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FCIC Official Transcript of the Hearing on "Too Big to Fail": Expectations and Impact of Extraordinary Government Intervention and The Role of Systemic Risk in the Financial Crisis

Phillip Angelides

Bill Thomas

Brooksley Born

Byron Stephen Georgiou

Robert Graham

See next page for additional authors

UNITED STATES OF AMERICA

FINANCIAL CRISIS INQUIRY COMMISSION

Official Transcript

Hearing on

"Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and The Role of Systemic Risk in the Financial Crisis."

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Dirksen Senate Office Building, Room 538

Washington, D.C.

COMMISSIONERS

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Reported by: JANE W. BEACH, Hearing Reporter

PAGES 1 - 285

SESSION I: WACHOVIA CORPORATION:
SCOTT G. ALVAREZ, General Counsel
Board of Governors of the Federal Reserve System
JOHN H. CORSTON, Acting Deputy Director, Division of
Supervision and Consumer Protection,
U.S. Federal Deposit Insurance Corporation
ROBERT K. STEEL, former President and
Chief Executive Officer, Wachovia Corporation
SESSION II: LEHMAN BROTHERS
THOMAS C. BAXTER, JR., General Counsel and Executive Vice
President, Federal Reserve Bank of New York
RICHARD S. "DICK" FULD, JR., Former Chairman and
Chief Executive Officer, Lehman Brothers
HARVEY R. MILLER, Business Finance & Restructuring
Partner, Weil, Gotshal & Manges, LLP
BARRY L. ZUBROW, Chief Risk Officer,
JPMorgan Chase & Co.

P R O C E E D I N G S

(9:01 a.m.)

CHAIRMAN ANGELIDES: Good morning. I would like to call to order the meeting and hearing of the Financial Crisis Inquiry Commission. Today's hearing on "Too Big To Fail: Expectations and Impact of Extraordinary Government Intervention and The Role of Systemic Risk In The Financial Crisis."

Good morning. I am honored to welcome you as we open the last in a year-long series of public hearings held in Washington and New York examining the cause of the financial and economic crisis that has gripped our Nation.

Sadly, while the facts of this crisis may appear clearer through our rear-view mirror, the trauma is by no means behind us. Our country continues to struggle. The statistics make it clear that too many people are searching for jobs, trying to hold on to their homes, and praying they can salvage teetering businesses.

As we wind up our investigation and assemble our findings, this Commission is determined to peer behind these painful statistics and to help the American people understand how this calamity came to be.

Beginning next week, we will hear from some of the people who have been most devastated by the crisis in communities around the United States. We will hold a series of four field hearings in the home towns of some of the Commissioners to learn more about how the seeds of this crisis were sown on the ground.

The Commission will be in Bakersfield, California, on September 7th; Las Vegas on September 8th; and Miami on September 21st; and Sacramento on September 23rd.

We'll be looking at a range of issues from mortgage fraud and predatory lending practices to the struggles of community banks and the fallout of this financial collapse on neighborhoods and small businesses.

Since our first public hearing we have been on a journey together following the evidence wherever it has taken us. We have puzzled over the same questions that many Americans have asked: trying to figure out how a web of events that ensnared Wall Street came to strangle Main Street.

Today we are going to examine how a set of major financial institutions became too big to fail, and why the government decided to spend trillions of taxpayer dollars to salvage some of those institutions, and the financial system as a whole.

What we know from history is that taxpayers should feel at risk when major financial firms veer toward collapse. For decades following the Great Depression, government intervention was rare. But since the 1970s, bank bailouts have become more frequent and costlier.

What began in 1974 with Franklin National Bank grew into a longer list of bank rescues through the 1980s and '90s. First Pennsylvania Bank, Continental Illinois, First City, First Republic, MCorp, and the Bank of New England.

It now seems almost quaint that these institutions were once considered too big, or too important to fail. Today we have megabanks of a scale unimagined a generation ago. The combined assets of the five largest banks in the country tripled in size between 1998 and 2007, leaping from $2.2 trillion to $6.8 trillion.

The 10 largest banks expanded their share of assets in the banking industry from 25 percent to 55 percent between 1990 and 2005. And prior to their collapse, Fannie Mae and Freddie Mac held or guaranteed assets of approximately $5 trillion.

Time and again we have watched as financial institutions have taken on more risk, used more leverage, and chased bigger profits. When things have unraveled, taxpayers have been handed the bill and warned that they must save the Nation's financial system from perils created by the banks.

To my mind, we have been living in a kind of financial groundhog day. We vow to wake up and change course, and then we repeat what we have done before. Many people have asked this Commission whether the government during the most recent panic did the right thing to toss flotation devices to major financial firms while most of America took on water.

The real question before us is: How do we end up with only two choices? Either bail out the banks, or watch our world sink.

Many Americans believe that reckless financial institutions and greedy executives made appalling bets and came away not just unpunished but with a windfall of cheap capital that made them even more profitable. They remain justifiably angry that top executives pocketed big bonuses with taxpayer money, and they rightly worry that the largest surviving financial institutions are not just too big but now too big and too few to fail.

Over the next two days we are going to hear from witnesses who will answer questions about how and why these financial institutions were allowed to grow and take on so much risk.

We are going to explore how the financial system became increasingly interdependent and interconnected. We are going to learn more about how the government grappled with the crisis and then determined why certain banks and not others were deemed too big to fail. And we will explore whether the expectation of bailouts at taxpayer expense served to encourage greater risk-taking by the financial sector.

As we begin this hearing, let me note that the Commission staff has produced another in a series of excellent background reports located on our website: fcic.gov. The report dissects the governmental rescues of financial institutions during the decades leading up to the crisis that we are probing today.

In closing, before I turn the microphone over to Vice Chairman Bill Thomas, let me thank him for all his hard work and cooperation in what has been a very long and hard journey in service to this country.

Let me also commend Commissioners Holtz-Eakin and Commissioner Georgiou for taking the lead on this hearing.

Mr. Vice Chairman, the microphone is yours.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman. One of the things this Commission is not required to do--thank goodness--is to recommend policy measures to deal with the potential we found ourselves in in the future. Because, frankly, that on the one hand an easy job to do, and on another an almost impossible job to do. And when you bring commission together, that is almost always the seam which it rips apart.

Rather--I think wisely--Congress asked us to try to understand and explain the circumstances surrounding the crisis: what cause this particular financial crisis.

When I was younger--and I guess I have to say in the early days of television--there was a program hosted on CBS by Walter Cronkite called "You Are There." And it would go back to periods in history. And while that particular event was evolving, there would be a reporter's approach to discussing that particular period in history.

To a certain extent, that is what we are asking you folks and the other panelists, including Chairman of the Federal Reserve Ben Bernanke and Sheila Bair of the FDIC, to do in assisting us in understanding what happened. One of the real difficulties is to deal with something like too-big-to-fail and assume it is something you can define in the abstract. It is really an adjective.

And what wouldn't be of concern in a normal situation becomes one in a situation in which a series of events have occurred. It is almost an expectation. It is an action taken in anticipation of what might occur. And so you hope there are a series of nonevents which make it very difficult to prove that the decision that you made at the time was the right one. And it invites everyone to play the hindsight, Monday-morning quarterbacking game.

So it clearly is about the context in which decisions are made. And of course that is the policymaker's worst nightmare. I have often referred to the situation that Justice Potter Stewart found himself in on the Court when they were faced with defining "obscene." How do you sit down and define obscene in a series of phrases or sentences? And he gave the best answer that I think could ever be given: I know it when I see it.

Now unfortunately many of the decisions that were made which brought about the determination to intervene were behind closed doors, with some detail available to us but not nearly enough to explain to the American People what happened.

And so we are really asking you folks to do the best you can to provide us with a degree of understanding that our investigations have led us to believe, that there were a series of events that occurred that the American People would like to have a bit more knowledge about.

This isn't the first time we have investigated this idea of too big or too important or too interconnected to fail in terms of institutions, and it is not going to be the last investigation that we have. But we do have the ability to focus on two case studies: Wachovia and Lehman Brothers, as an example of decisions that were made that resulted in different outcomes.

I am also pleased to underscore the Chairman's comment about our hearings in various regions of the country. These have been all in Washington, save one that was in New York, investigational hearings; and we are now going to turn to what I think is one of our important assignments under the statute, and that is to hold so-called "field hearings," or informational, or listening hearings so that we can begin talking to those folk who really represent the last domino.

Because we have talked about a series of dominoes falling on other dominoes, and we are going to be looking at the last domino. Many of them are community banks. Many of them, people who were involved, a long-time involvement in business activities, and housing, and various financial services, who didn't have another domino to fall against; they simply fell on their numbers.

And that is the end result. The cliche is: From Wall Street to Main Street. And Main Street is where that buck stopped, where the buck was denied, and where the failure to make that buck has had such a significant impact on the American People.

So thank you, Mr. Chairman. I look forward to the questions as we continue to try to understand what people in particular contexts came to determine was the criteria for too-big-to-fail.

CHAIRMAN ANGELIDES: Thank you, Mr. Vice

Chairman.

And now, gentlemen, thank you very much. We will start our first panel. As the Vice Chairman indicated, we have two case studies we will be examining today: Wachovia, as well as Lehman. And tomorrow morning we will hear from Chairman Bernanke and Chairman Bair.

Gentlemen, I would like to ask you all now to stand and we will do what we have customarily done in these hearings, which is we will swear the witnesses. If you would please raise your right hand:

Do you solemnly swear or affirm under the penalty of perjury that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MR. ALVAREZ: I do.

MR. CORSTON: I do.

MR. STEEL: I do.

(Witnesses sworn.)

CHAIRMAN ANGELIDES: Thank you very much.

I thank each of you for your written testimony. We have asked each of you to give a up-to-five-minute oral presentation to the Commission this morning.

I am going to go from my left to my right to start off today, alphabetically, also, logical order. We are going to start with you, Mr. Alvarez. I am sure you have been here before, or in some room like this, and some building around the Capitol, but I will indicate that at one minute there is a light in front of you that will go from green to yellow with one minute to go, and then will go to red when your time is up at five minutes.

With that, Mr. Alvarez, if you would begin your testimony.

WITNESS ALVAREZ: Chairman Angelides, Vice Chairman Thomas, Members of the Commission:

I am pleased to testify about the acquisition of Wachovia Corp. by Wells Fargo in the fall of 2008. As an initial matter, it is noteworthy that the Federal Reserve was not requested to, nor did it in fact provide any assistance using its emergency lending authority under Section 13.3 of the Federal Reserve Act in connection with the acquisition of Wachovia. Nor did the FDIC provide any assistance under its extraordinary authorities.

The agencies were prepared to invoke the Systemic Risk Exception to allow the FDIC to provide extraordinary assistance if needed to reduce the potential adverse effects of Wachovia failure on the economy. However, that authority was not in fact used and Wachovia was resolved by an acquisition by Wells Fargo without any extraordinary government assistance.

To understand these decisions, it is important to understand the context. At the end of the second quarter of 2008, Wachovia was the fourth largest banking organization in the United States with assets of approximately $812 billion.

Wachovia experienced significant losses during a period of extreme financial turbulence and distress. The nation's economy was in recession, with housing prices declining and economic growth stalled. The financial system was also deteriorating quickly.

Within the four weeks leading up to the sale of Wachovia, Fannie Mae and Freddie Mac were placed into conservatorship, Lehman Brothers filed for bankruptcy, efforts by private investors to provide liquidity to AIG failed, and the Federal Reserve provided it with temporary liquidity using the Fed's emergency lending authority. And losses at a prominent money market mutual fund caused by the failure of Lehman Brothers sparked extensive withdrawals from a number of money market funds.

Then on September 25th, 2008, the FDIC seized and sold Washington Mutual Bank, the largest thrift in the United States. The day after the failure of WaMu, Wachovia Bank experienced significant withdrawals of funds by depositors and wholesale providers of funds.

It appeared likely that Wachovia would soon become unable to support its operations. On September 27 and 28, both Citigroup and Wells Fargo began due diligence reviews of Wachovia and indicated to federal regulators that government assistance would be needed in connection with each of their proposed bids to acquire Wachovia.

The Federal Deposit Insurance Act includes a Systemic Risk Exception that allows the FDIC to provide extraordinary assistance in the resolution of a bank if the Treasury Secretary, in consultation with the President, and with the recommendation of both the FDIC and the Federal Reserve Board determines that the assistance would avoid or mitigate adverse effects on economic conditions or financial stability.

The Federal Reserve was concerned about the systemic complications of the failure of the fourth largest bank in the United States during this fragile economic period. Markets were already under considerable strain after the events involving the GSEs, Lehman, AIG, and WaMu. The failure of Wachovia, an organization that was considered to be well capitalized, could lead investors to doubt the financial strength of other organizations that were seen as similarly situated.

Losses on debt issued by Wachovia could lead creditors to stop funding other banking firms and cause more money market mutual funds to break the buck, accelerating runs on these and other money funds.

This could lead short-term funding markets that were already under extreme pressure in the fall of 2008 to virtually shut down. Business and household confidence would be undermined by the worsening financial market turmoil, and banking organizations would be less willing to lend. These effects could contribute to materially weaker economic performance and higher unemployment.

For these reasons, on September 28th the Board unanimously recommended that the FDIC be permitted top invoke the Systemic Risk Exception in order to assist in the resolution of Wachovia that would avert serious adverse effects on economic conditions and financial stability.

First Citigroup and then Wells Fargo bid for Wachovia, and after a series of actions described in detail in my written testimony Wells Fargo ultimately acquired Wachovia in a transaction that did not require use of the System Risk Exception.

To better prevent and prepare for situations like this, the Federal Reserve has already adopted a multi-disciplinary approach that makes better use of our broad expertise in economics, financial markets, payment systems, and bank supervision so that the Federal Reserve can understand linkages among firms and markets that have the potential to undermine the stability of the financial system.

We are also augmenting our traditional supervisory approach that focuses on firm-by-firm examination with greater methods that better identify common sources of risk, and best practices for managing those risks. And we have developed an enhanced quantitative surveillance program for large bank holding companies that will use data analysis and formal modeling to help identify vulnerabilities at both firm level and for the financial sector as a whole.

We are also working actively to implement the provisions of the Dodd-Frank Act which addressed a number of gaps in the statutory framework for supervision. In particular, we are developing enhanced capital risk management, liquidity, and other requirements that would be applicable to large systemically important financial organizations, as well as developing resolution plans and other plans under the Act.

CHAIRMAN ANGELIDES: Can you wrap up, please, Mr. Alvarez.

WITNESS ALVAREZ: I appreciate the opportunity to describe these events and the Federal Reserve's role, and I welcome your questions.

CHAIRMAN ANGELIDES: Thank you very much, Mr. Alvarez.

WITNESS ALVAREZ: Thank you.

CHAIRMAN ANGELIDES: Mr. Corston.

WITNESS CORSTON: Thank you very much, and good morning. I appreciate the chance to be here.

Chairman Angelides, Vice Chairman Thomas, Commissioners: I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation to discuss the challenges faced by regulators in resolving large, complex financial institutions prior to the passage of the Dodd-Frank Act, and the collapse and sale of Wachovia, and the measures taken to improve the FDIC's supervision and resolution processes.

Before I begin my formal remarks, allow me to briefly introduce myself and my roles and responsibilities at the FDIC.

I am John Corston, Acting Deputy Director of the Division of Supervision and Consumer Protections, Complex Financial Institutions Branch. Part of my duties are to oversee the large insured depository institution program. This program provides forward-looking assessments of insured depository institutions over $10 billion in assets.

The FDIC's statutory authority to resolve depository institutions is governed by the FDIC Improvement Act of 1991, known as FDICIA, which requires the FDIC to use the least-costly resolution method, and to minimize expenditures from the Depository Insurance Fund.

The least-cost test involves a cost analysis of possible resolution alternatives based on the best available information at the time. FDICIA includes an exemption to the least-cost requirement for certain extraordinary circumstances under the System Risk Exception that was described by Mr. Alvarez.

In the case of Wachovia, severe time constraints and limited available information significantly limited the ability of the FDIC to develop resolution options.

The FDIC felt that a rapid failure of Wachovia could have resulted in losses for debtholders and counterparties, intensified liquidity pressures on other U.S. banks, and created significant adverse effects on economic conditions and the financial markets globally that was already experiencing severe market instability due to a succession of crises of large institutions.

These factors led to an unprecedented decision to use the System Risk Exception. Following the Lehman bankruptcy in early September in 2008, Wachovia experienced significant deposit outflows. Liquidity pressures on Wachovia increased over the evening of September 25th when two regular Wachovia counterparties declined to lend to the firm.

As of the morning of Friday, September 26th, Wachovia, the primary federal regulatory, the Office of the

Comptroller of the Currency, indicated to the FDIC that the institution's liquidity position remained manageable. However, by the end of the day Wachovia's situation worsened and it faced a near-term liquidity crisis.

This set into motion a highly accelerated effort to find and acquire for an institution that would provide protection of depositors and minimize damage to the wider financial system.

As noted earlier, severe time constraints, limited available information, and complexity and size of Wachovia led to government's approval of the System Risk Exception and the acquisition of Wachovia by Citigroup with government assistance. In the end, however, the Citigroup transaction was superseded by a bid by Wells Fargo to acquire Wachovia without government assistance.

While some have tried to draw parallels between Wachovia and Washington Mutual, these situations were very different. Having the ability to analyze the financial condition of stressed institutions, critical in developing strategies, in the case of Washington Mutual, the FDIC had adequate time to develop strategies and understand the risks associated with those strategies. In the case of Wachovia, the FDIC wasn't informed until the weekend before its collapse and, as a result, had very limited information that could be used to understand the market implications, especially in a market that was extremely unstable, or develop a resolution strategy.

In response to these challenges during the financial crisis, and aided by new regulatory tools made available by Dodd-Frank, the FDIC has taken a number of steps to improve our supervisory and potential resolution responses for systemically important institutions.

To address undue restrictions under the 2002 Interagency Agreement that governed our backup examination authorities, the FDIC and the FDIC Board of Directors approved a Memorandum of Understanding last month. The Memorandum of Understanding provides the FDIC authority to conduct special examinations and is not limited--and acknowledges the FDIC Board of Directors' authority to direct special examinations should circumstances warrant.

Furthermore, the Dodd-Frank Act provides the FDIC with broad new authorities not available during the crisis to close and liquidate systemically important firms in an orderly manner. These tools include the requirement to develop resolution plans known as "Living Wills"; statutory language to affirm the FDIC's enhanced backup examination authority, and a broad resolution authority of systemically important institutions.

In closing, the FDIC's improved supervisory tools and expanded on-site presence, better access to information, broader resolution powers to allow it to more effectively perform its role in managing systemic risk going forward.

I would be pleased to answer any questions from the Commission.

CHAIRMAN ANGELIDES: Thank you, Mr. Corston.

Mr. Steel?

WITNESS STEEL: Chairman Angelides, Vice Chairman--

CHAIRMAN ANGELIDES: I think your microphone, Mr. Steel?

WITNESS STEEL: Chairman Angelides, Vice Chairman Thomas, and Members of the Commission:

Thank you for the opportunity to appear here today before the Financial Crisis Inquiry Commission. My name is Robert Steel and I served as CEO of Wachovia from July 11th, 2008, until December 31st, 2008.

The Commission has requested that I address a number of issues, including the deterioration of Wachovia's credit portfolio in 2008, and the Company's discussion with potential merger partners in late September and early October of 2008.

As the Commission is aware, the housing market deteriorated throughout 2007 and 2008. In light of the worsening outlook for housing prices, changing borrower behavior, and mark-to-market valuation losses on Wachovia's residential mortgage-backed securities and collateralized debt obligations and leveraged lending portfolios, Wachovia reported a loss in the first quarter of 2008 of $707 million.

Second quarter losses, which like the first-quarter 2008 losses had been calculated prior to my arrival on July 11th and amounted to $9.1 billion, included a $5.6 billion loan loss provision. These losses reflected worsening housing and economic conditions and, more specifically, anticipated future losses in Wachovia's loan portfolio, primarily Wachovia's Golden West portfolio.

In the late summer and autumn of 2008, a series of unexpected and unprecedented events occurred in rapid succession in the financial services industry that increased the uncertainty and stress in the financial markets.

These events included the conservatorship of Fannie Mae and Freddie Mac on Sunday, September 7th, 2008; the bankruptcy of Lehman Brothers holdings; and the acquisition of Merrill Lynch by Bank of America announced on Monday, September 15th, 2008, and growing concerns about the viability of AIG which later culminated in a transaction in which the Federal Reserve required most of AIG's equity.

On Thursday, September 25th, in an unusual action the Office of Thrift Supervision announced the seizure of the largest savings bank in the United States, Washington

Mutual Bank. And the subsequent placement of Washington Mutual into FDIC receivership followed by a sale to JPMorgan for approximately $1.9 billion.

In addition, on September 25th, a tentative agreement in the U.S. Congress regarding the Administration's Economic Stabilization proposal collapsed.

The combination of these events from earlier in September, the seizure of Washington Mutual on Thursday, the 25th, and the collapse of Congressional agreement regarding the Administration's Economic Stabilization proposal, precipitated a sharp downward turn in financial markets.

The cost to insure Wachovia's debt, as evidenced by credit default spreads, increased substantially from Thursday the 25th to Friday the 26th of September. On Friday, the 26th, there was significant downward pressure on Wachovia's common stock and deposit base, and as the day progressed some liquidity pressures intensified as financial institutions began declining to conduct normal financing transactions to Wachovia.

In light of these deteriorating market conditions during the week of September 22nd, it appeared as though Wachovia was no longer in a position to engage in the public offering and private placement transactions necessary to raise capital, which in turn was considered to be the best method short of selling the company, for sustaining Wachovia in this tumultuous environment.

Headed into the weekend of September 27-28, management advised the Board of Directors that in light of the bank's inability to access the capital markets, Wachovia had begun discussions with both Citicorp and Wells Fargo regarding a possible merger, and that management intended to pursue both options during that weekend.

The failure of these negotiations could have resulted in Wachovia filing for bankruptcy, and the national bank being placed into FDIC receivership. Such a result would have been a major impact on Wachovia's creditors, counterparties, and employers more broadly on the U.S. economy.

On September 26th, Wachovia entered into a confidentiality agreement with both Citicorp and Wells and initiated subsequent negotiations with each of these banks toward a possible acquisition of Wachovia.

Both Wells Fargo and Citicorp conducted extensive due diligence investigations on Wachovia on September 27th and 28th, and in a response to a request by Mr. Kovacevich, the Chairman of Wells Fargo, Wachovia's outside counsel prepared and transmitted a draft agreement and plan of merger for the whole company to counsel for Wells Fargo.

Representatives of Citicorp, on the other hand, indicated to me their interest was to acquire only

Wachovia's banking subsidiaries, with an FDIC guarantee and assistance. As a result, the transaction would have created a residual entity with nonbank assets and other liabilities.

