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Paul Friedman

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**Testimony of Paul Friedman
Before the Financial Crisis Inquiry Commission**

May 5, 2010

Chairman Angelides, Vice-Chairman Thomas, and Members of the Commission: Thank you for the opportunity to appear here today. My name is Paul Friedman. From 1981 to June 2008, I was an employee of Bear Stearns. During my 27 years at the firm, I worked in a variety of positions in the Fixed Income division. Among my responsibilities at Bear Stearns, I oversaw the Fixed Income Repo Desk, and had a number of other operational responsibilities within the Fixed Income division. In 1991, I became a Senior Managing Director, which was the title I held when Bear Stearns was sold to JP Morgan Chase & Co. in March 2008.

I understand that the Commission has asked me to address primarily Bear Stearns' funding strategies, and in particular its use of the commercial paper and the repurchase ("repo") markets, to finance its business between 2005 and 2008.

Bear Stearns generally financed its business by borrowing funds on a secured and unsecured basis and through the use of equity capital. During 2006, Bear Stearns decided to reduce the amount of short-term unsecured funding, primarily commercial paper, that it borrowed. The firm made this decision primarily based on its belief, which I shared, that commercial paper tended to be confidence-sensitive, and could become unavailable at a time of market stress, while secured borrowing based on high-quality collateral is generally less credit sensitive and therefore more stable.

Bear Stearns implemented this strategy in late 2006 and 2007, and succeeded in reducing its short-term unsecured financing from \$25.8 billion at the end of fiscal 2006 to \$11.6 billion at the end of fiscal 2007, and specifically reduced its commercial paper borrowing from \$20.7 billion to \$3.9 billion. That funding was replaced by secured funding, principally repo borrowing.

I believe that this shift to the use of secured financing was a sound business decision. Indeed, the repo markets had functioned rationally and smoothly for most of my 27 years in the securities industry. Reducing the firm's reliance on short-term unsecured funding sources enabled Bear Stearns to reduce its dependence on any single short-term unsecured creditor, as well as its exposure to rollover risk, which is the possibility that the firm's lenders would not renew short-term unsecured funding lines. Although Bear Stearns continued to have access to the commercial paper market, the firm chose to shift to a funding model that utilized more secured borrowing and less unsecured borrowing in order to enhance the stability of its financing.

As part of the firm's transition away from unsecured borrowing, Bear Stearns also substantially increased the average term of its secured funding during the first half of 2007. Bear Stearns was able to obtain longer term repo facilities of six months or more to finance assets such as whole loans and non-agency mortgage backed securities, and generally limit its use of short-term secured funding to finance Treasury or agency securities. By increasing the amount of its long-term secured funding, the firm believed that it could better withstand a liquidity event.

From approximately August 2007 to the beginning of 2008, however, the fixed income repo markets started experiencing instability, in which fixed income repo lenders began shortening the duration of their loans and asking all borrowers to post higher quality collateral to support those loans. Although the firm was successful in obtaining some long term fixed income repo facilities, by late 2007 many lenders, both traditional and non-traditional, were showing a diminished willingness to enter into such facilities.

During the week of March 10, 2008, Bear Stearns suffered from a run on the bank that resulted, in my view, from an unwarranted loss of confidence in the firm by certain of its customers, lenders and counterparties. In part, this loss of confidence was prompted by market rumors, which I believe were unsubstantiated and untrue, about Bear Stearns' liquidity position. Nevertheless, the loss of confidence had three related consequences: prime brokerage clients withdrew their cash and unencumbered securities at a rapid and increasing rate; repo market lenders declined to roll over or renew repo loans, even when the loans were supported by high-quality collateral such as agency securities; and counterparties to non-simultaneous settlements of foreign exchange trades refused to pay until Bear Stearns paid first. Although this loss of confidence in Bear Stearns was unwarranted given the firm's strong capital position and substantial liquidity, it resulted in a rapid flight of capital from the firm that could not be survived.

In retrospect, I do not believe that there was anything that Bear Stearns could have done differently with respect to its funding model that would have prevented this run on the bank. When Bear Stearns increased its use of secured funding beginning

in 2006, the firm did not anticipate—and, I believe, could not have reasonably anticipated—that lenders would be unwilling to lend on a short-term basis even when the loans were fully collateralized by agency securities and other high-quality assets.

In the immediate aftermath of Bear Stearns' collapse, I prematurely, and incorrectly, believed that certain steps, such as raising equity, could have been taken in late 2007 and early 2008 that might have allowed the firm to survive the liquidity crisis of March 2008. However, after witnessing the unprecedented and overwhelming market forces in the Fall of 2008 – including the bankruptcy of Lehman Brothers, the fire sales of Merrill Lynch, Washington Mutual and Wachovia, and the severe distress faced by much larger financial institutions such as Citigroup, Goldman Sachs and Morgan Stanley – it became clear to me, as it is today, that those beliefs were incorrect. Bear Stearns was the smallest of the major investment banks, and I do not believe that obtaining more long-term secured financing or making any other changes in Bear Stearns' funding strategies would have enabled the firm to overcome these unprecedented market forces or withstand the liquidity crisis that the firm experienced in March 2008.

Thank you for the opportunity to testify before you today. I would be pleased to answer the Commission's questions.