidation of SGC. As part of this review, Commission staff has met with representatives of the SVC and other Stanford victims to discuss this matter and has requested any additional information from the SVC that may be relevant to their SIPA status. I expect that the Commission will act to make a final decision on whether SIPC should initiate a SIPA proceeding once all the facts available in this matter have been received and thoroughly reviewed.

○