Sheila Bair, Chairman of the FDIC, on Sunday contacted me by telephone and advised the FDIC believed that no transaction with Citicorp or Wells could be effective without government assistance. Chairman Bair confirmed that in the FDIC's view Wachovia posed a systemic risk to the banking system. Subsequently, Chairman Bair directed Wachovia to commence negotiations with Citicorp.

We then negotiated an agreement in principle which I signed. I participated on behalf of Wachovia in the negotiations with Citicorp towards reaching definitive agreements which would be presented to Wachovia's board and shareholders for approval.

These negotiations began immediately and were conducted in earnest and good faith by a team of Wachovia employees and outside advisors. These negotiations proved extremely difficult.

On Thursday, the 2nd--

CHAIRMAN ANGELIDES: Mr. Steel, if you could try to wrap up as quickly as possible. Thank you.

WITNESS STEEL: Yes, sir. We began to negotiate the transaction in good faith with Citicorp, but then decided to pursue the transaction with Wells Fargo.

Wachovia's Board of Directors approved the transaction later that evening, subject to receipt of fairness opinions. After receiving favorable fairness opinions, the next day, Friday, October 3rd, Wachovia and Wells Fargo announced their merger agreement to the public.

Thank you, sir.

CHAIRMAN ANGELIDES: Thank you very much, gentlemen, for your statements and for your written testimony. We are now going to proceed to Commissioner questions. I will begin the questions, followed by Vice Chairman Thomas, and then by the lead Commissioners on this research and investigative effort.

So I would like to talk a little bit about the matters about which I spoke in my opening statement. The key question in my mind, or at least one of the key questions is: How did we get to the point where the choice we faced across the system, and in this regard also, was either to let the financial system collapse or to move in and save very specific institutions.

I have been struck in reading the work of our staff--the document I mentioned that's been posted on the Web--about the pattern that has existed among many of these institutions that then find themselves needing government assistance, or certainly being in the category of either too big to fail or too important to fail: high growth, high leverage, a set of risky investments.

And the one thing I want to focus on in my question is essentially, with respect to the regulators, why weren't there efforts taken to contain risk and to evaluate systemic risk until the very end?

As I look at all the documentation all the way through with respect to Wachovia, what I see is, I don't really see either regulatory body who is here today, and the OCC is not here today, but in all the reports I do not see evaluations of systemic risk. In fact, I don't see those until the weekend really of September 27th, 28th, 29th, until in a sense the run has begun in the wake of WaMu's seizure by the FDIC.

So that is what I would like to focus on. To assist in my question, I would like to enter some documents in the record. They are:

The April 2007 Report of Examination of the Federal Reserve;

The July 22nd, 2008, Report of Examination of the Federal Reserve;

The August 4th, 2008, Report of Examination of the Office of the Comptroller of the Currency;

And then with respect to the action taken by the Fed, there are two memos from September 27th from Ms. Jennifer Burns to Elizabeth Gress and John Bebe; and then another memo from Jennifer Burns to John Bebe on September 27th, a Fed document regarding--documents regarding Wachovia's liability structure, as well as the recommendation of the Richmond Fed with respect to invoking the Systemic Risk Exception, which I believe was September 29th.

I would also like to enter into the record the FDIC Resolution invoking the Systemic Risk Exception of September 29th; the Memo of Recommendation of that same day; as well as the meeting transcript and minutes of the FDIC Board.

So now let me go to my questioning. As I look at Wachovia's growth, I see an institution I think much by acquisition that goes from about $254 billion in assets in 2000 to $782 billion by 2007. That is a compounded annual growth rate of 17.4 percent.

By 2007, the tangible assets to tangible equity leverage ratio was 23.3 to 1; uninsured deposits had climbed to over $160 billion; and, Mr. Steel, as you mentioned and I believe Mr. Corston may have also, the acquisition of Golden West had led to losses of more than $10 billion. The Pay Option ARM portfolio of Golden West was about three times Tier One equity capital.

As I look at what both the regulatory bodies have done is, as late as 2007 the Federal Reserve in its Report of

Examination is rating Wachovia at a 2, which means safe and sound. It is not until July 22nd of 2008 that the Federal Reserve downgrades Wachovia to a 3. But even at that point it said that there was only a remote--even though there was a downgrade, there was only a remote threat to its continued viability.

You cited the Fed Risk Management Oversight issues, decentralized risk management issues. You cited concerns about subprime concentration. The OCC downgrades to a 3 on August 4th.

But what really strikes me--and I am going to start with you, Mr. Alvarez, is all during this time as you look at the reports of examination by the Federal Reserve there is no look at systemic impact. Now Mr. Cole, who was the director of banking supervision at the Federal Reserve from 2006 to August 1st of 2009, does note that there were many constraints. While the Fed discussed internally the issues of significant growth, and need to secure more long-term funding, the need to acquire more capital, the fact is that when there are discussions about trying to get the institutions in a sense to build some bulwarks against those concerns, Mr. Cole said that they ran into pushbacks from firms.

He also noted a 2007 study that there was concern in the United States about losing, because of our regulatory burden, losing out to London and other financial centers. So there was a concern that if there was too much in a sense regulatory oversight of the banks we would lose our competitive advantage.

And there was also, Mr. Cole said, a real sense that risk management practices at large financial institutions had improved, and the industry had matured and was fundamentally better than at identifying bubbles and risks.

Mr. Cole also said that at the Federal Reserve Bank of course the focus was on holding company impacts on the depositories; that there really wasn't any look at systemic risk.

So I would like to ask you to comment. Was this a big hole? Did in fact the Federal Reserve, I'm going to use the word "fail," but was there a hole in the system where the Federal Reserve did not look at the systemic impacts?

From what I can see, I don't see any look at that until after the run begins on Wachovia.

WITNESS ALVAREZ: So the various points that Roger makes, Roger Cole makes, I think are correct. I would point out that we operate under a statutory framework for supervision.

Our authority to examine, the criteria we are allowed to look at, who we are allowed to look at, the degree of our investigation, is all governed by statute. And one of the gaps in the statute, and one that is fixed by the Dodd-Frank legislation, is that our focus by law is on the individual safety and soundness of particular institutions, not on the system as a whole, not a systemic macro prudential point of view. And there is no regulator in the banking area that is granted that kind of authority and oversight.

That is one of the things that emerged in this crisis as a gap in the system. That is one of the things that the Dodd-Frank bill addresses in a variety of ways. It addresses it by enhancing the authority of all the regulators to look at the systemic effect, as well as what we call the micro prudential, or the safety and soundness effects of particular institutions.

It also establishes a council that brings together regulators of different markets and different institutions so that gaps and systemic implications can be observed, and can be monitored. And where there are gaps, recommendations made to Congress.

So I think part of it was the statutory framework we were operating under. We also, as Mr. Cole mentioned, were limited to the institutions we could look at. We are required by law to defer to the primary regulatory of institutions that are otherwise regulated. That includes the bank, the broker dealer, and other regulated institutions.

So while we had a good relationship with those regulators and cooperated and shared information, it was clear that the primary role belonged to somebody else.

CHAIRMAN ANGELIDES: But let me just probe this a little more. Because again, you know, we are in the hindsight business, and an the extent we are aware of that. But if you see an institution growing by 17 percent compounded annual growth rate, you know, you see a tremendous wave of acquisitions and, I would stipulate, a fair amount of risk being taken, and this has been a pattern over time, the Fed did have the ability in the, quote/unquote, "good times" to require more capital, to make sure the bulwarks were there.

I mean, there's the old Biblical phrase, you know, seven years of feast, seven years of famine, and I think that families are often instructed, you know, save in the good times for the tough times ahead. Having come from state government myself, I know that a lot of states have suffered because in the good times they did not put aside a prudent reserve for the downturn.

I mean, looking back on it, shouldn't the Federal Reserve or the other regulators, seeing that kind of growth rate, in a sense have built some kind of bulwark for what would be an inevitable downturn of some scale?

WITNESS ALVAREZ: So we did encourage a bulwark. That is what capital is for. And the capital at Wachovia, even at the time it failed, was sizeable. It as well capitalized by all definitions.

Now the difficulty is when you are in a liquidity crisis, capital may not be your saving grace. You need to be able to sell assets, or raise funding in some other way. And that is what was happening in the fall of 2008. Liquidity was drying up. And so capital became less valuable as a bulwark.

I also would point out that growth and size by themselves are not bad. Growth of the banking system tends to mirror growth in the industrial and commercial entities in the United States. And large, multi-national corporations, which there are many of in the United States, find it convenient and helpful and very good for their business to have large American company banks that can finance the growth of these U.S. commercial and industrial entities as well.

So growth isn't by itself a bad thing.

CHAIRMAN ANGELIDES: I agree that growth, in and of itself, is not bad. But when you see 17 percent growth, you see a wave of acquisitions, and there has been a pattern--let me just say, one thing that has struck me, as you look at the staff report that has been put on the web, is over time there is a pattern to these institutions that do fall into trouble, which is aggressive growth, high leverage, increasing concentration of risky assets.

And so I am again probing: At any time prior to the 27th of September, did you ever say we ought to look at the systemic risk implications and/or that we ought to be concerned about the rate of growth of these institutions and the risk profile they are taking?

WITNESS ALVAREZ: So as I mentioned, our ability to look at the systemic effects was limited. But what we were doing was looking at the institution's ability to deal with the risks it was taking on.

And as you know from the memorandum of understanding and from the exam reports that you've just released, the Federal Reserve was cognizant of the risks that Wachovia was taking, and was urging Wachovia to address those risks, to improve its risk management systems, to increase its liquidity, to analyze more carefully its capital needs.

We had a variety of efforts under way at Wachovia and at other institutions to help them improve themselves so that they would be in a better position individually to deal with their difficulties.

Unfortunately, during the period 2008 it was a very difficult time for institutions to address problems that were beginning to emerge at those institutions. There was less funding available. There was less capital available. Liquidity was scarce.

So we were identifying and stressing that companies deal with problems as those problems were becoming apparent, but we were in a disadvantaged economic situation to address them.

CHAIRMAN ANGELIDES: I am going to ask you a couple of questions, Mr. Corston. It is really the same--now I understand you weren't the primary regulator. My understanding is you had one examiner on site?

WITNESS CORSTON: That's true.

CHAIRMAN ANGELIDES: By the way, were you ever blocked from access to Wachovia in investigations?

WITNESS CORSTON: No.

CHAIRMAN ANGELIDES: I know that with respect to WaMu the FDIC has said it was blocked by the OTS in participation in some of the exams at WaMu. Are you familiar with that?

WITNESS CORSTON: I am familiar with that, yes.

CHAIRMAN ANGELIDES: But not in the instance of Wachovia?

WITNESS CORSTON: Correct.

CHAIRMAN ANGELIDES: All right. But again I guess one thing I want to ask you is, in your role as essentially the backup regulator, but obviously with a significant amount of at risk, did you ever look before--as I look, again, at the trail I don't see any look at systemic risk implications for the system prior to the September 29th memos. Is that an accurate characterization?

WITNESS CORSTON: One of the things we did at the FDIC was, obviously as an insurer we are looking at our risks at the various insured institutions. But we had established what we referred to as the National Risk Committee within the FDIC. And it is staffed with top-level decision makers that include the division directors of our insurance division, supervision division, and resolution division.

It also has the Chairman and the Vice Chairman of the FDIC attend. One of the issues that we had seen, and became concerned about, was the amount of liquidity in the market, and the amount of structured products and the complexity in those structured products, and what we felt may be the excessive sensitivity to credit risk in some of those structured products.

We discussed that with our National Risk Committee and essentially were involved in trying to get more information as far as the sensitivity of those structured products.

Wachovia was very involved in that area. And we had our dedicated examiner spend quite a bit of time working with the primary federal regulatory, and the Federal Reserve in getting information and background and reporting for that committee.

You mentioned the issue of growth, and concern that we may have over growth. And as Mr. Alvarez points out, growth isn't always bad. But for the FDIC, if growth results in higher risk or more complexity, it does become more of a challenge for the FDIC.

For example, when they, "they, Wachovia," purchased Golden West, Golden West was what we would consider an institution that was more of a monoline, having really a single product in an option Adjustable Rate Mortgage portfolio that was largely collateral-based.

And for the FDIC to have that level of embedded risk in a single institution is problematic, and you can see that with the results of Indy Mac, Countrywide. The absorption of Golden West into Wachovia allowed a monoline institution with a single risk to go into a far larger institution that had diversified risk.

Of course the issue with Wachovia is that it had a lot of other risks that exposed it to sensitivities in the market and liquidity in that market.

One of the things and questions you had about, you know, was there something maybe we missed, I have to say one of the toughest things as a supervisor and having to go to my board of directors, it is tough to go and not have options for them that are viable. And one of the things I don't think that we fully appreciated was the sensitivity to the capital markets in the funding markets to the credit risk in some of these products, and how quickly that pullback could be.

With Wachovia, you see the ratings were 3. We actually had, to our LIDY system, had downgraded Wachovia to what we call a C-negative in March of 2008, and essentially saying that institution is subject to a downgrade within the next 12 months. We had discussions with the OCC and subsequently they did downgrade that institution and we did have concerns about it.

But the appreciation for the sensitivity to the funding markets was something we did not have a full appreciation for. And when the markets became so displaced, this institution stood out as one that really could not weather that storm.

CHAIRMAN ANGELIDES: All right. Let me--but it does seem to me, and one last comment, that there's--in a sense, I mentioned in my opening statement, it is almost like financial groundhog day; that we see these institutions take--the pattern is very similar in terms of growth, leverage, risk; and on the upside, we don't take the kind of prudential steps that we should take.

Do you believe, in retrospect, that that was a failure, or a big, gaping hole in the system? Because I don't see the kind of look at systemic risk and liquidity prior really to the weekend after the run has begun. Would you agree, just kind of 'yes' or 'no' that that was a big gap?

WITNESS CORSTON: I would agree it's a statutory gap because it was very difficult for us to, when an institution was profitable, and when we're dealing with the primary federal regulator that we were getting feedback that the risks were adequately managed, very difficult to say the growth, just the growth in itself, is the problem.

CHAIRMAN ANGELIDES: All right. Mr. Alvarez?

WITNESS ALVAREZ: So I reiterate what I said before. I think that that was a gap that the Dodd-Frank bill is attempting to close.

CHAIRMAN ANGELIDES: Okay, one more question before I yield my time and then come back. And this is for you, Mr. Corston, and I will ask Ms. Bair about this tomorrow.

She expressed some significant reservations about the invocation of the System Risk Exception. She, in the transcript, talked about how she's acquiescing to the decision; "I'm not completely comfortable with it," "whether it's the best resolution, I don't know."

What was at the core of this concern?

WITNESS CORSTON: She would be able to answer that question. The information that we presented to her prior to the board meeting, and at the board meeting, was an institution that was suffering extreme liquidity stress; that something had to be done.

I am sure that board, including her, would have liked far more information and far more time to make their decision, and I know that was a concern.

CHAIRMAN ANGELIDES: All right. Mr. Alvarez, one last question for you. One of the things we are trying to examine is why certain institutions were deemed too big to fail, and why others weren't.

I look at the memos from the Fed, as well as the memos from the FDIC, and I ask myself why didn't Lehman fit that criteria. I mean, what's the difference between Lehman and Wachovia in terms of systemic risk? The both seemed to be in a position where they had enormous systemic risk, at least according to the memos I saw, but one was in and one was out.

WITNESS ALVAREZ: So first of all, we don't have a list of systemically--

CHAIRMAN ANGELIDES: No, but you made a determination.

WITNESS ALVAREZ: --institutions--but I think, as you'll find in the discussion this afternoon, the difficulty with Lehman wasn't that it had a systemic effect; I think it has shown that its failure did have a systemic effect; but we didn't have the tools to do anything other than what we did.

Lehman needed far more liquidity than the Federal Reserve could provide on a secured basis. And without that security, we are not authorized to provide lending. We didn't have authority to provide capital. The TARP wasn't enacted--

CHAIRMAN ANGELIDES: Well, but let me probe you on that a little, Mr. Alvarez. I mean, you wrote an opinion on March 9th, which I would like to enter into the record, which is regarding the authority of the Federal Reserve to provide extensions of credit. And you said at that time that the statutory text, quote, "leaves the extent and value of collateral within the discretion of the Reserve Bank."

You went on to say in that opinion that requiring loans under 13.3 to be fully secure--I'm sorry, it's a 2009 opinion, I'm sorry, March of 2009. You went on to say that requiring loans under 13.3 to be fully secured would, quote, "undermine the very purpose of Section 13.3, which was to make credit available in unusual and exigent circumstances to help restore economic activity," closed quote.

And the other thing--and I will get into it more this afternoon--but was there ever an opinion rendered during the course of the deliberations on Lehman that legally credit could not be extended? Because there appears--and we'll talk about it this afternoon--that there were many discussions about extending credit through the Primary Dealer Credit Facility.

But the issue of kind of a legal stopper never comes up, as far as I can see.

WITNESS ALVAREZ: So there was no time to write a legal opinion on the Lehman weekend. Everything happened incredibly quickly. In the space of this hearing we were dealing with all of the collapse of Lehman. So there wasn't time for that.

On the other hand, if I could explain my legal opinion, the statute says that the Federal Reserve can lend so long as the Reserve Bank is secured to its satisfaction. The credit is either endorsed--that means guaranteed by somebody else--or secured to the satisfaction of the Federal Reserve Bank.

Collateral is one way that a Reserve Bank might find it is secure. It may be the value of the collateral makes it feel that it will be repaid. But the point is, it has to be able to feel comfortable that it will be repaid.

CHAIRMAN ANGELIDES: But here--

WITNESS ALVAREZ: And there was not, at Lehman going into that Monday, the belief that the Federal Reserve would be repaid, because the collateral was inadequate.

It was a company that was failing. It was a company that did not have other sources of income to ensure that it would repay the Fed. And there was no third party or other source of funds to repay if Lehman did not.

So the Federal Reserve believed that it would not recover the funds it would give to Lehman, and that is why it did not extend the credit.

CHAIRMAN ANGELIDES: But very quickly, I just want to ask you, did you ever do a--I know that the private consortium went in and obviously was trying to value the assets of Lehman, and I want to ask you because you happen to be here this morning, I know that there was valuation, but of course they're doing it in a compressed time frame and you could argue the private consortium had some motivation. Just kind of yes or no, did the Fed ever do a collateral analysis? Did anyone in the Federal Government? I've never seen a collateral analysis.

WITNESS ALVAREZ: A written report on the value--

CHAIRMAN ANGELIDES: Yes.

WITNESS ALVAREZ: --of the collateral? No. There was no time for that, nor

CHAIRMAN ANGELIDES: No legal opinion. Well, except, Mr. Alvarez, let me point out, there was time for extensive memos on Wachovia.

WITNESS ALVAREZ: I would point out that also for Lehman Brothers, unlike Wachovia, we weren't the supervisor. So we didn't have the access to information or the understanding of the company in the same way we do of Wachovia where we are the supervisor, and it is a little different situation.

CHAIRMAN ANGELIDES: All right. Thank you, Mr. Alvarez.

WITNESS ALVAREZ: Thank you.

CHAIRMAN ANGELIDES: Vice Chairman.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman. I think I have an extraordinary opportunity, given the fact, Mr. Alvarez, you have been at the Federal Reserve I believe from '04 to the present day?

WITNESS ALVAREZ: I actually was born at the Federal Reserve.

(Laughter.)

VICE CHAIRMAN THOMAS: Nestled in a basket of money.

(Laughter.)

VICE CHAIRMAN THOMAS: Well, no, that I wish, but not true.

VICE CHAIRMAN THOMAS: Excuse me, Federal Reserve Notes.

(Laughter.)

VICE CHAIRMAN THOMAS: Mr. Corston, I understand that you were born at the FDIC in '87, and have been there ever since?

WITNESS CORSTON: That's correct.

VICE CHAIRMAN THOMAS: And, Mr. Steel, you were at Treasury, the Under Secretary of the Treasury for Domestic Affairs from '06 to '08, but then extraordinarily you moved in July of '08 to Wachovia.

WITNESS STEEL: Yes, sir.

VICE CHAIRMAN THOMAS: So that you would be part of this string of decisions and results.

So I will play Walter Cronkite and "You Are There." I am asking these questions as the former Chairman of the Ways and Means Committee, cognizant of Article I of the Constitution which reserves all powers to the Congress to make laws affecting the revenue of the United States; and that all three of you gentlemen, when you were in government, two of you still in government, the third when you were in government, were in Article II, the Executive Branch, on the execution of the laws of the United States.

When we talk about that--and you were there, Mr. Corston, I understand, on that meeting of the board of directors on September 29th--

WITNESS CORSTON: That's correct.

VICE CHAIRMAN THOMAS: --when you were looking at a potential decision to deal with Wachovia.

Mr. Alvarez, on page 10 of your testimony you--no, excuse me, on page 6 of your testimony you emphasized, in the observance of the behavior of the FDIC meeting, on page 6: "On September 28th, the Board by unanimous vote determined that compliance by the FDIC was the least"--met all of those requirements. And so you emphasized the "unanimous vote." It was a unanimous decision.

WITNESS CORSTON: Yes, that was my board. I wasn't speaking about the FDIC Board.

VICE CHAIRMAN THOMAS: Oh, you weren't speaking about the--

WITNESS CORSTON: I was speaking of the Board of Governors.

VICE CHAIRMAN THOMAS: I apologize. What was the vote, if you're allowed to tell us that in a public meeting, of the Board of Directors?

WITNESS CORSTON: The FDIC?

VICE CHAIRMAN THOMAS: Yes.

WITNESS CORSTON: Unanimous.

VICE CHAIRMAN THOMAS: It was a unanimous vote of the FDIC?

WITNESS CORSTON: Correct.

VICE CHAIRMAN THOMAS: Was it, in the vernacular, an easy unanimous vote?

(Pause.)

You know what I mean. Just talk.

WITNESS CORSTON: I was a presenter, I would say I got very few questions. I think, though, that it was not an easy decision for those making them.

VICE CHAIRMAN THOMAS: What was part of the concern about making that decision on the part of the Board of Directors?

WITNESS CORSTON: That's easy to answer, and it's the same problem I had. We dealt in very short time frames with a lot of gaps in information. And while we had information regarding Wachovia, we had very little information regarding really the outside and collateral impact which we knew could be substantial, but it was hard to calibrate a measure.

So when we presented our case, we knew this to be a very, very significant factor that decisions were going to be made upon, yet it was very difficult to provide hard facts.

And I deal with institutions where, generally when I got up in front of my board, I present hard facts, and it is fairly--whether you agree or not, at least you can understand the fact set. And I think this was the challenge we had that evening, or morning.

VICE CHAIRMAN THOMAS: And as you indicated to the Chairman, what you liked to do was go into meetings with viable options. And obviously viable options are those based upon fact, that you had some certainty on presenting a course of action, if that course of action was accepted.

Was there concern in the FDIC, or in the Chairman, or others, about the potential of the FDIC holding the bag? That there would be some concern about costs to the FDIC of this agreement?

