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Warren Spector

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Testimony of Warren Spector
Before the Financial Crisis Inquiry Commission

May 5, 2010

Chairman Angelides, Vice-Chairman Thomas, and Members of the Commission, my name is Warren Spector. I was the co-Chief Operating Officer and President of Bear Stearns from 2001 through August of 2007. I thank the Commission for the invitation to appear, and I hope that my testimony will assist the Commission in its efforts to better understand the causes of the financial crisis.

The Commission's task is an important one. Our country is emerging from the most severe economic crisis since the Great Depression, the causes of which are intensely complex and interrelated. Developing a deep and thorough understanding of these events is critical to the ongoing policy debate over financial reform, and I appreciate the hard work that is required of the Commission as it undertakes this daunting but crucial project.

The Commission has asked me to address several topics related to Bear Stearns, including the historical growth of particular business units at Bear Stearns, certain practices at the company in the years leading up to my departure in August 2007, and various strategic decisions made at Bear Stearns. My career at Bear Stearns spanned over two decades and I was at times throughout those 24 years involved in several of the divisions and departments within Bear Stearns that you have identified. By providing an overview of my roles and responsibilities, I hope I can shed light on each of these topics.

When I joined Bear Stearns in 1983, I worked in the mortgage area of the government bond department. At the time, Bear Stearns primarily traded mortgages backed by

the government. In 1983 and 1984, some of the very first deals were created that bundled residential single-family mortgages into pools known as collateralized mortgage obligations, or CMOs. This process involved compiling pools of mortgages, dividing them into slices or tranches, and selling pieces of those tranches to qualified investors. As a general matter, the investment community welcomed the early securitization of mortgages because it catered both to institutions seeking early cash flows, such as banks, and to institutions interested in longer, later cash flows, such as pension funds. Also during my first few years at Bear Stearns, Fannie Mae and Freddie Mac created programs to provide struggling S&Ls with guaranteed securities in exchange for the mortgages on their books. I worked on creating analytical tools to understand the prepayment characteristics of individual pools of mortgage-backed securities, and I later traded those securities.

In my opinion, the securitization of mortgages provided a real macroeconomic benefit. The fundamental role of securitization is to match those in need of capital with those who have capital to provide, and to provide a mechanism to make this matching process convenient and easy to use. As a general matter, I believe that the advent of mortgage securitization in the early 1980s and the subsequent securitization of other financial assets was beneficial to the public, as it provided a vehicle for lenders to sell off loans in exchange for the capital necessary to make additional loans.

Bear Stearns strove to differentiate itself in this area. We conducted extensive research, and provided our clients with the information and tools necessary to understand the growing mortgage market. As a result, we developed an excellent reputation in the mortgage securities industry. As the mortgage market grew, Bear Stearns' mortgage department grew

along with it and consequently became a larger share of the Fixed Income division and the firm. By the late 1980s, Bear Stearns had a much larger market share than when I joined the firm.

As a result of the mortgage department's success, I was given broader responsibility within Bear Stearns and became responsible for Fixed Income. In this capacity, I oversaw the growth of all areas within Fixed Income — including government, corporate, and high-yield bonds, derivative trading, commodities and foreign exchange — as well as the continued growth of the mortgage area.

Our goal throughout my career at Bear Stearns was to diversify our businesses across a range of different platforms. Initially, we broadened business domestically; later, we sought to expand all of Bear Stearns' business lines on a global basis. In 2001, I became co-Chief Operating Officer and President of the firm, and began to focus increasingly on major structural reorganization initiatives and firm-wide strategic objectives.

Among my areas of responsibility was Bear Stearns' asset management business. In 1995, the CEO of Bear Stearns Asset Management ("BSAM") began reporting to me. The asset management group was relatively small at that time, and primarily managed institutional assets invested in traditional equity and debt products. By the 2000s, I mainly worked with the group's CEO on the business of maintaining and building asset management as a franchise within the firm. I was involved in approving the hiring of senior managers, discussing opportunities for growth, and developing both traditional and alternative investment products.

Launching new hedge funds occurred as part of the normal course of business within the hedge fund group of BSAM, with input from the parent company's Hedge Fund Committee. The two hedge funds that collapsed in the summer of 2007 — the High Grade

Funds — were started in 2003 and 2006. They were designed and marketed as leveraged funds invested in highly rated asset-backed securities. The concept behind the creation of the funds was that asset-backed securities historically had price stability and virtually no defaults at the AAA level, so investing with leverage would likely yield consistent returns. I understood that the funds were designed to invest in investment-grade structured finance securities with an emphasis on those rated triple-A and double-A.

Although the funds reported consistently positive returns through 2006, when the investment climate changed by the Spring of 2007, the market value of the underlying securities began to decline. As a result, the High Grade Funds began to experience investor redemptions and, later, margin calls from their repo counterparties. By late Spring, the Executive Committee of Bear Stearns — of which I was a member — had been informed of and become involved in addressing the problem, including holding near-daily discussions about the funds and about how to avoid their collapse. For example, we discussed reducing the funds' exposure, and the funds were instructed to aggressively reduce their positions in order to reduce their leverage. We also seconded the head of the Mortgage Department at the broker-dealer to BSAM on a full-time basis, and we asked the head of the Fixed Income repo desk at the broker-dealer to focus on the funds' counterparties and repo agreements. And finally, the Executive Committee received an assessment of the funds and approved a certain amount of repo financing to one fund that we believed still had sufficient value to support such additional financing. In effect, Bear Stearns stepped into the shoes of certain of the fund's repo counterparties in an attempt to salvage value for the fund's investors. Ultimately, these steps to save the funds were unsuccessful. These funds were invested in asset-backed securities, many of which were linked to residential mortgages, that experienced an unprecedented decline in value.

You have also asked me to address risk management practices. Risk at Bear Stearns was managed through a system of checks and balances. Each business unit was responsible for managing its risk, and the head of each division was then responsible for managing the aggregate risk within its units. The Executive Committee approved explicit limits for all areas of the firm — at the trading book level, and also by unit and by department — which were monitored by department heads.

These limits were reviewed and monitored by the Risk Management Group, which was an independent unit that reported to the Executive Committee and met regularly with the Board's Risk Committee. This group, headed by Bear Stearns' Chief Risk Officer, served as an independent check on the business units' own risk management function. It distributed daily P&L statements that highlighted any significant gains and losses. It also provided daily written reports to senior management commenting on changes in exposure, any unusual trades, and any concentrated positions. The Risk Committee held weekly meetings, and the Risk Management Group made monthly presentations to the Executive Committee. At the weekly meetings, trading managers reported on their positions and their risk, and the risk management teams were present to verify the accuracy of these reports and to express their views. In this way, the Risk Committee and the business units served as constant checks on each other. There was an active dialogue among senior management about the firm's overall risk appetite, which we reviewed during both weekly and monthly meetings.

As a distinct legal entity with distinct fiduciary duties, Bear Stearns Asset Management had its own risk management group, which reported to the management of BSAM. Managing risk in asset management was a fundamentally different exercise from managing risk

in trading. The focus of risk management in BSAM was to monitor each portfolio's adherence to its stated guidelines.

In my opinion, Bear Stearns' risk management practices were robust and effective. During my tenure on the Executive Committee I found the Risk Management team to be highly trained and very experienced. Overall, I thought Bear Stearns was well-managed, and I was saddened and disappointed when the firm collapsed.

I appreciate this opportunity to share my views, and I look forward to your questions.