WITNESS CORSTON: With regard to the case that I presented, in our analysis the actual bid that was presented by Citi and the analysis that we had from our field staff working with the OCC and Federal Reserve, it really showed that we had no loss exposure.

Now we were given, you know, a fact set that is not entirely, you know, a 100 percent probability, but we were very comfortable that the actual dollar exposure was likely zero for the FDIC.

VICE CHAIRMAN THOMAS: So that is why on page 10 of your testimony you said, as a result, quote, "there was no expected loss to the FDIC associated with the transaction"?

WITNESS CORSTON: Correct.

VICE CHAIRMAN THOMAS: So you were home free.

Mr. Alvarez, in your testimony on page 10, in terms of examining the arrangement, you say, under the "Federal Reserve Assistance" in the middle of page 10: "The Federal Reserve did not provide any emergency financial assistance in connection with the Wells Fargo-Wachovia merger."

So in terms of taking care of your birth place, there was no risk, financial obligation, or other financial role that the Federal Reserve would play?

WITNESS ALVAREZ: That's right. That's right.

VICE CHAIRMAN THOMAS: So the Federal Reserve was home free with this arrangement.

WITNESS ALVAREZ: Yes. I have to add a small footnote. We weren't asked--

VICE CHAIRMAN THOMAS: Small in size, or small in importance?

WITNESS ALVAREZ: I think in both.

VICE CHAIRMAN THOMAS: Okay.

WITNESS ALVAREZ: The--while it is true we were not asked, nor were we expected, to provide any emergency assistance, Wachovia, as were many banks at the time, was borrowing, the bank itself, at our discount window--

VICE CHAIRMAN THOMAS: The discount window was open, but that's an ongoing, normal function.

WITNESS ALVAREZ: Yes, exactly.

VICE CHAIRMAN THOMAS: And once you make that decision, that is part of your commitment.

WITNESS ALVAREZ: That's right.

VICE CHAIRMAN THOMAS: But it wasn't outside of that--

WITNESS ALVAREZ: Correct. That's right.

VICE CHAIRMAN THOMAS: --that the Federal Reserve was going to have any kind of exposure.

WITNESS ALVAREZ: That's correct.

VICE CHAIRMAN THOMAS: So the Federal Reserve is home free; the FDIC is home free.

Mr. Steel, in your testimony I found on page 5 that your information was kind of secondhand. For example, in the middle of page 5, at your request, the Chairman very shortly thereafter called Mr. Sherborn and provided details on the proposed transaction, quote, "including that it would not require any government assistance."

WITNESS STEEL: Yes, sir.

VICE CHAIRMAN THOMAS: And then lower on the page, when you landed--you were actually in flight, so things were happening while you were moving, and of course this is at the time that you were at Wachovia after you had left the Treasury, it says: Consistent with what she told Mr. Sherborn, Chairman Bair described Wells Fargo's proposal to me as requiring no government support, with no risk to the FDIC Fund.

WITNESS STEEL: Yes, sir.

VICE CHAIRMAN THOMAS: But the solution, not withstanding the fact that the FDIC took the unusual measures in its minutes to move to a Citi-Wachovia structure, was not talking about that arrangement, was she?

WITNESS STEEL: No, sir. She was speaking about the proposed transaction by Wells Fargo.

VICE CHAIRMAN THOMAS: And the proposed transaction by Wells Fargo came after the FDIC had met and decided, by unanimous vote, that it was appropriate to go forward with the safeguards and the small risks of possibly having FDIC funds exposed.

WITNESS STEEL: Yes, sir.

VICE CHAIRMAN THOMAS: On the 29th. Right, Mr. Corston?

WITNESS CORSTON: Yes.

VICE CHAIRMAN THOMAS: What happened on September 30th? This would be back at your old stomping ground, Mr. Steel, the Department of Treasury. There was at that time an IRS notice, No. 83, which changed a more than two-decade-old regulation dealing with the acquisition of companies, in terms of whether or not the acquisition focused on the acquisition for purposes of tax benefit rather than any of the other reasons that firms might want to merge.

In fact, IRS issued an opinion which turned the law on its head. It didn't provide it--now we're familiar with NOLs. We used to, the Congress and the Ways and Means Committee, used to deal with Net Operating Loss reachback because it was a way to transfer previous losses to current situations, and previous profits to current situations where you wanted to shift time to provide assistance. It was always on a fixed time that it was available, and it was always across the board available. That if you met the dollar amounts, you were able to utilize them. If you didn't, you didn't.

But in Notice 83, the IRS said it was available to banks only to shift losses that would accrue to the acquiring company.

So you were at Wachovia at the time, and subsequently with the acquisition of Wachovia to Wells Fargo you moved then to a position I understand on the board of Wells Fargo. Is that correct?

WITNESS STEEL: Yes, sir. After the closing of the merger, several Wachovia--former Wachovia directors were invited to join the Wells Fargo Board, and after a brief period in January-February of '09 I did join the Board.

VICE CHAIRMAN THOMAS: Well I'm trying to understand. If I'm there, and you folks are in the positions you are, let me in on when Treasury began looking at what you called, Mr. Corston, "viable options," including the reversal of a two-decade-old regulation which significantly governed what you could or could not do in trying to salvage financial institutions that you might define as too-big-to-fail, because suddenly laying on the table an ability to acquire a bank or a financial institution in which the concern is failure, therefore significant losses, could actually be incorporated by the acquiring corporation and used to offset taxes?

And that was the choice that was made, not withstanding the FDIC made the other choices. What was your reaction, Mr. Corston, to the September 30th announcement by the IRS that they were changing the fundamental rules of the game, which would clearly change the potential relationships between these financial institutions that you folks were so concerned about the day before in your minutes?

WITNESS CORSTON: Well my reaction was more towards the Wells Fargo, coming up with a viable bid as a result. And certainly that was far more palatable of an option that the one we came to over the weekend.

VICE CHAIRMAN THOMAS: So the means justified the end? You were very pleased with the fact that IRS made this change in the regulations, unilaterally, without consultation with the Legislative Branch that has the Constitutional responsibility to change the law.

In essence, they changed the law. But it was convenient. It was appropriate. It was a better deal. But on the previous deal, FDIC was okay. Federal Reserve was okay. Why didn't you look at continuing the process and not leap at the opportunity to take this extreme, fundamental change in the Tax Code brought about by an IRS notice?

WITNESS CORSTON: The issue on the weekend really was the liquidity issue. We did not know if Wachovia would have enough liquidity to operate Monday. And that was a concern, and a concern we presented to our Board.

And the problem was, we just did not know. But we did know that the implications of them not being able to operate, and the resulting impact on counterparties and other institutions could be fairly significant.

So our decisions were made, as I said earlier, unfortunately in a very, very compressed time frame with really not a tremendous amount of information.

VICE CHAIRMAN THOMAS: Mr. Steel, you were at Treasury in an Under Secretary position from 2006 to 2008. Was there any discussion in terms of Mr. Corston's viable options of looking at this shift in the definition of what you could do under the IRS notice?

WITNESS STEEL: No, sir, not that I'm aware of.

VICE CHAIRMAN THOMAS: Was it brought up in any discussions when you were desperately looking for a solution? Because I know Treasury talks to FDIC, and the Federal Reserve, and you all sit around, and you try to resolve problems collectively, making sure that no one winds up holding the bag, certainly not the Federal Reserve or the FDIC, or, Mr. Steel as you characterize, there would be no government exposure or cost.

WITNESS STEEL: No, sir, no discussions of this technique or issue.

VICE CHAIRMAN THOMAS: Mr. Corston?

WITNESS CORSTON: There were none at my level.

WITNESS ALVAREZ: None that I'm aware of.

VICE CHAIRMAN THOMAS: So this immaculate birth of an IRS notice which fundamentally changed the way in which corporations could deal with the Tax Code on an acquired corporation's losses was so significant that it shifted your decisions to allow the Wells Fargo to go forward.

Citibank was a little upset, weren't they? Didn't they take some legal action?

WITNESS CORSTON: That's correct.

VICE CHAIRMAN THOMAS: And you probably weren't supportive of that legal action, because it could have left a bit of exposure, not withstanding the size of it, but exposure to the FDIC. You were supportive of this utilization of the regulation change? Was there discussion in the FDIC about this is a better way to go?

WITNESS CORSTON: The discussions I was involved with was with analyzing basically the two transactions. And the Wells Fargo transaction not requiring any assistance with the FDIC or exposure was a far better proposal.

VICE CHAIRMAN THOMAS: Right. You're home free. And we knew Federal Reserve is home free.

Mr. Steel, how can you characterize, or even utilizing other people's characterizations because apparently you support them by including them in your testimony as an explanation, that there wouldn't be any government cost to the IRS Notice 83 solution?

What it was was a significant loss of revenue to the Treasury, unprecedented. So how could you say there was no cost to the government? Unless you saw the government as the Executive Branch.

WITNESS STEEL: No, sir. I believe that the way I would frame this distinction is that drawing a distinction between specific government support for an instant transaction in one case versus a change in the IRS Tax Code which was available to all others who might be in a position to take advantage of it.

VICE CHAIRMAN THOMAS: All other corporations?

WITNESS STEEL: All other institutions who fit the qualifications to be able to take advantage of it.

VICE CHAIRMAN THOMAS: Which were financial banking institutions.

WITNESS STEEL: Yes, sir.

VICE CHAIRMAN THOMAS: It was--in the vernacular we used to talk about it in terms of making these kinds of decisions--it was a rifle shot. They changed the law for a specific group of institutions.

Did anybody think that was lawful? I understand it was convenient. It certainly was a solution that wasn't available on the 29th when the FDIC made its decision. It became available on September 30th, and Wells, sharpening its pencil, by October 2nd decided this was a pretty good deal, and that they could do it without any government assistance.

How can you not call changing the Tax Code to provide you with significant tax benefits doing it without government assistance, as you describe, Mr. Steel? Isn't taking money away from the taxpayers and the General Fund through a change in the Tax Code "government assistance"?

WITNESS STEEL: I understand your perspective. What I tried to describe was a distinction between support for a specific transaction and support for what you just described as a group of people, meaning financial institutions. And that being a distinction in my mind with a difference.

VICE CHAIRMAN THOMAS: Well this isn't my characterization. A fellow who teaches law at the University of Virginia that I got to know very well, because we selected him as Chief of Staff of the Joint Committee on Taxation, Professor George Yin, said, quote, "Did the Treasury Department have the authority to do this? I think almost every tax expert would agree that the answer is no. They basically repealed a 22-year-old law that Congress passed as a backdoor way of providing aid to banks."

And of course what happened, once Congress discovered what had been done by the IRS, they immediately slammed the door on this provision, although I believe two other banking institutions got through before the door was closed.

I guess what just amazes me is, looking at this time period, late September early October, there was a focus on the FDIC making sure they were home free. There was a focus on the Federal Reserve making sure they were home free. The ends justifying the means was quite all right for Wells Fargo and for the assumption by Wells Fargo of Wachovia, because it made it government assistance-free? Well it wasn't. It cost the taxpayers to utilize this.

And I guess what is so amazing to me, when you begin to examine the options open to you, that I think a lot of us have a concern about the kinds of discussions that went on behind closed doors; what the options were that were defined as viable, including up to changing the law of the Internal Revenue Code to make it expedient to take a course of action that didn't cost the FDIC anything, and it certainly didn't cost the Federal Reserve anything. But to characterize it as "no government assistance," "no government cost," is to tell me a whole lot more about those key decision makers' view of the world at the time they had to make decisions for the American People, for the American taxpayers, and for the American Government.

I knew who you were looking out for. I'll reserve my time, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you, Mr. Vice Chairman. Mr. Georgiou.

COMMISSIONER GEORGIOU: Thank you, Mr. Chairman. I guess I'd like to, without overly belaboring the point, like to follow up with Mr. Steel on the point that the Vice Chairman made.

Do you still serve on the Wells Board?

WITNESS STEEL: No, sir, I do not.

COMMISSIONER GEORGIOU: Okay. Do you know how much that Tax Code change benefitted Wells? Or whether it is still a continuing loss carryforward that's permitted under that modification of the Tax Code?

WITNESS STEEL: No, sir, I do not.

COMMISSIONER GEORGIOU: Does anybody here know?

(No response.)

COMMISSIONER GEORGIOU: Does anybody on our staff know?

(No response.)

CHAIRMAN ANGELIDES: Actually, in an analysis provided, Wells has contended that they have not reaped any benefit to date, but I believe that's their statement; that they have not yet utilized or reaped any benefit to date, but there are projections for future use and availability of that credit.

COMMISSIONER GEORGIOU: And that's because they haven't made enough money in the interim to use the loss carryforwards.

I mean, I guess the point that I think the Vice Chairman made, and I think anybody else--

CHAIRMAN ANGELIDES: But I will say, on my time, there was an estimate provided when the measure was repealed, I believe, saying that the costs would be about $7 billion. That's my recollection. But, Mr. Vice Chairman--

VICE CHAIRMAN THOMAS: And there is printed information, and I will provide it for the record, that indicates that the difference between September 29 and October 2nd was a 10-fold benefit to Wells Fargo in terms of the tax provision.

COMMISSIONER GEORGIOU: Well, I mean obviously, you know, tax loss carryforwards are valuable in that they shield future income from taxation. So at the end of the day, although the FDIC didn't have to impact the Insurance Fund, the Fed didn't have to provide direct assistance, ultimately the taxpayers will be impacted by the diminution in revenue that would otherwise have been collected from Wells when and if they utilize these tax loss carryforwards.

The point, I suppose, at the end of the day isn't that that particular method was utilized, but the characterization of it as "not government assistance." It was a different form of government assistance, that's all. It was perhaps a delayed form of government assistance. But at the end of the day, the taxpayers will have less revenue, which is the same as expending the same amount of money, effectively, to impact on the taxpayer over time.

And I guess I was interested in some of the things, Mr. Steel, that you said to our staff in the interview that they conducted with you. One of the things you said was the resolution process, you believed, should be mean-spirited with all parties paying a price as a pedagogy or methodology for resolution. I think that people should not be too big to fail, but given the concentration issue how should people fail in a way that doesn't have ripple effects.

Could you elaborate upon that, in your view?

WITNESS STEEL: Surely. I think I would start with what I believe are the right principles. And then I would talk about preventative perspectives. And then the right approach, once events develop.

So let me try with that methodology. As you recounted from my interview, my personal belief is that no institution should be too big to fail. But we do have a reality. And that is that the nature of the government involvement, in particular with depository institutions, sets up a situation that is complex with regard to moral hazard and the relationship between these institutions, where we have a complicated message that we are not crystal clear on.

So that is the reality. But my belief is that no institution should be too big to fail. So then what do we do about that?

I believe that there are certain things we do in advance, and some of them Mr. Alvarez described, whether it is living wills, more effective regulation and supervision, and efforts to understand systemic risk, as the Chairman discussed in great detail. Those are examples of things we can do in advance.

Then I think you get to the very complex issue of when institutions run into trouble what is the method by which, if you adopt my perspective that no institution should be too big to fail, what do you think should be the methods by which institutions are wound down or fail so as to have the least effect on other people and other parties?

And there my view is that we have processes for bankruptcy, and that we should use as much of the processes characterized by bankruptcy as we possibly can before we get to the issue of thinking about government support. So that is the philosophical perspective I would bring to that second part of the discussion.

COMMISSIONER GEORGIOU: Well a lot of us on this Commission share that view, but one thing that is our charge is to attempt to evaluate and elucidate for the American People how it is that we got to the point where so many institutions were provided with extraordinary governmental assistance.

And of course they only--the policymakers only face the choice of whether to save an institution when they are on the verge of failure, which of course customarily occurs not in an isolated manner when one particular institution fails in a time when it is generally a rosy economic circumstance--if that occurs, quite often we allow them to fail because it is not really going to impact anyone else.

The problem is when circumstances present themselves, as they did in 2007 and 2008 when liquidity was being withdrawn from the marketplace and was difficult to obtain.

And as we look at those issues, we are doing so with the hope that we will learn something about it that might enable us to address these matters differently on a go-forward basis.

One concern I have is that it appears that, just the top six largest banking organizations in American--that would be Bank of America, JPMorgan Chase, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley--their assets grew from 17 percent of GDP in 1995 to 58 percent of GDP in 2007 as we approached the high point of the financial crisis. But they are 63 percent as of the end of 2009.

So they are not any smaller. Those six banks have a 5 percent greater size relative to GDP now than they did during the crisis. So my question to you, and I guess I will start with you, Mr. Steel, because you've got long experience in the private sector as well as the public sector, and then I will turn to the other two of you if I can:

Are we really any less likely to be compelled to save one of these six very large and very interconnected financial institutions in the event that we have a liquidity crisis anywhere near as severe as we had before?

And I raise this because it seems to me that there are conceivable circumstances in the future that could lead there. Obviously commercial real estate loans are not as large in number as residential real estate loans, but if we all concede that the loss of value in the residential real estate marketplace was a significant factor as a trigger of the crisis, you know, could we face a similar one as the commercial real estate losses have to be absorbed in these institutions over the next few years?

And are we any better positioned today than we were two years ago to avoid the need to provide extraordinary governmental assistance to these institutions?

Mr. Steel?

WITNESS STEEL: I will revert back to the methodology I was describing. I think first it is, are we building or in the process of building better capabilities for thinking ahead, thinking systemically as the Chairman suggested, having a more robust perspective from supervisors and regulators, and are we building tools so that we are more aware and have a better line of sight on these institutions?

I think that is in the process of happening.

Then you get to the second part of your question, and here I think we have to be very disciplined about setting into process now methods by which we deal with this before we get into the situation.

As you said, quite correctly, when you have a situation like we had in 2008 where several institutions are being stressed at the same time, then you need to know in advance what are you going to do? And that is why I have liked or preferred some of the perspectives of recognizing that we have to say in advance we are going to move in this direction and be more tough-minded with regard to potential bankruptcies and things like that.

COMMISSIONER GEORGIOU: Well but how do you do that? I mean, you have to do it well in advance of the crisis, do you not?

WITNESS STEEL: Yes, sir.

COMMISSIONER GEORGIOU: Do you think we are doing that now?

WITNESS STEEL: I think that this is all yet to be determined. As Mr. Alvarez was saying, they are going to be writing--I think he said to me before we began testifying--50 rules in the next 18 months. It will be in the work of implementing this legislation that we will see how people do with this.

COMMISSIONER GEORGIOU: Okay. Mr. Corston?

WITNESS CORSTON: I think we certainly have an opportunity to address these issues that we've faced in the past. One of the points you raise about the concentration of assets in the largest institutions, under our current process for resolutions you will notice that, to resolve a large institution it generally is absorbed by another institution.

So, giving the example of Washington Mutual, it gets absorbed by JPMorgan Chase, and now we have a larger JPMorgan Chase. We look at Wachovia, and the solution for Wachovia is absorption by Wells Fargo, and now we have a larger Wells Fargo. Those statistics you mentioned, I think if you look at each crisis the concentration of assets afterwards, we see more and more concentration in banking assets in larger institutions. And frankly, you know, under the--before Dodd-Frank, that really was our only way out for a large institution, to have it absorbed by another institution.

One of the things as the FDIC looking to resolve an institution, you need time. You need information. And you need to be able to understand structures. Dodd-Frank will provide that information.

One I think of the key pieces of Dodd-Frank is that when institutions make decisions right now they make them with sole focus on the bottom line. So if you are sitting at Citigroup, JPMorgan Chase, you are not concerned with your structure necessarily, if it had to be wound down in an orderly manner. That doesn't cross your mindset. That isn't a business decision.

With Dodd-Frank, that becomes a business decision. And for the FDIC, it is a crucial decision. Because in many of these structures, whether it be their legal structure, their information systems, basically just the structure of some of their products, if you make simple decisions at the beginning, at the outset, we understand some of the decisions that they are making at the outset, not under a compressed time frame where we have to deal with it in a weekend but actually going back when institutions are making the decision we're going to buy, in the case of Golden West, we want to buy, or Wachovia wants to purchase it, we look at the structure and we're able to work with the institution to make it I think more palatable for us to absorb.

COMMISSIONER GEORGIOU: Let me focus on that for just a second. Obviously Wachovia bought Golden West. Right?

WITNESS CORSTON: That's correct.

COMMISSIONER GEORGIOU: Right. And, you know, Golden West was a monoline. They had these pick-your-payment mortgages that we know people picked--when given the option to pick a payment, they generally picked a lower one than a lot of people would like, right? And sometimes they even picked ones that resulted in negative amortization that actually didn't even meet the interest, let alone the reduction of principal on their payments, so their loans just kept ballooning, and after time these are the kinds of loans that caused problems not just at Wachovia but similar types of loans caused problems at many institutions.

Do you feel that you have the authority--does anybody have the authority now to address a similar type acquisition that will create within one of these larger financial conglomerates that kind of focused risk that helped to bring down Wachovia?

WITNESS CORSTON: One of the keys in Dodd-Frank is that when institutions have mergers or they structure themselves in a certain way, we can look at those structures seen through a living will process that, is it something with which our corporation can deal? And ultimately if we can't, we have the ability to force divestiture.

It's something that--I mean, there are steps along the way, but at least it provides the ability to influence some of these structures to get the complexity and the size to a manageable size for our corporation to deal.

And ultimately under the bankruptcy code is the goal.

CHAIRMAN ANGELIDES: Two minutes.

COMMISSIONER GEORGIOU: Thank you very much, Mr. Chairman. Let me just--I just want to highlight one point before I turn to Mr. Alvarez. And that is, that some of the most astonishing testimony that we have heard over the last many months was testimony from the leadership, the CEO, the chief risk officer, and the chief financial officer of Citigroup who testified that they didn't know that certain CDOs that were sold within their investment banking subsidiaries had a liquidity put provision that required them to buy those CDOs back, which they ultimately exercised in their $25 billion worth of CDOs bought back, which at the time was one-third of the $75 billion of capital that Citi had on its books.

In a similar circumstance, AIG's leadership testified that they didn't know that there were collateral calls associated with the credit default swaps that they sold, that their Financial Products Division sold, that required, when those tranches were downgraded, required collateral to be put up. Which of course led to the demise, or would have been the demise of the oldest and best-capitalized insurance company in the history of the world.

Are we presenting a problem now that is going to be exceedingly difficult in the future to resolve without bailing out institutions, by creating institutions that have so many diverse product lines and so forth within them that they are exceedingly difficult to manage? Or are those just outliers?

I mean, to call Citigroup and AIG just an outlier seems to me to be inappropriate. They are central--they have been central to our financial system for a very long time.

So is part of the problem when these large institutions are created that they are difficult to manage, and they are difficult to supervise as well from the regulatory perspective? And is that just setting us up for a difficulty that is going to be a problem in the future?

Maybe Mr. Alvarez, just very briefly, if you could just respond to that? I've run out of my time.

CHAIRMAN ANGELIDES: Why don't you respond, and then we will go on.

WITNESS ALVAREZ: That is an incredibly difficult question and problem, but one way to think about it is Dodd-Frank does put more responsibility on the agencies to ensure that large organizations have enhanced requirements to deal with risk management.

And there have been accounting changes that help with the Citi problem and what they are responsible for and not responsible for.

AIG fell in a gap in regulation. There was no one who was supervising the top of the organization, which does not relieve the management from its responsibility to know what is going on, but may explain why there wasn't more government pressure for the management to know what was going on.

Those things I think they attempt to address in Dodd-Frank. I think another thing to keep in mind is that going forward the tools that we have to deal with the crisis are different than what they were up through 2008-2009.

The Federal Reserve will no longer have the ability to make loans to individual specific institutions like AIG. So that tool is taken away. And in its place is put a requirement that we resolve these institutions by wiping out the management and the shareholders, and assessing losses across the creditors, and closing down the institutions.

So the approach going forward will have to be different. More regulation on the front side to try to prevent the problem, and more drastic solutions in the event someone gets into trouble.

COMMISSIONER GEORGIOU: Well we wish you Godspeed in your work because this is extraordinarily important work for the American People to implement this. And I would urge you to, in your analysis--I'm sure you're doing this--but to try to bring in your analysis all the off-balance sheet exposures that all of these institutions had that rendered them incapable, and their capital inadequate when crunch time came. So you've really got to look at them holistically within the institutions and then systemically across the board. And to the extent you have been given that authority by this new legislation, I urge you to use it.

Thank you very much.

CHAIRMAN ANGELIDES: Thank you. Mr. Vice Chair, you wanted to say something?

VICE CHAIRMAN THOMAS: Yes, a brief 30 seconds to Mr. Corston in terms of your answer to Commissioner Georgiou about corporations looking to their bottom line. Didn't the FDIC do exactly that when on the 29th you unanimously accepted a shared relationship with Citibank in the acquisition of Wachovia by Citibank, and then two days later when you were let off the hook by virtue of an unprecedented Executive Branch usurpation of tax law provided an out that really was a solution that better protected your bottom line?

WITNESS CORSTON: When I present my analysis to our Board of Directors, I present analysis that shows the least-cost and most protection to the Deposit Insurance Fund. And my analysis showed, when we got the Wells offer, that the exposure to the Deposit Insurance Fund was less than that of Citigroup, and so it would ultimately be better for us, or at least less risky.

VICE CHAIRMAN THOMAS: So if I line up your loyalty responsibility, it is to the FDIC first, and to the American taxpayer second. That's just what you said. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman, and thank you, gentlemen, for taking the time to help us today to think about this issue.

I think it goes almost without saying that the nature of government intervention into financial institutions and markets is a signature of this particular era, and one of the most controversial aspects of public policy you could imagine.

It really does raise some questions that we have to somehow answer. In particular, did the intervention, or the expectation of intervention, cause or exacerbate the crisis that we have lived through? That's an important question.

For institutions that received it, what were the criteria that were applied for who gets the help, how much do they get, what form does it take? And in terms of thinking about the sort of notion of identifying those that will merit intervention, what are the dimensions that policymakers are looking at?

Is it scale? Large institutions get attention? Is it interconnectedness? The fact that many counterparties may be deeply affected due to the failure of an institution? Is it the business of being similarly situated? That allowing one institution to fail sends signals about others that are similarly situated and thus exacerbates panic? Or is it just the nature of market conditions that dictates the need to intervene?

And these are all dimensions of the problem that have been bandied about in our discussions in preparation for this hearing, and I think I was asked to lead this preparation in part because I have proven I don't understand how to think about this problem.

So I wanted to start with you, Mr. Steel, and just ask you: During your tenure at Treasury, as we saw financial market conditions evolve in the fall of 2007 and into 2008, what institutions was the Treasury surveiling? What criteria were applied? Were you looking at the largest? Were you looking at counterparty exposures and measuring them?

How was the Treasury thinking about this problem and the systemic fallout from individual institution failure?

WITNESS STEEL: Well, when I reflect back at

Treasury--and I was there from 2006 to 2008--that it really was in the summer of 2007 when you saw the first cracks start to appear. And basically what began with housing related issues spread into securities markets. And then began to have the reverberations into specific institutions, is how I think about the process developing. And everyone has their own image of this, but that's mine.

I believe that there's no question that it was tough to keep up with this situation as it was developing, challenging; and that I think that our focus rolled along with the phenomenon that I just described where there was original focus on the challenges of housing and foreclosures and what could we do to understand and try to be constructive towards housing and focus on foreclosures.

Roman numeral two was, as this spread to the securities markets, then it was really a matter of things like the commercial paper market, and particularly asset-backed commercial paper market.

And then you saw into monolines and also over-arching this same period was great concern about the GSEs. And so I think that was the leading up to the institutions.

And first with the securities firms, and then into the commercial banks. And that was the transition of how we monitored and how we tried to follow the different things, just from a time frame or the lens on how things lined up, sir.

COMMISSIONER HOLTZ-EAKIN: So it is--I don't want to put words in your mouth--is it fair to say you were then looking at firms that were similarly situated as specific markets became more impaired?

WITNESS STEEL: Well I think we did our best to also think about the interconnectedness, too. Because when you look at the effects on the monoline industry as it spreads out to other areas, and what it means for securities that are on the balance sheets of lots of other institutions, all kinds, insurance companies, commercial banks, securities firms, so I think it was really trying to understand the interconnectedness and the institutions that were affected by the situation we were examining as we worked through those challenges.

COMMISSIONER HOLTZ-EAKIN: But scale, per se, didn't appear to be that important? And when I hear you talk, it is not the size of the institution that matters. It's other characteristics.

WITNESS STEEL: All kinds of things. I think, actually, as I tried to say, this began at I think the grassroots level of trying to understand the effect on foreclosures on homeowners. That was really the first. And then from there you had the ripples. And where does ABCP lie? And it turns out that if General Electric has a problem with ABC commercial paper, then asset-backed commercial paper, that affects--and it also affects credit cards; it affects student loans; and it affects all types of securitized credit.

And so this was a phenomenon that went in lots of directions.

COMMISSIONER HOLTZ-EAKIN: So my understanding of the Dodd-Frank legislation is that, as Mr. Alvarez said, the nature of the intervention is now changed. The Fed will not be permitted to provide liquidity to individual firms. But it will and should stand up, as it did in this crisis, facilities for which there will be broad eligibility for liquidity assistance.

If that kind of facility is in place, and it's getting commercial--asset-backed commercial paper, whatever it may be, does that change the way we will have to worry about the supervision of institutions and their systemic implications? Or have we taken care of that by providing broad-based liquidity to those markets?

WITNESS STEEL: I'm not sure I have a perspective on that, to be honest.

COMMISSIONER HOLTZ-EAKIN: Not even a guess? I guess all the time.

(Laughter.)

COMMISSIONER HOLTZ-EAKIN: Sorry. Let me turn to you, Mr. Corston. You have been at the FDIC for a long time, in fact long enough to have lived through FDICIA, which is at least putatively supposed to have reined in the FDIC's ability to assist large banks when they're in trouble.

In your career, was there the sense that the 1991 law put handcuffs on you and raised the bar in terms of your ability to provide FDI assistance to troubled institutions?

WITNESS CORSTON: It certain narrowed the options. I think that with prime corrective action it gave us a structure to work within, and it gave the industry a structure to work within. And I know as an Examiner that actually made things easier to implement. But with that structure there certainly were some constraints, also.

COMMISSIONER HOLTZ-EAKIN: So the decision to provide the System Risk Exception in the Wachovia case was a very important decision? A precedent-setting decision?

WITNESS CORSTON: Absolutely. That was a very unique situation, and obviously a very difficult one for our Board to make.

COMMISSIONER HOLTZ-EAKIN: So can you tell me a little bit about the process for making that decision, and what you looked at in Wachovia to identify it as systemically important?

WITNESS CORSTON: Sure. At my level I deal with the examiners at the ground level, and am responsible for producing information and analysis so executives or directors at the Federal Deposit Insurance Corporation can make decisions.

With regard to Wachovia, we knew that it had credit exposure. Certainly with the Golden West portfolio it provided some unique types of risks because it's difficult to calculate the embedded risk in a pick-a-pay portfolio when you really can't tell what is really a nonperforming loan.

COMMISSIONER HOLTZ-EAKIN: But those are Wachovia-specific risks.

WITNESS CORSTON: Okay.

COMMISSIONER HOLTZ-EAKIN: What are the systemic dimensions--

WITNESS CORSTON: The systemic dimensions when we--

COMMISSIONER HOLTZ-EAKIN: --that you talked to in--I mean, there was a memo, I'm sure, that set these down.

WITNESS CORSTON: Sure. As we got--worked with Wachovia and we got to the weekend of the 25th, we had a situation in a market that was very unstable. We had an institution that had a funding structure that was very sensitive to the types of displacements that were taking place in the market. And we knew that it had this exposure.

What we were not clear on was to the degree it could impact the outside markets and other institutions. We were certain--

COMMISSIONER HOLTZ-EAKIN: But you drew the conclusion that it would, because that is the nature of systemic risk.

WITNESS CORSTON: Our analysis showed that there definitely would be an impact. And the impact would be significant.

COMMISSIONER HOLTZ-EAKIN: And what would those impacts be? And how large would they be? And how did you measure them?

WITNESS CORSTON: As I mentioned before, these are very difficult to measure and we were dealing in very compressed time frames. So we're dealing with limited information.

But we did know we had very large institutions also funded in a similar manner to Wachovia. We knew the market was concerned about some of these institutions. And we knew that if something happened to disturb or give less confidence to various counterparties at Wachovia, and they could see what happened there, it could impact other large institutions with which we may have to deal right after a situation at Wachovia; and ultimately, it appeared, it could freeze up the funding market. And that was an extreme concern.

COMMISSIONER HOLTZ-EAKIN: So you viewed Wachovia as being an indicator for similarly situated firms. There were others out there that looked like Wachovia, and if people saw Wachovia go down they would draw the same conclusions?

WITNESS CORSTON: They had similar circumstances as Wachovia.

COMMISSIONER HOLTZ-EAKIN: You didn't make the same decision with Washington Mutual. Why not?

WITNESS CORSTON: With Washington Mutual, the structure, and especially the liability structure, was quite different than that of Wachovia. They didn't have the same foreign deposit exposure.

They didn't have the same wholesale funding exposure. They didn't have a sizeable broker-dealer at the holding company. They didn't deal in complex structured products.

So to measure the impact at Washington Mutual which, while large, was really a large thrift that had fairly simple funding structure, and it was far easier to calibrate the collateral impact of that institution relative to Wachovia.

COMMISSIONER HOLTZ-EAKIN: And you didn't feel the same concern that there would be other large thrifts structured like Washington Mutual that would come under attack?

WITNESS CORSTON: No, because essentially it was the largest. And we had dealt with some of the weakest ones already. So--and again, because of the structure of their funding they're not as sensitive to the funding market that Wachovia was.

COMMISSIONER HOLTZ-EAKIN: Mr. Alvarez, the Federal Reserve drew the same conclusion, that Wachovia was systemically important for the same reasons?

WITNESS ALVAREZ: Very much the same reasons. And many of the things that you outlined. And I presented it in more detail in my testimony. I believe the Commission has the memo that we used to analyze the Wachovia situation. So you'll see that--I mean, it was the context.

The economic situation was very important to making the judgments about systemic risk of individual institutions. The scale. Wachovia was the fourth-largest depository institution--third largest by deposits--so incredibly difficult, large and interconnected.

We looked at measures of interconnectedness, how some--to the extent we could, where the commercial paper was placed and the effect that not being able to pay commercial paper might have on other institutions. Some of its other large exposures to different markets and different institutions.

The fact that it was well capitalized, considered well capitalized, and the market didn't seem to see failure of Wachovia coming, unlike WaMu where I think the market saw that WaMu died over a long period of time and there was some opportunity for folks to prepare for that.

The importance of Wachovia--

COMMISSIONER HOLTZ-EAKIN: So do you agree that there should have been no intervention with WaMu?

WITNESS ALVAREZ: Yes, we agree that there should not have been intervention in WaMu.

COMMISSIONER HOLTZ-EAKIN: There are some who assert that the failure of WaMu actually triggered a run on Wachovia. Do you agree with that?

WITNESS ALVAREZ: I think that, as Mr. Steel pointed out, the day after Wachovia--after WaMu failed, two events occurred. That was also the day that the legislation failed. And both of those things had a pretty dramatic effect on Wachovia.

The question though I think isn't so much whether it had a bad effect on Wachovia, but if we had stopped the failure of WaMu, or aided in WaMu, would have have changed circumstances with Wachovia? And I think that is where there is much more doubt. It is not clear that, if we were to have provided assistance to WaMu, that that would have prevented the problems that occurred at Wachovia.

COMMISSIONER HOLTZ-EAKIN: I'll reserve the balance of my time.

VICE CHAIRMAN THOMAS: Do you want two additional minutes?

COMMISSIONER HOLTZ-EAKIN: No. I'm going to come back later. Thanks.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Yes. Thank you.

Actually, I just want to follow up on that one comment. It does strike me that in this crisis it appears that the expectation of government intervention is so baked into the system that the two institutions that weren't saved, Lehman and then WaMu, triggered panic in the system.

It strikes me that, obviously in the wake of Lehman there's tremendous panic and the government now has to wade in with an $85 billion loan the next day. And in this instance, WaMu is not saved and the run begins really that afternoon and the next day on Washington Mutual.

Which brings me back just to my original point, which is it seems to me that it's so baked into the system that the focus should have been, in the past and in the future, on as the problem is growing, the risks are growing, the institutional scale is growing, that's where the focus needs to be. Because when you get to the tail end and there is panic, there appears to be no viable option but rescue.

Is that a fair observation?

WITNESS STEEL: I think that, yes, sir, the more challenging the situation, the fewer options you have. And another way to think about it, which is constant with the situation at Wachovia, was that as things became more challenging, some of the planned alternatives became more difficult to execute.

So, yes, sir, I think that prevention and a better diagnostic approach in advance certainly gives you more optionality on choices of paths.

CHAIRMAN ANGELIDES: And it seems to me that if you are going to have banks that are too-big-to-fail, then you need regulators who are tough enough to handle those banks of enormous scale.

Next would be Senator Graham.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman. It seems to me that the key question here is, will there continue to be the political support to do what has been done in the past few months, which is the intervene at the time of ultimate crisis.

Second, if that is suspect, that continuing political support, what are the fundamental ways to avoid reaching that point of extremis.

There are many Members--there are many candidates this fall for Congress who are running on a platform of no more bailouts, and are committing themselves not to support programs like the TARP Program, should they be elected to Congress.

Whether they will be a majority voice or not is unknown, but that voice is certainly going to be louder in the next Congress than it has been in the present Congress.

So if you assume that it is going to be more difficult to come to the assistance, and if the consequences of not coming to the assistance are as catastrophic as we have described, then it seems to me it puts a particular premium on figuring out how to avoid getting to that extremis.

There are at least a couple of options:

One is that those institutions which have the characteristics, whether they are size, complexity, interconnectedness, similarity, sort of the herd effect, should they be restrained somewhat like the Sherman Antitrust Act was used to restrain the growth of large industrial conglomerates at the end of the 19th and throughout the 20th Century?

Or, can we have a regulatory system that will be engaged at an early enough stage with these large, complex institutions to avoid them getting into extremis?

What is your sense as to is it possible to control these organizations of this size and complexity in their current form? Or will it necessitate fundamentally changing the system which has allowed these enormous institutions to evolve? I will start with Mr. Steel.

WITNESS STEEL: Thank you, Senator.

I think you provided two choices, and I believe that my perspective would be to support the second one. And that is, that we can develop the right tools, capabilities, so as to do a better job of regulating and managing these important institutions.

I believe that the idea of a size limitation, or interconnected limitation, or an importance limitation is less realistic. There are benefits that come from having larger institutions in terms of product offerings, economies of scales, and things like that. And the global nature of the world is such that many of their competitors have these characteristics.

So my view would be to favor the second of the alternatives you suggested. And I alluded earlier to whether it's a systemic perspective with regard to all of these institutions, whether it's the idea of living wills, or planning in advance with the regulators how a wind-down would occur, and what are the stress points. And whether it's a matter of regulators, as Mr. Alvarez said, having learned from the past and doing a better job going forward.

So that would be my instincts, sir, to the question.

COMMISSIONER GRAHAM: Mr. Alvarez?

WITNESS ALVAREZ: I agree with Mr. Steel, I think, and one of your early points, that it's going to take regulators with strong backbone going forward. We are not going to be able to stop crises from occurring.

On the other hand, we can prepare ourselves better for it and lessen the impact hopefully. And one of the ways to deal with that is by having strong regulation of the large institutions that are complex to make sure they assess the risk, they deal with the risk, they're prepared for the risk in a better way than they have been in the past.

I think also on the back end we are going to--we are trying a new experiment now. I think the Federal Reserve has not been, itself, happy with being in the middle of providing assistance to some large institutions.

My chairman has said that providing a loan to AIG was one of the worst experiences of his life. And so going forward, Congress has reassessed the tools. We won't be providing that kind of assistance anymore. And I think that sends a message to the industry itself that, you know, the idea that the Federal Reserve will be able to stand behind you and provide liquidity if you get into trouble is no longer present.

Now you have to confront, as management of an organization, you have to confront the likelihood, expectation, that if you're in trouble a new resolution will be in your future.

So it does require a lot of work, strong work on the front end. And then a different look on the back end.

COMMISSIONER GRAHAM: Someone mentioned that there will be some 50 regulatory initiatives required to fully implement the Dodd-Frank bill as it relates to this issue of intervention at the time of crisis.

WITNESS ALVAREZ: That's just 50 rulemakings at the Federal Reserve. That doesn't count the other federal agencies and what they have to do.

COMMISSIONER GRAHAM: Have any of those 50 been implemented to date?

WITNESS ALVAREZ: No. We are just a little over a month into it, but we have begun working in earnest.

COMMISSIONER GRAHAM: Which ones do you think the public should be most focused on as an indicator of whether the Federal Reserve will use this authority with sufficiently aggressive stance to avoid institutions in the future getting into extreme trouble?

WITNESS ALVAREZ: Well we will be seeking public comment on our rulemaking, so we will invite comment from the public.

The ones that I think are going to be most useful will be enhanced capital standards, enhanced risk management standards, a provision dealing with living wills, provisions dealing with the so-called Volcker Rule, the activities, derivatives activities and other proprietary exposures that can occur inside depository institutions and their affiliates.

We also will be doing a rulemaking on our lending authority and how it can be used in the future. All of those I think will be of prime interest to folks worried about dealing with the crisis going forward.

COMMISSIONER GRAHAM: Mr. Corston, you--excuse me, it was actually Mr. Steel commented that while you were still in the Treasury in 2007 you began to become concerned that there were some warning signals. Did I hear that correctly? Weren't there some warning signals before 2007?

We have heard, for instance, that in 2006 the rate of acceleration of home prices started to slow, and by the end of 2006 there were evidences of declining home prices; that foreclosures started to go up in 2006; that several of the subprime loan originators went bankrupt in 2006.

Those would all seem to me to be early warning signals that something--that some steps needed to be taken or we were going to be in the emergency room pretty soon. And the fact that they were not taken I think got us to the emergency room in the fall of 2008.

Why weren't those 2006 indicators enough to get the Treasury activated?

CHAIRMAN ANGELIDES: Mister--Senator Graham, two minutes to wrap up.

WITNESS STEEL: Well certainly there were, and especially in hindsight, some signs that housing was having some unusual activity, and that we were having challenges start to appear.

I can tell you that at that time in 2006 and early 2007 it was not our view that the prices would fall as much as they later did. And it was the subsequent significant decline in the asset prices that I think really was the fuel to the situation.

And so maybe we should have, or Treasury should have, or I should have seen more things coming, but at that time it didn't seem to have the trajectory that would take it as far as it did, or be as pernicious as it turned out to be.

COMMISSIONER GRAHAM: Do you think, if what I suggested that there's going to be an increased caucus that says no more bailouts, no more TARP, will that cause the Treasury and other regulatory and supervisory agencies to take a longer, or earlier look at what is going on in order to reduce the chances of getting to the point where the bailout would appear to be necessary, but may not be politically available?

WITNESS STEEL: To me, sir?

COMMISSIONER GRAHAM: Yes.

WITNESS STEEL: I would hope that would be the case. And I think Mr. Alvarez and I have shared--have turned out to have similar perspectives as to what some of those preventive steps might be, and whether it is stronger supervision by regulators and supervisors, increased capital, a systemic perspective with regard to risk, living wills that anticipate how one would deal with a winddown. Those are all the right types of things that I think could be beneficial.

COMMISSIONER GRAHAM: Thanks.

CHAIRMAN ANGELIDES: Thank you, Senator Graham. Mr. Hennessey.

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman. I think all my questions are for Mr. Alvarez. And if I could, they are actually about the other firm that we're talking about on the next panel, about Lehman.

So I was very interested in Mr. Fuld's testimony. So if I could, since I have you here, even though you're coming before him, I would like to ask you about the Lehman situation.

Your explanation before was very helpful about secured versus unsecured loans. Just to restate, as I understand it the Fed can only make secured loans?

WITNESS ALVAREZ: Correct.

COMMISSIONER HENNESSEY: Collateral is one form of security. But as I further understand it, the difference between the Bear Stearns situation and the Wachovia situation is that there were both buyers available, and there was security?

WITNESS ALVAREZ: Correct.

COMMISSIONER HENNESSEY: Is that the basic?

WITNESS ALVAREZ: That's basically--that's right.

COMMISSIONER HENNESSEY: Okay. Now I've heard numerous people say that the Fed chose not to act in the case of Lehman. I hear that over and over and over again. There is an implication that there was a viable legal option available for the Fed to prevent Lehman from going into bankruptcy, and that the Fed chose not to take it.

I've heard the Chairman say differently. In your view, was there a viable legal option available at the time to prevent Lehman from failing?

WITNESS ALVAREZ: So there was no acquisition. As you pointed out, there was no merger partner that came forward to acquire Lehman, as there had been in Bear

Stearns. A very big difference.

I think that if the Federal Reserve had lent to Lehman that Monday in the way that some people think without adequate collateral and without other security to ensure repayment, this hearing and all other hearings would have only been about how we had wasted the taxpayer's money. And I don't expect we would have been repaid.

That was not a situation the Federal Reserve wanted to be in, nor could we be in legally. So from my perspective there wasn't a legal option. It was of course--well, I think that's the answer.

COMMISSIONER HENNESSEY: Okay. Now I want to ask you a few things about Mr. Fuld's testimony.

VICE CHAIRMAN THOMAS: Could I just--when you said "Chairman," you were referring to the Chairman of the Federal Reserve?

COMMISSIONER HENNESSEY: Chairman Bernanke, correct.

VICE CHAIRMAN THOMAS: Okay, thank you. For the record.

COMMISSIONER HENNESSEY: Yes. In his written testimony, a couple of things stand out. This is Mr. Fuld's written testimony for the next panel. He says there was no capital hole at Lehman Brothers. And he said Lehman had adequate financeable collateral. Could you give your view, or your understanding of the Fed's view at the time on either or both of those points?

WITNESS ALVAREZ: So I think we believed on that Monday that--let me separate out two things. There's the broker dealer, and there's the rest of the Lehman Brothers. The broker dealer was a sizeable portion of Lehman, but the rest of Lehman was also very large.

We did in fact lend to the broker dealer through the week afterwards as it was going towards bankruptcy and the bankruptcy court then sold the broker dealer. But the broker dealer itself had adequate collateral and only needed a relatively small amount of funding.

The parent of Lehman Brothers, though, in order to operate, and from our experience with Bear Stearns, be the guarantee of all its obligations going forward, its liquidity had tremendously diminished. It may have had capital, but its assets, the value of its assets was declining rapidly. There were few people willing to deal with the company on any basis that didn't involve massive amounts of collateral, which they weren't able to post to deal with third parties.

So third parties were not funding the institution. For us to take on that obligation would have been to lend into a run of Lehman Brothers, at least so we believed, and lead to its collapse.

I can understand management would have a different point of view. They were working very hard to save the company. They had a plan to save the company and were trying to raise additional capital, and wanted more time.

It was just our estimation that we couldn't take that risk. We weren't going to be in a secured position and couldn't move forward.

COMMISSIONER HENNESSEY: Okay. Good. If I could, I want to follow up on the distinction between whether or not they were solvent and whether or not they were liquid.

I understand the point that everybody was losing confidence in them and Mr. Fuld's testimony suggests that there were basically rumors going around, and that people, including the Fed, had bad information about their liquidity situation.

What I am trying to understand is: Where they actually solvent at the time? Apart from the liquidity run, were there assets greater than the value of their liabilities? And I have gone through parts of the bankruptcy report which suggest that there were valuation issues, and everybody talks about everybody else losing confidence, but when you look at their balance sheet, were they solvent?

WITNESS ALVAREZ: So I am a lawyer as opposed to an accountant, so--

COMMISSIONER HENNESSEY: What was your understanding of the Fed's view at the time?

WITNESS ALVAREZ: And I think actually, having prepared for Wachovia and not reviewed the Lehman balance sheet in awhile, I would rather, if you could, if you asked that question to the next panel which is more prepared for it.

COMMISSIONER HENNESSEY: Okay, could I ask, could you get someone at the Fed to give us something in writing that describes what the Fed's view at the time was of their solvency to the extent that it can be separated out?

WITNESS ALVAREZ: Sure.

COMMISSIONER HENNESSEY: Mr. Fuld talks about a few actions that Lehman asked the Federal Government to do that the Government did not do. And, Mr. Corston, if you are a part of this answer as well, please jump in. He mentions three, specifically:

One is permitting Lehman to convert to a bank holding company;

Two is granting Lehman's Utah bank an exemption under Section 23(a) of the Federal Reserve Act to raise deposits;

And then the third is a ban on naked short selling. We'll skip that one.

Could you talk about either of those two?

WITNESS ALVAREZ: So the notion of Lehman becoming a bank holding company is one that Lehman explored through the early part of the summer. And it has benefits and costs. One of the big costs being supervision by the Federal Reserve and all the regulatory burden that comes along with that.

The problem I think turned out to be, at the time Lehman wasn't certain of the benefits. It was afraid that it would look like a gimmick. That it really didn't have any substance to it. And in fact, I think that the substance in--the real substance of the change to becoming a bank holding company and the perception are very different.

It is often thought that if a company becomes a bank holding company it has greater access to the Federal Reserve discount window. That's not true. It gains no additional access.

What it does gain, though, is some of the imprimatur from the Federal Reserve that it meets minimum financial standards, and that it is now supervised in the same way as other similarly situated bank holding companies.

But Lehman determined in the end that that wasn't enough of a benefit to cause it to take on the burden, so it didn't pursue that application.

COMMISSIONER HENNESSEY: If I could press you on that, you're saying that Lehman decided not to pursue it? Because his testimony says that they were not permitted to become a bank holding company, suggests that it was a 'no' from the Fed.

WITNESS ALVAREZ: So there was never an application filed by Lehman Brothers. There were preliminary talks. I know we at the Board did not tell Lehman that they would not be able to pass muster. So, you know, it's clearly a judgment management has to make. Management has to be willing to pursue that option and deal with the costs.

VICE CHAIRMAN THOMAS: Would you like an additional two minutes?

COMMISSIONER HENNESSEY: Yes.

WITNESS ALVAREZ: Then briefly on 23(a)--

COMMISSIONER HENNESSEY: 23(a).

WITNESS ALVAREZ: 23(a) would allow Lehman to transfer some assets that could have been originated by a bank but were not, were originated in the holding company, it could transfer those into the bank. It had an industrial loan company supervised by the FDIC.

It sought some 23(a) relief, but I don't recall--and John may have a better memory on this than I--that it sought any significant 23(a) relief there.

Of course one of the issues around 23(a) is: Are the quality of the assets being transferred to the bank going to put the bank at risk? The bank is insured by the FDIC. That's direct taxpayer exposure. So the agencies, the Federal Reserve and the FDIC, were very careful about allowing institutions to transfer riskier assets into the bank.

It is hard for me to believe that they would have gained enough liquidity from transferring assets from Lehman Brothers into the bank to have prevented the failure of Lehman, perhaps delayed it some period of time, but I doubt to solve the problem.

COMMISSIONER HENNESSEY: Okay, if I could, just in my remaining minute, his conclusion is, quote, "In the end, however, Lehman was forced into bankruptcy not because it neglected to act responsibly or seek solutions to the crisis, but because of a decision based on flawed information not to provide information with the support given to each of its competitors and other nonfinancial firms in the ensuing days."

Could you respond to that?

WITNESS ALVAREZ: So I think I can agree with the first half, but not the second half of that statement. I think the management of Lehman tried very hard to save the company. They raised capital in the Spring. They attempted to raise capital again in the Summer. They have a plan that they were in the process of implementing in September when they failed that would have downsized the company, selling off a bunch of assets and raising more capital. So management was trying very hard, and there should be no illusions about that.

I think they failed not because the government wasn't willing to help them, but because there was no--they were a victim of the circumstance and the economy, and some bad decisions that they had made through the years leading up to that that they didn't have time to unwind or get out of.

COMMISSIONER HENNESSEY: And if I could, 30 seconds, his phrase, based on--or "because of a decision based on flawed information," I believe means a decision by the government based on flawed information. Do you agree with that?

WITNESS ALVAREZ: I'm not sure what he's referring to. Our information flows are from Lehman, so I'm not sure what he had in mind there.

COMMISSIONER HENNESSEY: Thank you.

VICE CHAIRMAN THOMAS: Mr. Chairman?

CHAIRMAN ANGELIDES: Mr. Vice Chairman.

VICE CHAIRMAN THOMAS: Mr. Alvarez, if we provided you lunch would that be enough inducement to have you hang around for the second panel?

WITNESS ALVAREZ: Um--

VICE CHAIRMAN THOMAS: You don't have to answer that one. I would like an answer to the next question from actually all of the panel.

It's obvious that we're not going to be able to ask and follow up on any number of questions that we would have an interest in, and we will come to the conclusion after the hearing, as we've done with each hearing, that there were things we would like to have asked.

Would all of you be willing to respond back to us in writing if we send you some questions that we arrive at, in writing, after this hearing?

WITNESS ALVAREZ: Oh, most certainly.

WITNESS CORSTON: It would be my pleasure.

WITNESS STEEL: Yes.

VICE CHAIRMAN THOMAS: Thank you very much, Mr. Chairman.

CHAIRMAN ANGELIDES: Yes. I'm going to go to Ms. Murren, but one of the things, since Mr. Hennessey raised it, I think what I want to do at this point is, it will be the subject of the subsequent panel, but enter into the record a chronology which has been prepared by our staff of selected events related to Lehman Brothers and the possibility of government assistance, if I could enter that into the record with its attachments.

And the only observation I make, and I think we'll talk about it at greater length this afternoon, is--and, Mr. Alvarez, maybe you may want to stay after lunch--but I think it shows a relatively more complex picture. And I'm only going to make the observation that I did not, as I said, see anything in the chronology where a legal opinion was offered that would have stopped consideration of financial assistance, nor a collateral analysis by the Federal Government. And what you do see in this chronology is a recognition of the systemic problems that can arise if Lehman were to go bankrupt.

You do see discussion about the fact that there are tools and authority available. And clearly financial assistance is being considered. You also see political concerns about the bailout.

So what you see in this, it seems to me, is obviously a complex situation you're trying to deal with. And I am not sure at the end of the day, but we can examine it in greater fullness, whether in and of itself the legal bar was the sole constraint.

It looks as though there were a number of considerations--political, financial--at work here. Is that a fair statement? Because I never see, at some point even as far back as July, when there's consideration. For example, I think Mr. Dudley proposes a Maiden Lane type solution. I never see the Fed saying "can't do it; not legally possible."

And it doesn't seem to me the collateral value declines so precipitously in just 60 days.

WITNESS ALVAREZ: So of course through--

CHAIRMAN ANGELIDES: And I meant to hold this till later, but you're here and I'll just ask that one question before I go on.

WITNESS ALVAREZ: You will also have experts on Lehman this afternoon, and I think I will defer to them.

On the other hand, I can briefly add that we were doing role playing contingency planning all through 2008 with all kinds of institutions to try to learn how to think about these problems. Because we very seldom had much time to actually act.

And while it's often easy, and sometimes even fun, to create a solution when the pressure isn't on, when the facts are real and you understand really what your constraints are, a lot of times those scenarios that you dreamt up in the calmness of the summer aren't available and don't work.

So we had a few of those. And I think that it is not surprising to me, as the person who has to write memos, that on a weekend like Lehman we wouldn't have been able to write the kind of memos that you would like to see. We would like to have had the opportunity to write them, as well, but it just didn't happen.

CHAIRMAN ANGELIDES: I'll defer my questioning till this afternoon. Mr. Hennessey, you'd like a--

COMMISSIONER HENNESSEY: Yes, just to engage on this point here. I'm not sure what your question is. I mean, what we've heard is that--is that his judgment is that there wasn't a viable legal option. Okay, so they didn't write that down at the time. But as he's saying it was a busy weekend.

CHAIRMAN ANGELIDES: It was more than the weekend. And we can do it this afternoon, but I didn't see in the course of two to three months any expression in all the communications about there being any legal bar.

COMMISSIONER HENNESSEY: So is your question about the legality of it? Or about the Fed's analysis of whether or not there was sufficient collateral?

CHAIRMAN ANGELIDES: Whether that was the decision, whether it was a more complex decision than just we can't do it, legally.

COMMISSIONER HENNESSEY: Okay, but if--

WITNESS ALVAREZ: So I didn't mean to leave the impression it was a simple and not a complex decision. It clearly was. There were a lot of factors involved.

CHAIRMAN ANGELIDES: I mean, I guess, just to answer Mr. Hennessey's question, there are two issues that have been posited why we can't do this: the legal authority based on not enough collateral. And what I see an absence of in this chronology over two or three months is any focus on the legal bar; and any focus on the government on the inadequacy of the collateral.

Now maybe that came all together in the final weekend.

COMMISSIONER HENNESSEY: Right. I understand. And I guess what I'm getting at is, I'm not sure I understand sort of the other variables, because at least my experience at the time is if you don't have a legal option, you don't worry about the other consequences of the other aspects. You say, okay, that's not legal, what else can we do.

CHAIRMAN ANGELIDES: That's what I'm questioning, whether the legal constraint was really the bar here, or whether in fact there was a conscious decision to allow Lehman to fail, or a number of considerations that went into the mix from political, to financial, to strategic, versus just purely we can't do it legally. That's what I'm driving at.

COMMISSIONER HENNESSEY: Can I probe a little bit more? I mean, we're hearing from the General Counsel that it was his judgment that it was illegal. Are you questioning whether that judgment was right? Or whether that was actually how the decision was made at the time?

CHAIRMAN ANGELIDES: I think I'm questioning whether that was the totality of the decision. And particularly in light of the March 2009 decision, which seems to give the Fed enormous latitude.

So I'm just trying to get to what were all the factors that went into that decision. So--and again, we can defer the balance of this for this afternoon, but that's what I'm trying to drive to.

VICE CHAIRMAN THOMAS: Mr. Chairman, 30 seconds?

CHAIRMAN ANGELIDES: Without a prejudgment.

COMMISSIONER HENNESSEY: I don't understand the logic, but I won't press the point here.

VICE CHAIRMAN THOMAS: Speaking of legal options, I just want to put on the record a timely statement. Because in an investigation by Richard Delmar, counsel to the Inspector General of the Treasury Department, in the action that was taken by Treasury on Notice 83, he concluded there was, quote, "a legitimate argument that this constitutes overstepping by Administrative action," and coming from the IG of Treasury I consider those pretty strong terms in terms of what they're allowed to say and not to say.

So I guess some folk were considering playing, or coloring outside the box. And in fact they did.

CHAIRMAN ANGELIDES: Ms. Murren.

COMMISSIONER MURREN: Thank you, Mr. Chairman, and thanks to all of you for being here today.

I have a series of questions I would like to ask, just to make sure I understand with some clarity what's been said today, and also what we've read in your testimony.

It appears as though there really isn't a hard and fast list of rules, or criteria, or measures by which you determine if a firm is in fact going to pose a risk to the system should it fail; and that oftentimes that that determination is made not only based on the intrinsic characteristics of the enterprise, but also the environment that you're dealing with at the time. And it includes such things as investor, or market sentiment, which are very difficult to predict and also difficult to handicap.

Would that be fair?

WITNESS STEEL: Yes.

COMMISSIONER MURREN: Yes. With that in mind, then, taking the new rules, you all seem to have gained a lot of comfort with some of the new legislation that's passed about the ability that you will have in the future to be able to govern situations where firms may fail.

And I am curious about what would have been different if you were to apply the rules that we now have today at the time when you were looking at situations like Wachovia? So then how would your body of knowledge have been different? And how might the outcome have differed had we had those rules instead of what we had at the time?

Mr. Corston, if you could?

WITNESS CORSTON: One of the important pieces is, especially with complex institutions, is for our corporation to reach outside the insured institution to be able to address affiliates and holding companies.

A lot of institutions have highly risky business activities that take place across legal entities, so it crosses--such as broker dealer operations that influence banking operations also.

The ability to address an entity in total is, from a practical standpoint, something you can actually implement far easier in a complex institution than dealing with a specific insured entity which is very difficult to decouple from a holding company structure.

The really key piece is dealing with having the ability to have a living will produced by an entity to understand how they perceive they can be broken up, to be able to influence some behavior and, from the decisions they made with regards to being able to break up the entity, and for us to be able to set up some resolution planning behind those, those legal--or the living wills provides a few things.

It will provide kind of up-front time information, and some influence over some of these structures. So I think it does--it does provide some fairly powerful tools for us.

COMMISSIONER MURREN: So then if you were to have applied those tools in the past at Washington Mutual or at Wachovia, how would it have been different?

WITNESS CORSTON: Well, dealing with Wachovia we had a broker dealer outside the institution. So the ability to understand the interconnectedness of the broker dealer not only with the insured institution but with the various counterparties.

The ability to, under our qualified financial contract rule, to be able to get an understanding of all the interrelationships, financial contracts, ahead of time; and understand the magnitude of these various contracts would be a tremendous help.

And then also looking at the structure, and understanding that the ability to work the holding company through the bankruptcy code, as well as the insured entity and the impact and interconnectedness of both, and to plan for that would be a tremendous help.

COMMISSIONER MURREN: So then the outcome might not have differed, it just would have been a little bit easier as you went along?

WITNESS CORSTON: It might not have differed, but it certainly would have been--I think we would have made much more informed decisions.

COMMISSIONER MURREN: Thank you. Mr. Alvarez?

WITNESS ALVAREZ: So I agree with what Mr. Corston has said. We would have been able--some of the handcuffs would have been taken off on our supervision. We would have had more enhanced capital risk management, liquidity, and other requirements. Contingent capital is something that we'd be exploring, and that would be something that we hope in a crisis will be a useful tool. Living wills, definitely, to prepare for a crisis.

I think the greater effect of Dodd-Frank, though, would be in the other institutions that we've been mentioning today: AIG, Bear Stearns, Lehman Brothers. Those institutions I think would have been subject to higher capital requirements, more liquidity, better supervision, They would have had supervision. Many of them had no supervisory regime.

And so hopefully it would have--we wouldn't have gotten into this cycle that so many Commissioners have been worried about about starting to, you know, help an institution, Bear Stearns, and create the moral hazard that goes along with providing government assistance, and the expectations that that creates for other large institutions.

If we could break that cycle, I think we end the too-big-to-fail, as it were. Then that makes it easier to deal with a Wachovia, more natural to deal with a Wachovia, and hopefully less stress on a Wachovia.

COMMISSIONER MURREN: And also, from what you said then, some of the other firms would have been in a better financial position and might not have failed?

WITNESS ALVAREZ: Or if they weren't in a better financial position, would have been put into liquidation. That's right.

COMMISSIONER MURREN: Thank you. Mr. Steel, if you could comment on the financial position at Wachovia, applying again the rules that we have today backward, would the company's financial position have been dramatically different from what you can see?

WITNESS STEEL: Well I think if you--if we take the prism that's been suggested as part of the new regulation, certain parts of it certainly would have been constructive with regard to how Wachovia ran its business.

In particular, those things that I previously described as good-health type activities: stronger regulation; more engaged regulators and supervisors; living will for planning for resolution. I think it's very difficult and early to say with specificity what differences might have been, given the fact that so many of the rules related to this legislation have not yet been written.

And so I find that a bit of a leap that's uncomfortable, but I think that there's no question that a more robust regulatory supervisory regime, and a tighter lens on potential capital, would be positive.

COMMISSIONER MURREN: Thank you.

Thank you. I've exceeded my time, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you, Ms. Murren.

Ms. Born.

COMMISSIONER BORN: Thank you, Mr. Chair. We have heard a great deal on this Commission about how interconnections among financial institutions played a role in the government's decision to rescue institutions, or provide extraordinary government assistance.

And all of our largest commercial bank holding companies and investment banks were among the world's largest over-the-counter derivatives dealers at the time they received extraordinary government assistance, as was AIG.

There were millions and millions of these transactions in existence in mid-2008. They had a notional amount of over $680 trillion. Most of the institutions that were bailed out had extraordinarily large concentrations of these very large positions of these instruments. And I wanted to ask whether or not the derivatives positions of the institutions played any role in your agency's consideration of whether they should be rescued?

And maybe we should start with Mr. Alvarez.

WITNESS ALVAREZ: So most certainly AIG, the derivatives activities there, were a key factor in measuring both the risk to the institution and the interconnectedness of the institution.

I think derivatives for all institutions were one of the things that we looked at to understand the connections between an institution and others in the marketplace and its exposure, the result of whether an institution's failure would have ramifications broadly in the system.

Derivatives are one way of transmitting that kind of risk, as you are aware.

But with AIG in particular, they had a sizeable book of unhedged derivatives exposure that posed tremendous risk to them. It was collateral calls on that that was one of the sources of their financial difficulties, and the size of the book showed interconnections throughout the world with major institutions and governments and municipalities here in the United States as well.

So it was a big indicator of the risk of that institution failing.

COMMISSIONER BORN: Did the Federal Reserve have information on the derivatives interconnectivity of all these institutions?

WITNESS ALVAREZ: No, we did not. And that is a big gap in understanding the systemic effects of institutions, and one that I think the Dodd-Frank bill makes great strides to remedy.

COMMISSIONER BORN: How will it do that?

WITNESS ALVAREZ: It will do that in a couple of ways.

It creates the authority in the CFTC, the SEC, and the Federal Reserve to collect information about derivatives' exposures. It also requires more clearing of derivatives at central counterparties. And strongly organized central counterparties, which we think will reduce the risk.

The Federal Reserve also, as I'm sure you're aware, was involved several years ago in trying to have the industry commit more of its derivatives' exposure to paper in a more regularized way, and keep track of that.

Dodd-Frank takes another step in encouraging warehouses that will keep the information about contracts, and when they're due, and their various terms. So it takes a number of steps I think to improve the resilience of that part of the market.

COMMISSIONER BORN: Mr. Corston, is this a issue that the FDIC looks to in, number one, considering systemic risk; but secondly, in the process of resolution of a failing institution?

WITNESS CORSTON: It's extremely important. And I think one of the most important pieces of it is the transparency of the derivative positions in the contracts. And, as Mr. Alvarez has suggested, some of that is being dealt with.

But for us as a deposit insurer, our ability to understand these positions, the risk characteristics, and know them quickly is very important.

COMMISSIONER BORN: How does the FDIC handle the derivatives portfolio of a commercial bank when it fails, and the FDIC undertakes resolution?

WITNESS CORSTON: Not an area I directly deal with, but essentially the FDIC has to look at financial contracts and to determine whether a very short window, 24 hours, whether they want to keep a contract or not.

So our ability to understand really the position on a contract and whether it's advantageous to the receiver or not is very important.

COMMISSIONER BORN: Of course over-the-counter derivatives were deregulated in 2000 with the Commodities

Futures Modernization Act, and I'm sure that that made it more difficult for the agencies to have an understanding of the marketplace and to have the information about exposures of various institutions.

Mr. Alvarez, in your discussions with the Commission staff you've talked about the role that deregulation played in the marketplace, and perhaps in making the marketplace more fragile and exposed to the kind of crisis we had. Do you think that deregulation was a factor?

WITNESS ALVAREZ: Well I do. I think that there was a strong press for deregulation through the late '90s and most of the 2000 period, and I think that weakened both the resolve of the regulator and the attention paid by institutions to the risk management that it should have-- that the institution should have had.

Regulatory burden is important to watch. It is something the agencies need to be mindful of, particularly as it applies to small institutions, but the regulatory reduction we were doing across the board I think weakened our resolve at larger institutions, which was a mistake.

COMMISSIONER BORN: I would like to place in the record the transcript of Mr. Alvarez's interview with our staff on March 23, 2010. Thank you.

CHAIRMAN ANGELIDES: Thank you. Mr. Wallison.

COMMISSIONER WALLISON: Thank you, Mr. Chairman. And thank all of you for coming, and for the service that you all have done for our country over many years, and especially through the very difficult times you experienced in 2008.

I would like to turn attention to something that we haven't discussed here, and that is the decision to rescue Bear Stearns. To me this was in effect the original sin, because everything changed after Bear Stearns was rescued.

Among other things, participants in the market thought that all large firms, at least larger than Bear Stearns, would be rescued. Companies probably did not believe they had to raise as much capital as they might have needed because they probably thought they didn't have to dilute their shareholders because the government would ultimately rescue them, and fewer creditors were going to be worried about their capitalization.

The Reserve Fund probably did not think it had to eliminate from its balance sheet the commercial paper it held in Lehman because it thought Lehman would probably be rescued and it wouldn't have to suffer that loss.

Potential buyers of, say, Lehman probably thought they were entitled to get some government support, since the buyer of Bear Stearns, JPMorgan Chase, got government support. And finally, Lehman itself has said, Fuld has said that he thought Lehman would be rescued. And so he was likely to drive a much harder bargain with potential buyers.

So the decision on Bear Stearns was exceedingly important in analyzing this entire process. Mr. Alvarez, Mr. Steel, you were both I think probably involved in that. And I would like to get your thoughts.

First of all, one of the things that flowed from Bear Stearns was the question of moral hazard. And I would like to know whether in consideration, when you were giving consideration to whether to rescue Bear Stearns, any thought was given to the question of moral hazard, what that would do to the market in the future?

And secondly, since now regulators are expected to consider systemic issues when they examine or otherwise supervise financial institutions including nonbank financial institutions, I would like you to give us some indication of what you think a systemic risk is and how, apart from the circumstances at the moment, you would be able to define "systemic risk."

So if I may, can I start with you, Mr. Alvarez?

WITNESS ALVAREZ: Certainly. So yes there was consideration given to moral hazard. It was one of the things that actually I think made the decision at Bear Stearns and each of the decisions after that either to help or not to help an institution very difficult for members of the Board of Governors.

They were very worried about moral hazard, very worried that they would be viewed not as simply a lender of last resort but as the support for everyone.

I think that is one of the reasons that you see in the leadup to Lehman so much discussion about how there will be no government assistance, and Hank Paulson, Secretary Paulson at the time, in particular saying that there would be no government assistance, in part to try to negate the moral hazard that had been created by Bear Stearns.

It was also one of the reasons that the Chairman of the Fed, Chairman Bernanke, began calling for a resolution regime, because he needed and felt that we needed a more certain way to pass on losses to the shareholders, to replace management, to try a different avenue.

So moral hazard is something that we were very worried about in all of our situations.

COMMISSIONER WALLISON: So if I can interrupt, why then did you decide, to the extent that you can recapitulate everything that was on the plate at the time, why did you decide, given the consequences for moral hazard to which you were so sensitive, to rescue Bear?

WITNESS ALVAREZ: Because we thought at the time that if we didn't provide assistance to allow a merger of Bear, that--and I think we view that a little differently than a "rescue"; we facilitated the sale of Bear Stearns--that if we hadn't done that and Bear Stearns had collapsed at that point in 2008, the cost to the system would have been much greater than the cost of the moral hazard going forward.

COMMISSIONER WALLISON: How did you make that decision? What "costs" were you considering? And how could you actually add up all of those costs? What did you have in mind?

WITNESS ALVAREZ: I appreciate it's not, as has been probed today, there's no single number, or even a series of numbers that you can add up and be certain about. There's a lot of judgment involved. But in early 2008, if you recall, the financial system was under severe stress.

The Recession had begun. There was the various indicators of market activity that were showing that markets were closing. Funding was becoming shorter and shorter in term. In fact, I think Chairman Cox had testified that at that point, while the SEC's rules are based on the idea of liquidity based on collateralized borrowing, it never occurred to the SEC that there could be borrowing or even collateral wouldn't be sufficient. And that's the problem that the broker dealers found themselves in at the time.

So we were worried about a collapse of Bear, Lehman, Goldman, Merrill Lynch, all right in a row at that period of time and the consequences of that.

COMMISSIONER WALLISON: And you were able to assess those as very likely to occur?

WITNESS ALVAREZ: We were--so we were very worried that they would occur. We thought that the loan that we provided in connection with an acquisition of Bear Stearns would be repaid so that the Taxpayer, while subject to risk, would not actually take any losses.

It was the tool that Congress gave us to deal with these kinds of situations. So we also had to face the potential that we had a tool, didn't use it, there was a horrible effect, and the Federal Reserve stood by.

So weighing all those together, we decided to provide the credit.

COMMISSIONER WALLISON: Mr. Steel, could you provide any further information about what was in your mind? You were at the Treasury at the time, and probably the key official at the Treasury, other than the Secretary, who was concerned with issues of this kind.

WITNESS STEEL: Well I think that you're right--you're correct to suggest, as you did in your opening comment, that this in a way set us on a path that became increasingly challenging to manage, point one.

Point two, there had been entreaties earlier that year for government to get involved with weaker financial institutions, which we had chosen not to respond to. Monolines, other things like that. And the markets worked, and they recapitalized themselves, and their business model changed.

This was an especially difficult one for me. As you suggested earlier, I had spent almost three decades in the securities industry, and I viewed that securities firms were different than depository institutions. And that over my career I had seen people be successful, and people be unsuccessful, and the freedom to fail was part of the dynamic that characterized this segment of the financial services industry.

As--

VICE CHAIRMAN THOMAS: I yield the Commissioner an additional two minutes.

COMMISSIONER WALLISON: Thank you.

WITNESS STEEL: Excuse me. As Mr. Alvarez said, I think we drew a distinction--again, maybe it's too fine, but I think it's with a difference, or it was interpreted as a difference--that facilitating a merger with a loan that we fully expected to be repaid--or excuse me, the Fed fully expected to be repaid, because it's their decision--was appropriate, given the dynamic.

And there was, if my memory is correct, the PRI of Bear Stearns in the previous 12 months was 169-3/8ths, and when this transaction was going to occur, the original proceeds were $2. And so the idea that this was done without any pain, the company would change management, management would be--from Bear Stearns would leave; the shareholders would pay a significant price; and so the bridging to Bear Stearns with this loan seemed to be appropriate at the time.

COMMISSIONER WALLISON: But with all respect, the issue was not money here. The issue I've been trying to raise is the moral hazard consequences of going ahead with Bear Stearns. So the fact that the government was going to be paid back is not as significant as the fact that the creditors were actually rescued here and would, from that point on, have a completely different attitude toward what the government was going to do in the future than they might have had before Bear.

WITNESS STEEL: There's no question that that point is correct and fair. I didn't say in my answer that certainly we discussed this moral hazard issue. And given the benefit of hindsight and all the other things that happened subsequently, then you have to probe at this perspective to think about this.

COMMISSIONER WALLISON: Thank you for the additional time.

I will have other questions later, if there is time.

CHAIRMAN ANGELIDES: Mr. Thompson.

COMMISSIONER THOMPSON: Thank you, Mr. Chairman, and welcome gentlemen, and we do appreciate all of what you do for our country.

What is clear is that there appears to be no formulaic approach to dealing with too-big-to-fail. There is no standard approach by which you can calculate or determine whether or not an entity falls into that category. So it is very judgmental.

What is also clear from not just comments made by you but comments made by Chairman Bair and Chairman Shapiro was that this was in fact a huge--my word not theirs--failure in supervision, where in fact had some things been done on the front end we might have mitigated the crisis that we are now suffering through as a country.

Yet, each of you--at least two of you--have said that the Dodd-Frank Act has the potential to change the world and make things much better for our country the next time around.

So why are we, as Commissioners, or the American People, to believe that supervisory failures won't occur the next time around? That the Dodd-Frank bill may set some foundation for what regulations are going to be put in place, but we will fail once again to implement those regulations in practice?

Mr. Alvarez?

WITNESS ALVAREZ: So I think that supervisory failures come in two categories. There's those that are the result of regulators not doing their job well enough, and there's all of us who realize we could do our job better, and we want to do our job better.

But there are also supervisory, regulatory, statutory gaps. There are things that we just could not do no matter how much we wanted to do them. And that is where I think the Dodd-Frank bill is most important.

It plugs a bunch of supervisory gaps. It authorizes the regulators to look at all systemically important institutions. That authority didn't exist before. It authorizes us to take a systemic approach to supervision. Before we were constrained to taking a micro view of the safety and soundness of particular institutions.

So it takes off some handcuffs that were put on during the period of regulatory burden reduction to keep the regulators from doing too much in the supervision and regulation.

So all of those I think are important improvements to our ability to do a better job on the supervisory front.

I agree that there is no way to be certain that the regulators will get everything right, or do our jobs perfectly going forward. So there has to be changes at management of institutions. Their focus on their own risk management and how they deal with it, that's their responsibility as well and they have to deal with that better.

Investors have to do a better job of paying attention to what they invest in, not simply rely on a rating of somebody they don't know about an instrument they don't understand when they put that in their portfolio.

So there is blame to go all the way around. And while we deserve our part, and we'll deal with our part, I think for us to deal with a crisis more successfully going forward, everyone is going to have to chip in and do a better job than we did leading up to 2007.

COMMISSIONER THOMPSON: Mr. Corston?

WITNESS CORSTON: I think to add on to those, it broadens the focus to systemic issues and which the individual agencies didn't necessarily have a clear perspective on.

It recognizes that as these institutions have gotten larger and complex, it isn't just an insured institution in our case, but you're looking at holding company structures which you're going to have to address. And it also addresses the issue, the fact that, given the size of these institutions, there's upfront work that needs to be done with regard to establishing the living will process.

COMMISSIONER THOMPSON: Well no one wants to be the person that turned the lights out on the party, and there was a big party going on here called the bubble. And what changes have to happen in the management of the regulatory organizations such that they're willing to step up and turn the lights out?

(Pause.)

WITNESS ALVAREZ: So I--I'll take a start. I think the most--it's very hard to identify bubbles when they're happening. You don't know if it's--

COMMISSIONER THOMPSON: This one was pretty apparent to everyone, wasn't it?

WITNESS ALVAREZ: Well, I think--I think there was a real debate about whether this was--whether there had been a repeal of the business cycle and housing prices could go, increase for a long period of time and be sustainable, or whether there was to be an end.

And where the end would be was very much subject to debate. But I think, given the difficulty in identifying when the punch bowl needs to be pulled away, the most important thing we can do is to try not to set the conditions for the creation of a bubble.

So as a supervisor we think about making sure that institutions identify the risks that they're taking on, and how they are going to address those risks and reduce those risks. Making sure now that they understand not just how the risk affects them, but how the risk affects others in the market that they're dealing with.

So as an example, the originate-to-distribute model for mortgages was, from a very narrow point of view of a bank supervisor looking at safety and soundness, a very good approach. Because banking institutions were originating mortgages, helping the housing market, but not taking on the risk of those mortgages, selling them to investors who understood the risk and dealt with the risk.

Well as it turned out, they didn't understand the risk. They weren't dealing with the risk. And while the institution originating it wasn't taking on risk directly, it was creating weakness in the system that reverberated back on the institution itself.

Being able to have a systemic point of view about risk allows us to take steps to address those kinds of models, and hopefully identify them in advance, have the underwriting standards in this case improved, and perhaps take steps for investors to pay more attention to the risk.

So it allows a different perspective. And hopefully in that way allows us to reduce the conditions for bubbles so that they won't be as large.

I don't think there is anything we can do to prevent them all, or to identify everything in advance, and to prevent a crisis, but we can certainly do more now than we could before.

COMMISSIONER THOMPSON: Mr. Steel?

WITNESS STEEL: I don't think I have anything additional to add. I think that I would be unoptimistic that we are going to have regulation that will be perfect, and that we will not catch anything, or that--I just don't think that is realistic. So the idea of planning in advance as to how to think about how bubbles develop, and behavior develops, and then to do as much as you can to have the institutions take on more responsibility. And I think as Mr. Alvarez said, you have lots of responsibility by lots of different parties that wasn't discharged as we would wish.

And it basically goes with regulators. It goes with managements. It goes with individuals. And it goes with Congress. And they're all examples where everyone could have been more perceptive, more honest, and more forward thinking about these things.

COMMISSIONER THOMPSON: Thank you very much. Thank you, Mr. Chairman.

VICE CHAIRMAN THOMAS: Mr. Chairman, I want to associate myself with the "take the punch bowl away" position of Mr. Alvarez. Because if you turn out the lights, there was a whole lot going on in the dark.

(Laughter.)

VICE CHAIRMAN THOMAS: And that was one of the problems that we wound up having. So pull the punch bowl.

CHAIRMAN ANGELIDES: All right. I think we are at the appointed hour. Noon, straight up. So I want to thank this panel.

Are there any additional?

(No response.)

CHAIRMAN ANGELIDES: All right, I want to thank this panel--one question, Mr. Wallison?

COMMISSIONER WALLISON: I'd like to ask one or two.

CHAIRMAN ANGELIDES: Well why don't you ask one, and then we'll wrap on down. And Mr. Thomas has another--Mr. Thomas, do you want to yield that?

VICE CHAIRMAN THOMAS: Oh, sure.

CHAIRMAN ANGELIDES: Another minute, then we'll wrap up. Why don't we do one question, and then we'll put it to bed.

COMMISSIONER WALLISON: I have so many questions. This question I think is for Mr. Corston. We've looked at

Citi, and at the time we looked at Citi it looked like a pretty weak institution in 2008. It didn't seem to improve much between--after 2008, a little bit. But the question that is bothering me is: The FDIC approved the idea of Citi, which we near insolvency itself as many people said, to pick up another institution that was also weak in the form of Wachovia.

I don't understand how that decision could have been made. What was in the minds of the people at the FDIC who unanimously agreed to do that, to take an already large and seemingly confused institution like Citi and graft onto it another institution that the market had already concluded was, if not insolvent, at least in seriously illiquid conditions? Can you explain that?

WITNESS CORSTON: That's a great question. When we--

CHAIRMAN ANGELIDES: See if you can explain it in 30 seconds--no.

WITNESS CORSTON: I'll do 30 seconds.

CHAIRMAN ANGELIDES: As quickly as you can.

WITNESS CORSTON: When you look at Wachovia, and you look at Citi, Citi had a largely wholesale funding structure and not a very large retail deposit base. What Wachovia had was a fairly decent retail franchise, albeit with some wholesale funding and certainly some baggage that would have gone along with it.

The thought was, to be able to incorporate the two would allow to stabilize some of the funding structure at Wachovia and add some core funding structure at Citi at the same time. So it's taking two institutions that had some financial weaknesses, but there were some synergies that actually could--they could grow off of and actually build some strength within them. But certainly your concerns are very well--

COMMISSIONER WALLISON: Thank you.

VICE CHAIRMAN THOMAS: Mr. Chairman, to conclude once again, when we said that we should take the punch bowl away and it would be the regulators who took it away, we meant that you were supposed to dump it out and now continue the consumption at the regulation stages. I think that was a question that we would be very concerned about. But of course you were relieved of it by Treasury/IRS making a decision which I think was frankly outside the bounds. I think I said that.

CHAIRMAN ANGELIDES: Yes, you have. All right, members. Thank you very much, panel members. And to the Members of the Commission and the public, we will come back here at 12:25, a little behind schedule but close enough to catch up.

(Whereupon, at 12:05 p.m., the Commission meeting was recessed, to reconvene at 12:28 p.m., this same day.)

AFTERNOON SESSION

(12:28 p.m.)

CHAIRMAN ANGELIDES: The meeting of the Financial Crisis Inquiry Commission will come back into order. We are now going to start session two for today as part of our hearing on institutions that are too big or too important to fail.

This afternoon's panel is about Lehman Brothers. I want to welcome the panelists. Thank you for coming here today. We will start today's proceedings, as we always do, by asking all of you to please stand up to be sworn in. And if you would please raise your right hand, and I'll read the oath: Do you solemnly swear or affirm under the penalty of perjury that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MR. BAXTER: I do.

MR. FULD: I do.

MR. MILLER: I do.

MR. ZUBROW: I do.

(Panelists sworn.)

CHAIRMAN ANGELIDES: Thank you very much, gentlemen. We thank you for your written testimony, and now we look forward to your oral testimony.

To each of you, we are asking that each of you speak for up to five minutes. As I indicated earlier this morning, in front of you will be a set of lights. When there's one minute remaining, the green light will turn to yellow. And then at five minutes it will turn to red. And if you would turn your microphones on when you do give your testimony.

And with that, since I went left to, my left to my right this morning, I am going to go the other way this afternoon, just to show the amazing nonpartisan, bipartisan nature of this Commission, and I am going to start with Mr. Zubrow and ask that you open the testimony today.

WITNESS ZUBROW: Thank you very much, Chairman Angelides, Vice Chairman Thomas, Members of the Commission:

My name is Barry Zubrow. I am the Chief Risk Officer of JPMorgan Chase, and have served in that role since I began working for the bank in December of 2007.

Thank you for the invitation to appear before the Commission today. You have asked me to address several topics related to JPMorgan, including our triparty repo program generally, and our relationship with Lehman Brothers in particular.

JPMorgan is one of two major banks providing triparty repo clearing services in the United States, and we serve as triparty agent for Lehman's broker dealer subsidiary.

At the beginning of each trading day in a process known as "the unwind," JPMorgan would advance Lehman the cash needed to buy back securities Lehman had sold to investors the night before. These advances were entirely discretionary and meant to be fully collateralized by the securities being repurchased.

On a typical day during the summer of 2008, these advances exceeded $100 billion daily. As of late 2007, JPMorgan generally took no margin, or "haircut," on these large discretionary loans we made to Lehman each morning.

This magnified the risk that JPMorgan would be unable to recoup the full amount of our advances if the collateral had to be liquidated. I consultation with the Federal Reserve, shortly after the near-collapse of Bear Stearns in March of 2008, we began taking margin on the interday advances made to all of our broker dealer clients.

In addition, JPMorgan executives held a high-level meeting with Lehman in June of 2008 to discuss the unique risks we faced from the unwind, and the interday extensions of credit to Lehman, and identified a multi-billion dollar collateral shortfall.

Lehman executives agreed to pledge additional collateral to JPMorgan then in the form of securities. By late August and early September 2008, Lehman's deteriorating financial condition was becoming increasingly apparent.

Nevertheless, we were determined to support Lehman by continuing to unwind the triparty repo book each morning and otherwise acting on a business-as-usual basis.

But our growing exposure to Lehman also included derivatives transactions for prime brokerage clients, and requests by Lehman's derivative counterparties for novations.

JPMorgan and Lehman understood that Lehman's credibility in the markets could collapse instantly if JPMorgan declined to take on this additional exposure.

To protect ourselves without triggering a run on Lehman, we requested $5 billion in additional collateral, an amount which was far from sufficient to cover all of our potential exposure to Lehman, but that we believed Lehman could reasonably provide.

On September 9th, Lehman agreed to pledge additional collateral and delivered approximately $3.6 billion over the next few days. An analysis performed around September 11th of 2008 indicated that some of the largest pieces of collateral that Lehman had pledged were illiquid, could not reasonably be valued, and were supported largely by Lehman's own credit.

This was inappropriate collateral because it was essentially claims against Lehman pledged to secure other claims against Lehman. For this reason, as well as the increasing risk in continuing to support Lehman as that week progressed, we requested an additional $5 billion in cash collateral. This amount was still less than what we believed could be justified as a risk management matter, but it was an amount that we also believed, based on their own statements, that Lehman could handle.

Not withstanding our efforts to provide support to Lehman in the marketplace, a run on the bank eventually ensued for reasons wholly unrelated to JPMorgan. However, JPMorgan never turned our back on our client. We continued to make enormous discretionary extensions of credit to Lehman, and to trade with the bank directly and for the benefit of prime brokerage clients, as well as to accept novations.

Even after Lehman filed for bankruptcy, JPMorgan continued to extend many tens of billions of dollars of credit to Lehman on a daily basis, allowing the broker dealer to stay afloat long enough to sell its business to Barclays Capital and transfer more than 100,000 customer accounts.

As a result of our continuing support to Lehman, JPMorgan ended up with nearly $30 billion in claims against the bankruptcy estate. More than $25 billion of those claims arose out of exposure that JPMorgan took on after the Lehman bankruptcy filing, as part of our efforts to support

Lehman in these increasingly distressed markets.

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

CHAIRMAN ANGELIDES: Thank you very much, Mr. Zubrow. Mr. Miller.

WITNESS MILLER: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Microphone, please.

WITNESS MILLER: Thank you, Mr. Chairman. I appreciate the opportunity to testify before this Commission. My name is Harvey Miller. I am an attorney and a partner in the Law Firm of Weil, Gotshal & Manges, which is the major law firm involved in the bankruptcy case of Lehman Brothers.

My role is to present the circumstances surrounding the commencement of a bankruptcy case by Lehman Brothers Holding, Inc., on September 15, 2008. It would be virtually impossible to summarize in five minutes my written testimony, but I will try to do the best I can.

The commencement of the formal bankruptcy case was totally unplanned. Bankruptcy was never in the contemplation of Lehman as it struggled through the economy's financial slowdown during 2008, and was subjected to the negative effects of the collapse of Bear Stearns and Co., in March of that year.

At the time of the bankruptcy filing, the Lehman enterprise represented the fourth largest investment banking firm in the United States. The consolidated enterprise had reported assets of over $6 billion and liabilities close to that amount.

The Lehman enterprise was global. It operated pursuant to a classic holding company structure. Lehman Brothers Holdings was the parent corporation. It managed and directed the affairs of the subsidiaries and affiliates.

While Lehman had over 8,000 subsidiaries, approximately 100-plus were active and engaged in the business. Lehman had offices in every major financial center in the world. Lehman's business included derivatives, commercial loans, underwriting, real estate, bank ownership, and broker dealer operations.

At the time of the filing, the enterprise employed approximately 26,000 people, persons. Over 10,000 employees were located in New York City. Each day the enterprise engaged in thousands of transactions involving the movement of billions of dollars.

The parent corporation acted as a bank for the Lehman enterprise. Generally each night all cash from operations was swept into cash concentration accounts at the holding company, and each morning cash would be disbursed to various subsidiaries and affiliates as needed.

Lehman's cash needs were supported by substantial borrowings. A large portion of those borrowings were short-term, which negatively affected Lehman's ability to refinance as the economy slowed and was adversely impacted by the expanding subprime mortgage crisis that began in 2007.

Lehman's liability depended to a large extent on the confidence of the financial markets and the public. Any disclosure of bankruptcy consideration would have been disastrous to its continued operations.

Public comments made after the collapse of Bear Stearns by various hedge fund spokesmen and others as to Lehman's alleged insolvency and vulnerability to bankruptcy had a negative effect on Lehman.

During the week preceding September 15, 2008, Lehman's financial condition materially deteriorated and was aggravated by the announcement of negative quarterly earnings. As that week progressed, Lehman's situation became more precarious. Lehman was being bombarded by demands of its clearing banks for additional collateral security and guarantees or face loss of clearing facilities.

Lehman was confronting a major liquidity crisis. Substantial pressure had been applied and was intensified to find a major partner--a merger partner or a sale to resolve its financial distress.

During that time, negotiations were ongoing as to a possible merger or sale involving Bank of America or, alternatively, Barclays. My involvement as a bankruptcy and reorganization attorney occurred during the week of September 8, 2008, when my firm was first contacted as to potential bankruptcy planning if an alternative transaction or other financial support was not forthcoming.

At that time, almost all senior Lehman personnel were involved in the merger or sale discussions and, as a consequence, there was no direct contact with Lehman personnel.

The direct personnel contact began during the evening of Friday, September 12th, when there was a meeting at Lehman with representatives of the Federal Reserve Bank of New York to get a determination as to the liquidity of Lehman.

That meeting, which was attended by a large portion of the financial staff of Lehman, included the CFO, and it was reported at that meeting that Lehman would not be able to give a complete picture on its liquidity until the close of all the markets and all the information came in from its global offices so that the conclusion would not be available until late that evening or that night, or Saturday morning.

The events that followed after that were very dramatic, including meetings over the weekend at the Federal

Reserve Bank of New York. The net of those meeting was a decision that was made, and Lehman was told that there would be no federal assistance, and essentially suggested or directed that the Lehman representatives return to the Lehman headquarters, cause a meeting of the board of directors to be convened, and that Lehman should adopt a resolution to commence a bankruptcy case before midnight of that day.

That was an impossible task, but after consideration of the inevitability of bankruptcy because of the lack of liquidity, a bankruptcy petition was filed at 2:00 a.m., electronically, with the United States Bankruptcy Court for the Southern District of New York.

There were many events and many facts that went into what occurred, and the systemic consequences that resulted during the following week. I am very pleased to have the opportunity to answer questions that the Commission may have, and I refer to my written testimony as to the circumstances which surrounded the filing of the bankruptcy petition and my conclusions or opinions as to why that decision was made by the regulators.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you, Mr. Miller. Mr. Fuld.

WITNESS FULD: Chairman Angelides, Vice Chairman

Thomas, and Members of the Commission, thank you for the invitation to appear before you today.

Lehman's demise was caused by uncontrollable market forces and the incorrect perception and accompanied rumors that Lehman Brothers did not have the capital to support its investments. All of this resulted in the loss of confidence which then undermined the firm's strength and soundness.

Those same forces threatened the stability of other banks, not just Lehman, but Lehman was the only firm that was mandated by government regulators to file for bankruptcy. The government then was forced to intervene to protect those other firms and the entire financial system.

In March 2008, Bear Stearns nearly failed. I believed then and still do now that had the Fed opened the window, the financing window, to investment banks just before the Bear problem, that decision might have provided the necessary liquidity to keep Bear Stearns operational and, more importantly, might have lessened the need for additional government intervention.

With Bear Stearns gone, Lehman as the next smallest investment bank became the focus of the marketplace and was subject to increasingly negative and inaccurate market rumors.

Critically, in 2008 Lehman reduced its total exposure to less liquid assets by almost 50 percent, going from approximately $126 billion to $69 billion. We further strengthened our capital and liquidity positions by raising $10 billion of new equity, and pursued a wide variety of new capital opportunities.

During that same period, Lehman proposed to government regulators converting to a bank holding company and imposing a ban on naked shortselling. Both of those requests were denied for Lehman, but granted for other investment banks shortly following Lehman's bankruptcy filing.

Unfounded rumors about Lehman continued to besiege the firm and erode confidence. An investment bank's very existence depends on confidence to consummate transactions, to pledge collateral, and to repay loans. Without that confidence, no bank can function or continue to exist.

This loss of confidence in Lehman, although unjustified and irrational, became a self-fulfilling prophesy and culminated in a classic run on the bank starting on September 10th, 2008, leading to that Sunday night when Lehman was mandated by government regulators to file for bankruptcy.

Notably, on that same Sunday the Fed expanded for investment banks the types of collateral that would qualify for borrowings from its primary dealer credit facility. Only Lehman was denied that expanded access.

I submit that, had Lehman been granted that same access as its competitors, even as late as that Sunday evening, Lehman would have had time for at least an orderly wind-down or an acquisition, either of which would have alleviated the crisis that followed.

There are a number of completely incorrect claims which have been held up as explanations for the demise of Lehman Brothers. To this day, these incorrect claims still persist in the public domain. Just because those incorrect assertions are repeatedly made, that does not make them true.

I highlight some of these claims only because I believe this committee needs to hear what is true.

First, there was no capital hold at Lehman Brothers. At the end of Lehman's third quarter, we had $28.4 billion of equity capital. In contrast to the false market rumors about Lehman's mark-to-market determinations, even the Lehman Bankruptcy Examiner found immaterial differences in the firm's asset valuations, ranging from a low of $500 million to a high of $1.7 billion.

Assuming that full $1.7 billion in additional writedowns as estimated by the Examiner, Lehman still would have had $26.7 billion in equity capital. Positive equity of $26.7 billion is very different from the negative $30- or negative $60 billion holds claimed by some.

Second, Lehman had adequate financeable collateral. Many people to this day do not know that on September 12th, the Friday night preceding Lehman's bankruptcy filing, Lehman financed itself and did not need access to the Fed's discount window.

In addition, on that Monday, September 15th, Lehman's broker dealer subsidiary borrowed about $50 billion from the New York Fed by pledging acceptable collateral. The Fed was paid back 100 cents on the dollar.

What Lehman needed on that Sunday night was a liquidity bridge. We had the capital. In the end, however, Lehman was forced into bankruptcy not because it neglected to act responsibly or seek solutions to the crisis, but because of a decision based on flawed information not to provide Lehman with the support given to each of its competitors.

In retrospect, there is no question we made some poorly timed business decisions and investments, but we addressed those mistakes and got ourselves back to a strong equity position with a tier one capital ratio of 11 percent.

We also had financeable collateral, and we also had solidly performing businesses. There is nothing, nothing about this profile that would indicate a bankrupt company.

Let me just end by saying that I am proud to have spent my entire business career of over 40 years at Lehman Brothers, and I am more proud to have been its Chairman and CEO for its last 14 years.

I thank the Commission for its time and I look forward to addressing any questions.

CHAIRMAN ANGELIDES: Thank you, Mr. Fuld. Mr. Baxter.

WITNESS BAXTER: Chairman Angelides, Vice Chairman Thomas, Members of the Commission:

Thank you for the opportunity to speak about the events that brought Lehman Brothers to bankruptcy, events that occurred during 2008 when our Nation was in the midst of the worst financial crisis it has experienced since the Great Depression.

I would like to start with a question that I'm often asked about Lehman. Why did you allow Lehman to fail?

It's an understandable question, but it contains a false premise. The Federal Reserve did not "allow" Lehman Brothers to fail. Instead, the Federal Reserve, the Treasury Department, the SEC, and others tried incredibly hard to save it to avoid the harmful systemic consequences that we have seen.

In my written testimony I discuss in greater detail the Federal Reserve's actions to address the Lehman problem. Now, given time limitations, I will focus on two matters.

First, we needed a suitable merger partner for Lehman.

Second, we needed that merger partner to provide a guarantee similar to the one that JPMorgan Chase provided in its acquisition of Bear Stearns wherein the acquiring institution agreed to backstop Lehman's trading obligations between the signing of the merger agreement and the merger closing.

By Sunday, September 14th, at the government's request a group of Lehman creditors and counterparties had agreed to finance approximately $30 billion of Lehman's illiquid assets to facilitate a Lehman rescue.

An indispensable element of the plan, however, as Secretary Geithner and others have pointed out, was a willing and capable merger partner. As of that Friday, there were two candidates: Bank of America and Barclays.

On Saturday, September 13th, Bank of America reached an agreement to acquire Merrill Lynch, thus leaving Barclays as the only potential acquirer with the resources and ability to merge with Lehman.

On Sunday, September 14th, with the consortium financing committed, we learned for the first time that

Barclays could not deliver the needed guarantee without a shareholder vote, which could have taken months, and there was no way to predict if the shareholders would even vote for the transaction to proceed.

Lehman simply didn't have the luxury of that amount of time. I explored with counsel whether the UK Government or the Financial Services Authority might waive this requirement so the guarantee could go forward and the rescue could proceed.

I learned at the UK Government was not amenable to a waiver. Thus, Barclays ceased to be the capable buyer that we needed to rescue Lehman, and we had no other suitors.

This guarantee was indispensable to Lehman's rescue. Our experience with Bear Stearns is most instructive. With Bear we had a willing and capable acquiring party, JPMorgan Chase, that guaranteed Bear's trading obligations from the merger announcement in March of 2008 to the merger closing in June of 2008.

This kept Bear as a going concern and provided the necessary protection to counterparties during one of the most vulnerable periods in any transaction, the period between merger contract and merger closing.

If during that critical period a merger falls apart because of a failed shareholder vote, for example, the counterparties will not be protected against the obvious risk of the target's bankruptcy. Many have asked why the Federal Reserve did not intervene and guarantee the trading obligations of Lehman pending its merger with Barclays.

They observe that we lent approximately $29 billion to facilitate the merger of JPMorgan Chase and Bear Stearns, and they look at our commitment to lend up to $85 billion to AIG.

Under the law, the New York Fed does not have the legal authority to provide what I would characterize as a 'naked guarantee,' one that would be unsecured and not limited in amount. Lehman had absolutely no ability to pledge the amount of collateral required to satisfactorily secure such a Fed guarantee.

Finally, without security a guarantee of this kind would present enormous risk to the American taxpayer. Upon a Lehman default, the taxpayer would be liable for Lehman's trading obligations.

In the end, no rescue was affected because we had no willing and capable merger partner.

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

CHAIRMAN ANGELIDES: Thank you very much, Mr. Baxter. We will now start with the questioning.

Mr. Fuld, I am going to start with you. In your written testimony you indicated that Lehman's demise was the result of turbulent market conditions. But would you stipulate at the start, given the growth in your institution, the extraordinary leverage, the nature of the assets, that also the risks taken by the institution also led to its demise?

WITNESS FULD: Let me try to talk to that. You're asking me specifically how did we grow, and what was the basis upon which we grew and thereby increasing risk?

CHAIRMAN ANGELIDES: And I'm talking about your leverage ratios, which of course exceeded 30 to 1 by 2007, 39 to 1 plus intangible equity, tangible assets to tangible equity; the risk profile of the institution plus the enormous growth. I mean asset growth from about $200 billion I think, or $224 billion in 2000 to about $691 billion in 2007. Just the risk profile, your aggressive risk posture.

WITNESS FULD: I would--I would say that the aggressive risk posture is not an accurate depiction of how we ran Lehman Brothers.

Our balance sheet certainly did grow. It grew as we gained and increased earnings, which then became net work and equity capital. We did in fact, in 2007, run a higher leverage ratio. At least half of that was our match book. Please remember that we were one of the largest government dealers maybe even in the world. And that match book was a series of short-term contracts to finance our clients that bought governments and other securities.

Having said that, we did in fact have too much commercial real estate, as I have spoken about before. We had about $129- to $130 billion of what I called "less liquid assets," which included about $50 billion--maybe a touch more--of commercial real estate. We brought that down to $30 billion.

We had $45 billion of leverage loans, which we brought down to about $9 billion. We had about $35 billion of residential mortgages, which we brought down to about $17 billion, and actually $4 of that $17 billion was sold to BlackRock just prior to our filing, which never got consummated.

So all in all, we had about $130 billion. We brought that down to about $69 billion. We brought our leverage down by increasing our capital, by taking $25 billion of writedowns, and by selling a lot of these less-liquid assets.

We de-risked our positions. So that by the time we got to the third quarter, we had a Tier One capital ratio I believe was close to 11 percent, which by a number of standards is fairly solid.

We had a strong liquidity pool, which

unfortunately evaporated in three days after the run on the bank ensued. And we believe, and I believe clearly to this day, that our actions that included bringing down the balance sheet, raising capital, pursuing solutions with the regulators about asking for bank holding company status, trying to pursue either capital providers or actual buyers of the firm, that we pursued everything we possibly could have to have prevented what occurred on that September 15th.

CHAIRMAN ANGELIDES: All right, let me ask you a quick question, or a couple of quick questions, kind of 'yes/no' and your best recollection.

Were you ever told by federal officials that there was no authority under 13.3 to lend to you, or to provide liquidity pre-bankruptcy? Were you told that that was the bar?

WITNESS FULD: I never had that conversation, to my recollection.

CHAIRMAN ANGELIDES: All right. Are you aware of any collateral analysis that was done by the Federal Government, by the Federal Reserve Board of New York, by other federal entities in terms of the inadequacy of your collateral? Were you ever in a sense presented with their assessment of your collateral, and insufficiency thereof?

WITNESS FULD: Not specifically our collateral, but we did have three meetings with the Federal Reserve Bank of New York that reviewed our funding capabilities, whether that involved collateral I assume that that was--

CHAIRMAN ANGELIDES: Are these the stress tests you're talking about?

WITNESS FULD: Well the stress tests were in fact after our filing. These were, these were funding reviews. I actually participated in all three of them. There were different other people that participated. Our CFO, our treasurer, our Chief Legal Officer, but we had three of those. I forget the dates offhand, to tell you the truth, but it was June, July, maybe earlier. Never did I get any feedback on those, and certainly no negative feedback.

CHAIRMAN ANGELIDES: All right. Earlier today we entered into the record a chronology prepared by our staff that had supporting documents, so let me just quickly make a couple of notations I want to ask you and Mr. Baxter about.

First of all, if you look at this chronology, which you lived so you don't have to review, gentlemen, but it starts in March with the rescue of Bear Stearns, the acquisition of Bear Stearns by JPMorgan, and concludes just after the bankruptcy filing.

And here's what I take from it. It's obviously very hard, as the Vice Chairman said. We're looking back and trying to discern what happened in the moment. But obviously what the Federal Reserve has said is that assistance was not extended. I'm trying to get to what was the policy decision. What was the strategic decision, the why, of not assisting Lehman, or not assisting in a way where there could be a more orderly wind-down.

And when I look at this chronology, at least my first takeaway from this, is that it seems to me that over a period of months what ends up being made is a conscious policy decision not to rescue the entity. At least that's my reading of the documents.

It seems to me during the course of this time that there was financial assistance considered with no legal bar being offered up. For example in July Bill Dudley is talking about a Maiden Lane type of facility.

In July also there's discussions about the willingness to provide funding under the PDCF if JPMorgan does not unwind transactions. There are a number of points along this chain where, for example, as late as September 10th Fed Assistant General Counsel Mark Vanderweed e-mails Scott Alvarez, and he basically says that the working groups have been directed to flesh out how a Fed-assisted B-of-A acquisition transaction might look.

According to the Bankruptcy Examiner, Mr. Geithner told the Lehman Bankruptcy Examiner that he told the FSA that government assistance was possible as late as September 11th.

There was a e-mail from Mr. Parkinson that refers on September 11th to a Federal Board of New York financial commitments. So it looks as though at least it is on the table, albeit with substantial debate.

It also looks like there's political considerations at play. Mr. Wilkinson, who is the Treasury Chief of Staff, says on the 9th of September that, quote, he, quote, "can't stomach us bailing out Lehman. It will be horrible in the press."

And there's another e-mail from Mr. Wilkinson saying, on the 14th: Doesn't seem like it's going to end pretty. No way government money is coming in. I'm here writing the USG COM's plan for an orderly wind-down. Also just did a call with WH, which I assume is White House, and USG is united behind no money. No way in hell Paulson could blink now.

So I see consideration of financial assistance, political considerations. There's a recognition of systemic problems. But in the end, there's no rescue. So I want to ask you. Do you believe it was a conscious, strategic, and political decision? Do you believe it was a result of just the surprise of Barclays not happening?

What do you think was at the nub of the decision not to rescue or provide liquidity for an orderly wind-down? Mr. Fuld? And then I'd like to ask you, Mr. Baxter.

WITNESS FULD: I apologize. I thought you were addressing that question to Mr. Baxter.

CHAIRMAN ANGELIDES: Do you want me to repeat it all--no.

WITNESS FULD: That was a lot, and you said a lot. I was not privy to that information that you just went through. I was not part of the conversations over the weekend.

For us it was less about--and I understand all the noise about crisis and bailout and moral hazard. Lehman had the capital. We needed the liquidity. We went into that last week with over $40 billion of liquidity. We lost close to 30 of it in three days. It was a classic run on the bank.

We needed the liquidity. I really cannot answer you, sir, as to why the Federal Reserve and the Treasury and the SEC together chose not to not only provide support for liquidity, but also not to have opened the window to Lehman that Sunday night as it did to all of our competitors.

And I must tell you that when I first heard about the fact that the window was open for expanded collateral, a number of my finance and treasury team came into my office and said we're fine. We have the collateral. We can pledge it. We're fine. Forty-five minutes later, they came back and said: That window is not open to Lehman Brothers.

CHAIRMAN ANGELIDES: Yes, that's in the chronology. All right, Mr. Baxter, let me follow up on this.

You see political considerations in this timeline. You see a debate about financial assistance. I never see anyone say during the months, we can even consider financial assistance because the condition of Lehman won't allow it. And I'm assuming that the kind of valuation of the assets didn't so precipitously drop in a matter of days so as to change the collateral equation.

But I also see in this chronology that Mr. Hoyt at Treasury actually says on July 11th, the Fed has plenty of legal authority to provide liquidity. And if we choose not to, which I doubt we would, but he talks about the authority, and then also there's assessments in here about impact, about an acknowledgement that, for example, it would be much more--this is a September 11th memo from Jason Mu to Mr. Bernanke saying it would be a much more complex proposition to unwind Lehman's positions than Bear Stearns because Lehman has twice as many positions. There's a number of other studies in here that said, look, there's going to be tremendous impact.

The size of the triparty repo book was much larger than Bear's, about $182 billion versus $50 to $80 billion.

Tell me all the policy considerations that go in? Or was it that from day one you were saying legally not possible? Because it sure looks like there's a heck of a lot of debate, a hell of a lot of debate here, about whether or not to rescue, whether or not to provide for an orderly transition, and none of this was cut off by a legal opinion and said not possible.

And we saw in the Wachovia instance, of course, that a legal opinion to facilitate a transaction, you know, came about. In this instance, you know, you see the opposite where apparently you're saying there's now no legal authority. But at the time I see no evidence of the inability to act legally.

WITNESS BAXTER: Let me see if I can clarify what exactly happened from the week beginning September 8th until September 15th. And it is not true that no federal assistance was provided to Lehman, and I'll explain that in a minute.

CHAIRMAN ANGELIDES: Are you talking about the lending post-bankruptcy, the broker dealer--

WITNESS BAXTER: Yes, sir.

CHAIRMAN ANGELIDES: --which was substantial, but post-bankruptcy.

WITNESS BAXTER: Yes, sir.

CHAIRMAN ANGELIDES: And the PDCF was available.

WITNESS BAXTER: And I'll explain that. But I think it's important to understand the framework that we went into Lehman weekend with. And our principal plan, our Plan A, if you will, was to facilitate a merger between a strong merger partner and Lehman. That was Plan A.

And rest assured, Commissioners, we worked night and day to try to make that plan happen. It wasn't about politics. It was about getting to the right result.

Now as I explained in my full statement, and as I explained in my oral statement this morning, we had a problem with the facilitated merger-acquisition in that we couldn't get the guarantee that we needed.

So the first question was: All right, we have financing, $30 billion of financing from the private sector, reminiscent of what happened in 1998 with Long Term Capital Management, and I was there, so we had that private sector financing lined up. It boiled down to the guarantee.

So the first question--and it's a legal question: Could the Fed issue a naked guarantee, a guarantee unlimited in amount like JPMorgan Chase's were in the Bear transaction, and unsecured?

And the answer to that question is: As a matter of law, that cannot be done by the Federal Reserve.

Now look at what happened in the Congress of the United States in October of 2008 when Express Guarantee authority was conferred on the Treasury--and I'm talking about Section 102 of the Emergency Economic Stabilization Act.

There you will see express authority for a guarantee of the kind that I'm talking about. The Fed has no such legal authority. And the reason is that in Section 13.3 of the Federal Reserve Act there's a requirement that we're secured to our satisfaction.

A naked guarantee of unlimited amount, unsecured, does not meet that statutory requirement. Full stop.

So Plan A couldn't be executed. Now Secretary Geithner, when I worked for him when he was president of the New York Federal Reserve Bank, used to say to the staff, and sometimes in an animated way, "plan beats no plan."

So he was not going to allow us to be in a position where we had no contingency plan. So our contingency plan for the facilitated merger-acquisition of Lehman, was the following:

The parent would file a Chapter 11 Petition. The U.S. Broker Dealer would stay in operation with the benefit of Federal Reserve liquidity until such time as a proceeding could be commenced under the Securities Investor Protection Act.

That was the contingency plan. The Plan B, if you will. Now just to give you a dimension--

CHAIRMAN ANGELIDES: Let me ask you a question--

WITNESS BAXTER: Let me give you a dimension to this.

CHAIRMAN ANGELIDES: But let me just ask you a question, because you said something--you've presumed this would be unsecured. So your position--

WITNESS BAXTER: --guarantee, sir.

CHAIRMAN ANGELIDES: Okay, but--all right, but--

WITNESS BAXTER: I'm moving on now to describe the secured facility. And with respect to the Broker Dealer, we had two widely available programs. One was the Primary Dealer Credit Facility that Mr. Fuld mentioned. Another was the Term Securities Lending Facility that we initiated on March 11th of 2008 before Bear. And then the third were routine Open Market operations.

So those facilities were fully available to Lehman. The question was: Would we continue those facilities available to Lehman's Broker Dealer post-petition? And we decided the answer would be yes.

Now on Monday, September 15th, in the evening--so I'm talking about post-petition by the parent, we extended credit to the U.S. Broker Dealer in the amount--and this is approximate--of $60 billion across the Primary Dealer Credit Facility, the Term Securities Lending Facility, and Open Market Operations. All of those are fully secured.

CHAIRMAN ANGELIDES: I'm aware of that. But let me just ask this brief question, because I want to move on and let the other Commissioners ask.

Why was it not extended prior to?

WITNESS BAXTER: The facilities were always available to Lehman pre-petition, and they were available to Lehman post-petition. Mr. Fuld is simply incorrect about this.

In the record of this Commission there's a letter to Lehman by Chris Burke, a New York Fed officer, and it says: You have access to these facilities. Now the haircuts were steeper post-petition, but the facilities were available, and they were used: $60 billion the first night, and approximately $45 billion on September 16th, and another $45 billion on September 17th.

So there's a misunderstanding about what was happening here. There was lending to the U.S. Broker Dealer after the petition was filed by the parent. It was fully secured. And that distinguishes, that distinguishes this situation from the naked guarantee which was not secured and not limited in amount, and not within the authority of the Federal Reserve.

CHAIRMAN ANGELIDES: All right. I'm going to return for more questioning later, but thank you very much.

Let me go to the Vice Chair now.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman. For those of us who reside in the second half of the alphabet, we appreciate your courtesy in terms of starting with "Z" and working over to "B" on the panel. You're just not familiar with how rarely we get that kind of an offer.

I would ask each of you, if you would, to verbally respond to our request that, as in the case with every panel, we wind up with questions after the panel is over; and that if we could submit written questions to you, would you give us a timely, whatever that means, a written response? Would you be willing to do that?

(Nods in the affirmative.)

WITNESS FULD: Yes.

VICE CHAIRMAN THOMAS: Okay, thank you, because it's hard to record head nods.

I am willing to admit that I have never, ever had an interest in, never followed, although I had to and others have, all the intricacies that we're trying to discuss. So I am going to ask some questions that are just kind of questions that most anyone would ask.

We focused on Bear Stearns. We understand there was someone, JPMorgan, who was willing to take on that relationship. Now this was in March, right, of '08. Events continued on for, what, five months, going onto six months by the time that we had gotten to September. Could any of you give me some understanding of the mental set of folks who had seen what happened to Bear, and you're looking--I believe, Mr. Fuld, you talked about, you know, who's next in line in terms of size, and ability. Didn't somebody start looking around in beginning to assume if what happened to them, God forbid, there but for the Grace of God went me, but maybe now, or I, and now it may be me?

Was there any concern or activity about this, trying to look for potential connections? Was there discussion on the street, or behind closed doors? Or at the Fed, were you guys talking about we may have to hook up a few more marriages? What was going on in that March to September period? Anybody?

WITNESS FULD: Let me try to help you with that. At the time of Bear Stearns, the record book as I understand it speaks to JPMorgan's first, second, and third cut at acquiring Bear Stearns was negative. The Fed continued to come back, create, recreate, find capabilities that would give JPMorgan the comfort with which to consummate this transaction.

So when that transaction was finished, that set two precedents. One, very difficult going forward for new capital providers to understand where the government was in their position, to either be a part of it or not part of it, to provide liquidity.

The Fed did open the window after Bear Stearns, which was a very positive move. In my view, that did answer the question of liquidity. And to a number of other investors around the world and counterparties, that did in fact mean that the Fed was there to provide liquidity for noncommercial bank entities, meaning investment banks.

It also set another precedent, though, in that the terms used were "crisis," were "bailout," and as I said in both written and oral testimony, had the Fed provided liquidity prior to the Bear problem, I think those words of "crisis" and "bailout" never would have been used.

I think it would have alleviated the problem. I can't talk about what was in Bear's book because I don't really know, and it would be inappropriate for me to do so, but I did see their stock drop from $80, to $60, to $40, to $2, later at $10. And as you correctly said earlier, the Chairman said I don't know how those assets changed so quickly in a seven day period.

So this was clearly a time of loss of confidence. A ton of rumors were swirling. Stock prices were going down. And investors were saying, if there continue to be asset sales, will these firms have enough capital to support those losses?

So that is the beginning. During that entire time, all the banks, not just Lehman, de-risked, raised capital, and I would tell you that for Lehman itself we raised, and I mentioned it, $10 billion of new equity capital. If you look at our total net losses, we raised close to let's say three, I think it was $3.7, $3.8 billion more than we lost net.

So with all our capital raises and all of our net losses, we came out close to $4 billion with additional capital, $4 billion of additional capital than when we started.

I don't want to take you through the whole litany again--

VICE CHAIRMAN THOMAS: No, that's okay, because that gets me then to--and I want to make sure I understood you correctly, Mr. Baxter, where you said that Lehman did not have the collateral to back a sufficiently large bridge loan. Is that correct?

WITNESS BAXTER: No, Vice Chairman. I was talking about the naked guarantee, a guaranty of the trading obligations of Lehman between merger with Barclays and closing of that merger.

And if you look back to the March transaction between Bear Stearns and JPMorgan Chase, you will see a guaranty without limit, and a guaranty that was unsecured. So we were working off that model. And the Fed has no authority to issue that kind of guaranty.

VICE CHAIRMAN THOMAS: I understand that. But what I hear Lehman saying is that they needed some assistance on--for liquidity; that they needed a liquidity bridge, if not a collateral bridge. And my only question is: Why was Barclays the only one who stepped up? Were there others?

WITNESS BAXTER: Well first let me say, in the period leading up to Lehman weekend--so that's the period from Bear Stearns mid-March 2008 to September 2008--

VICE CHAIRMAN THOMAS: April, May, June, July, August--

WITNESS BAXTER: On the basis of what I read in Mr. Velucas's report, Mr. Fuld was working very hard to try to find a merger partner for Lehman. And Mr. Fuld, during that six-month period, I don't believe, succeeded.

So when we got to Lehman weekend, what the government was trying to do is facilitate a merger of Lehman by coming up with a private-sector group who would finance illiquid assets and make Lehman more amenable to an acquiring institution like a Merrill Lynch or a Barclays.

Now those were the two institutions that were interested in a possible merger with Lehman at the time. The important point--and it is really an important point to focus on--is that we had the committed financing. We had gotten to that point by Sunday, September 14th.

So $30 billion was going to be provided by these private-sector institutions to take the illiquid assets out of Lehman to facilitate that merger. A really important point. And yet, even with that, even with that, we couldn't get that deal done.

So the problem, as we got--

VICE CHAIRMAN THOMAS: Because Barclays was a foreign bank?

WITNESS BAXTER: Barclays was a foreign bank and wouldn't produce the guaranty.

VICE CHAIRMAN THOMAS: Time lines couldn't produce--

WITNESS BAXTER: You know what happened with Bank of America is they decided to merge with Merrill Lynch.

VICE CHAIRMAN THOMAS: Yes.

WITNESS BAXTER: On Saturday, September 13th. So we couldn't get the merger done. And then the question became: Okay, what's the best alternative plan?

And in our view, and in the view of our bankruptcy advisors, the best alternative plan was to put the parent into a Chapter 11 proceeding and to keep the U.S. broker dealer alive with bridge financing from the Fed--not alive, waiting for some other hypothetical merger partner to arrive, because we didn't think that would ever happen; but alive along enough to conduct this orderly, orderly winddown of its positions until we could do the CIPRA proceeding.

That was the contingency plan.

VICE CHAIRMAN THOMAS: Okay, my problem is, on page 9 of your testimony--and this is where I need to have you explain to my your testimony--you say in the first paragraph, quote: "In this case, Lehman had no ability to pledge the amount of collateral required to satisfactorily secure a Fed guaranty, one large enough to credibly withstand a run by Lehman's creditors and counterparties.

WITNESS BAXTER: Let's imagine a--

VICE CHAIRMAN THOMAS: How short were they?

WITNESS BAXTER: Let's imagine an unlimited guaranty of the trading obligations of Lehman, which was $600 billion in asset size. So how much? How much collateral would you need for a guaranty of that kind?

And you can imagine that happening under the new authority in the Emergency Economic Stabilization Act, and how would you score it for purposes of the authorization, which was $700 billion? Would it wipe out the entire authorization? Perhaps it would.

And that's the point that I was trying to make, perhaps inelegantly on page 7, is this is a guaranty of enormous size. If you wanted to collateralize it to secure it, you'd need hundreds of billions of dollars of collateral, and Lehman didn't have that.

VICE CHAIRMAN THOMAS: They didn't have it, and they went into bankruptcy. In hindsight, was that tipping an indication that Lehman was maybe too big to fail based on what happened after Lehman? Or was it evidence that you could go right to some definition--we've always had difficulty in defining "too big to fail"--that you went fairly close to the border, and that Lehman wasn't too big to fail? And that the consequences of Lehman failing were expected?

I'm trying to understand what would have happened post-Lehman, had there been a bridge sufficient--although I don't understand where it's a bridge to, because if there wasn't anyone that would acquire them.

WITNESS BAXTER: We thought it was a bridge to nowhere in that particular point in time. But with respect to the overall point that you were making, Vice Chairman, I do believe Lehman was systemic. I don't believe that Lehman was the only systemic trigger, particularly during this incredible month of September 2008 which began with the conservatorships of Fannie Mae and Freddie Mac. Lehman was not our only problem during that month, as you know.

The day after Lehman filed its petition, we had AIG. And at the end of the month we had WaMu. So this was an extraordinary point in the crisis, and I think one of the most historic months in the history of American finance.

So had Lehman failed in May, it might have been a different circumstance, prior to this extremely confusing month of September?

WITNESS BAXTER: I believe Lehman would have been systemic in May. It would have been systemic in March. And it was systemic in September.

VICE CHAIRMAN THOMAS: Okay. Mr. Chairman, I want to reserve my time because I know there are others who have a whole series of questions they want to ask, and I took more than my usual time in the first panel, so I will reserve my time.

CHAIRMAN ANGELIDES: Thank you.

Mr. Holtz-Eakin? I'm going to mix it up a little.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Being a strategic advantage on you.

COMMISSIONER HOLTZ-EAKIN: Thank you, gentlemen, for taking the time to be with us today and to help us with this.

I want to go back to this issue of the availability of the PDCF to Lehman on Sunday night. And I simply cannot reconcile the two things I've heard. And so my question to you, Mr. Baxter, is:

Did everyone have the same access to that facility, using exactly the same collateral, right up to the point when Lehman filed at 2:00 a.m.?

WITNESS BAXTER: "Everyone" means the eligible primary dealers to borrow?

COMMISSIONER HOLTZ-EAKIN: Yes.

WITNESS BAXTER: There was--

COMMISSIONER HOLTZ-EAKIN: Including Lehman, importantly.

COMMISSIONER HOLTZ-EAKIN: There was--and it's a complicated question, and I want to make sure I answer it completely.

First of all, there was new authority under Section 13.3 to expand the collateral available for the PDCF.

COMMISSIONER HOLTZ-EAKIN: Which had been passed in Resolutions that afternoon--

WITNESS BAXTER: Correct, by the Board of Governors.

COMMISSIONER HOLTZ-EAKIN: Thank you.

WITNESS BAXTER: And those modified the earlier 13.3 resolutions that came over a Bear Stearns weekend, and that enabled us to set the PDCF up for operation on March 17th, 2008. So those are two things.

With that understood--

COMMISSIONER HOLTZ-EAKIN: Right.

WITNESS BAXTER: --and there may have been miscommunication in the fog of that particular Sunday between the Fed and Lehman Brothers.

But with that understood, what was decided is that Lehman had access to the PDCF with the expanded collateral, but with a higher haircut.

COMMISSIONER HOLTZ-EAKIN: Prior to filing?

WITNESS BAXTER: A higher haircut--post-petition--no.

COMMISSIONER HOLTZ-EAKIN: My question was prior to filing at 2:00 a.m. That's the question.

WITNESS BAXTER: I'm sorry, I didn't understand you.

Prior to filing, exact same terms for Lehman as for all other primary dealers.

COMMISSIONER HOLTZ-EAKIN: Mr. Fuld, is that your understanding? And if not, why?

WITNESS FULD: That is not my understanding at all. My understanding was that the Fed opened the window to investment banks with an expanded definition of acceptable collateral.

COMMISSIONER HOLTZ-EAKIN: Um-hmm.

WITNESS FULD: Not to be repetitive, my people came in to see me--

COMMISSIONER HOLTZ-EAKIN: When?

WITNESS FULD: I forget what time, but it was in the later part of Sunday, in the afternoon, and said: We're fine. The Fed just opened the window, expanded collateral, we are fine.

Forty-five minutes later, they came back. What we were told--I'll put it this way. What I was told was that the Fed said: Yes, we are expanding the window capability for expanded collateral--we're opening the window for expanded collateral, but not for you, Lehman Brothers.

That's what was told to me.

COMMISSIONER HOLTZ-EAKIN: As is usual, when confusion reigns, let's go to the lawyers. Mr. Miller, what is your understanding of this sequence of events?

WITNESS MILLER: Yes, sir. I have a different perspective on it.

You have to understand that we were talking about Lehman Brothers Holdings, Inc., the parent company, which ran the whole enterprise.

The PDCF window, which was discussed during the late afternoon, Sunday afternoon, at the Federal Reserve Bank, from my impression the condition on that window being open was that Lehman Brothers Holdings, Inc., would file a bankruptcy petition.

And if Lehman Brothers Holdings, Inc., filed a bankruptcy petition, the Fed would make available to Lehman Brothers, Inc., the broker dealer, an overnight repo and the other financing that Mr. Baxter referred to.

Those funds would only be available to fund the broker dealer, and not the other operations of Lehman, which were very extensive. So that it was a very--it was a PDCF financing, but it was limited to one entity. And the condition was that there would be--it wasn't even called a Chapter 11 filing, a bankruptcy petitioned filed before midnight.

COMMISSIONER HOLTZ-EAKIN: Okay.

WITNESS MILLER: Now if I could just add, sir--

COMMISSIONER HOLTZ-EAKIN: Please.

WITNESS MILLER: --going back to the Chairman's questions, during that fateful Sunday afternoon, and going into the early evening, the list of 'yes' or 'no' questions that the Chairman posed, at no time during the meeting down at the Fed were the Lehman representatives and the team from my office advised as to any of the rationale for what was being directed.

There came a point in that meeting in which basically we were told: Go back to Lehman. Get the board of directors together, and pass a resolution to file a bankruptcy petition. And then we will allow, because Lehman Brothers, Inc., as a broker dealer was not qualified to file under Chapter 11 as a stock broker, we will allow LBI, Lehman Brothers, Inc., to continue to operate for a week or so so that customer accounts could be dealt with. And, that ultimately at some point in time there would be a proceeding under the Securities Investor Protection Act.

It was just a temporary financing to get from A to B.

COMMISSIONER HOLTZ-EAKIN: So I'm now going to prove I'm truly confused. So what I think you just told me is that the broker dealer, which I believe should have had access on the same terms as everyone else, to the PDCF, was told it didn't have access unless there was a filing by the parent?

WITNESS MILLER: In the context of that meeting, yes, sir.

COMMISSIONER HOLTZ-EAKIN: That's what you understood them to say?

WITNESS MILLER: Yes, sir.

COMMISSIONER HOLTZ-EAKIN: Mr. Baxter, is that right? Or could the broker dealer have accessed it on Sunday night on the same terms as everyone else?

WITNESS BAXTER: It's not right. And that's why we put it in writing. There's a letter from Chris Burke who is an officer of the New York Fed to Lehman Brothers. It's in the--you have it in the record, and you can look at that and see what we said in plain terms.

There shouldn't be doubt about this. You have it in writing. And we put it in writing because we were concerned that communications weren't as robust as they should be.

And if you were--if I could take you back in time to Sunday, September 14th, and you could be with us, having been up for several days, not only the people at the Fed but the people at Lehman Brothers, you might understand better why there could have been a lack of clarity in terms of the communications.

Now there was also discussing about a lending--

COMMISSIONER HOLTZ-EAKIN: Could I ask you about the lending--Point of clarification. When was the letter? I just want to know the timing of the letter. Was the letter sent afterwards?

VICE CHAIRMAN THOMAS: We would like to ask the questions based upon our reaction to what you say. If you continue talking, we can't do that. We're trying to understand. When we ask you to suspend, we would appreciate it, not withstanding the continuity problems, that you would let them make the point.

CHAIRMAN ANGELIDES: And that was on somebody's time, not yours.

COMMISSIONER HOLTZ-EAKIN: I'll take it. It's okay. So an observation, which is that I understand how tired and difficult it was to understand, because I was on the McCain Campaign at the time and you ruined my life--

(Laughter.)

COMMISSIONER HOLTZ-EAKIN: And number two, when was the letter sent to clarify? Was this because after-- when was the letter sent?

WITNESS BAXTER: You know, I'm trying to remember one letter among many. I think it was September 15th.

COMMISSIONER HOLTZ-EAKIN: Okay.

WITNESS BAXTER: But--but we'll provide another copy, and the letter will speak for itself.

COMMISSIONER HOLTZ-EAKIN: So that night, it very well could have been the case that in the confusion Lehman was told they had no access, which they really did have?

I mean, I'm just trying to reconcile what's going on here.

WITNESS BAXTER: I don't think there was confusion about that particular point.

COMMISSIONER HOLTZ-EAKIN: Then why send the letter?

WITNESS BAXTER: I also don't think there was confusion about the decision by the Lehman Board of Directors, the parent, to file bankruptcy. Because we had a discussion with the board late on Sunday evening, and I participated in that discussion along with Chairman Cox, and I believe the Board of Directors of Lehman fully understood that they had to make a decision with respect to that filing.

I believe they made that decision in consultation with counsel. I believe the minutes of that meeting should probably show that the directors fully understood that they needed to make the fiduciary decision about whether or not to file, and that there was no strong-arming or leveraging with respect to facilities of the Federal Reserve.

That was their decision to make, and they had very competent counsel advising them at the time. And I have no question--

COMMISSIONER HOLTZ-EAKIN: We're clear on that--

WITNESS BAXTER: --no question that--

COMMISSIONER HOLTZ-EAKIN: I'll yield to the Chairman for a second.

CHAIRMAN ANGELIDES: Let me ask a quick question. So just to put a punctuation mark on it, apparently there was confusion because Mr. Fuld seemed to have a different understanding, and Mr. Miller seemed to have a different understanding.

And then apparently in our staff interviews of Mr. McDade and Mr. Lowett, what the chronology we put out today indicates is, it says Baxter tells them that Lehman cannot access the expanded window and had to file bankruptcy.

So you dispute that? You said you never told that to nobody?

WITNESS BAXTER: Correct.

CHAIRMAN ANGELIDES: So how did all these people infer all this? Why did they come to this conclusion? I mean, how does that happen?

WITNESS BAXTER: I think you'll have to ask them that, Mr. Chairman.

CHAIRMAN ANGELIDES: I guess I'll ask all of you, but I guess we have asked all of you.

WITNESS BAXTER: I would look at the letter.

CHAIRMAN ANGELIDES: Well the letter, what I understand now from the letter--and this is on my time--is it came the 15th, you're saying, the day of the filing. Not the Sunday, which was the 14th.

All right, Mr. Holtz-Eakin, thank you very much.

COMMISSIONER HOLTZ-EAKIN: So why do you, Mr. Baxter--how can you then explain why Mr. Fuld, who says he just needed a liquidity bridge, did not take the one that you're telling me he had?

WITNESS BAXTER: I'm trying to understand that question which asks about Mr. Fuld's state of mind.

COMMISSIONER HOLTZ-EAKIN: If there was no confusion, that they had the same access as everyone else on Sunday night, that they were never told they had to file bankruptcy, they simply chose to, his testimony is all they needed was access to something like the PDCF with expanded collateral and they would have been able to continue operation and continue to seek a merger partner. Why didn't they do that?

WITNESS BAXTER: The U.S. Broker Dealer needed access to funding the night of September 15th because the triparty investors were no longer there. The only place it could get funding was from the Fed. So that funding was required--

COMMISSIONER HOLTZ-EAKIN: That's the 15th. That's afterwards.

WITNESS BAXTER: The night of the 15th that funding was needed, and we had to take over from our brothers at JPMorgan Chase who were lending intraday. So that funding is committed.

So what you're talking about with additional funding to rescue the Lehman parent is it comes on top of the $60 billion that was already committed to the Broker Dealer.

So, you know, if you take--if you take what, what was offered in one of the statements that there was another $40 billion needed, we're up to $100 billion now. Now where's the collateral coming? How are you doing that? Those things are all, are all completely obscure.

COMMISSIONER HOLTZ-EAKIN: Thank you. That's all I wanted--

WITNESS BAXTER: So the difference is, funding--

COMMISSIONER HOLTZ-EAKIN: Thank you--

WITNESS BAXTER: --the sub, or funding the parent.

COMMISSIONER HOLTZ-EAKIN: Thank you.

Mr. Fuld, could you have--he's saying you did not have the combinatino of capital and collateral to make this deal go, and thus had to, as a matter of your fiduciary interest, do the filing. Is that correct?

WITNESS FULD: I'd like to clear up one piece. If the letter was in fact sent on the 15th--

COMMISSIONER HOLTZ-EAKIN: I know.

WITNESS FULD: --we had already filed by then.

COMMISSIONER HOLTZ-EAKIN: I know.

WITNESS FULD: So thank you for the letter, but--enough said on that.

We had $143 billion of combination of equity and long-term debt. So be definition we had $143, maybe it was $140, let's round it off, of what we called "unencumbered collateral." That means collateral that we were financing with our long-term debt and equity. That's number one.

We had the collateral.

Clearly, again, you don't need to hear it from me, we had the capital. As with the case with AIG, we had whole businesses. We could have put up Neuberger Berman as a business.

We were in conversations with at least two, but it was probably four that were thinking about buying Neuberger Berman between $7 and $9 billion. That had value.

We had $30-some-odd billion of private equity funds. We could have carved off eityher all or part of that, as in fact a business, and used that as collateral.

So we had collateral both in securities and in whole business forms.

COMMISSIONER HOLTZ-EAKIN: Thank you. I want to try to get back down to one of the major themes of this hearing, which is when institutions are perceived to be too big to fail, and when it is appropriate for government to step in.

I want to ask you, Mr. Zubrow, as a key counterparty of Lehman, whether you concur with Mr. Fuld's assessment of their financial condition on the 14th. And would you have provided repo on the 15th if they had accessed the expanded PDCF?

WITNESS ZUBROW: I think it was clear in the marketplace, both the week leading up to the weekend of the

13th, as well as over that weekend, that there was, you know, great concern in the marketplace among all sorts of counterparties about the ability of Lehman Brothers to continue to finance their various operations.

And so, going into that weekend, the triparty book of financing was obviously held by investors, and the question would then come up on Monday morning, the 15th, as to whether or not we would be able to do an unwind and provide intraday financing.

And certainly over the weekend of the 13th and 14th, we were very concerned that there would not be sufficient investor counterparties to continue to finance on the night of the 15th without a strategic resolution of the entire Lehman situation.

COMMISSIONER HOLTZ-EAKIN: So without a merger partner, with only a bridge to the 15th, you do not think there would have been a successful ability to sustain the repo operation?

WITNESS ZUBROW: It certainly appeared to us at that point that there was not going to be investor appetite to continue to finance Lehman's operations.

COMMISSIONER HOLTZ-EAKIN: Okay. In your view, JPMorgan's view, was Lehman a systemically important institution always? Or only in the market conditions you found in September?

WITNESS ZUBROW: I think there's no question that Lehman was a very important counterparty to many people in the marketplace. And as such they were a very important systemic institution.

I think the issue was obviously how was the government going to try to resolve the situation. And as Mr. Baxter said, there did not appear to be sufficient legal authority and mechanisms for the various regulators to be able to resolve the situation in the ways that obviously Congress has now provided for.

COMMISSIONER HOLTZ-EAKIN: Mr. Baxter, when the Federal Reserve was examining its options, what did it think would happen in the marketplace if it had to go to Plan B? What did it expect the fallout to be?

WITNESS BAXTER: First, Commissioner, I want to correct a mistake I made. I said Chris Burke's letter was September 15th. My counsel advises me it was September 14th. So I was a day off, and it was quite material because it was pre-petition.

COMMISSIONER HOLTZ-EAKIN: Okay.

WITNESS BAXTER: All right, with that, again, looking at the issues, we knew that there were going to be terrible consequences with Plan B.

COMMISSIONER HOLTZ-EAKIN: Specifically?

WITNESS BAXTER: We knew that there was going to be disruption in the derivatives market. We knew there was going to be disruption with respect to triparty. And that's why we tried to step in with a backstop to what would ordinarily be the money fund investors pouring money in overnight.

So we anticipated those things. And that's why it was Plan B. Plan A was way better from our point of view, and that's why we worked so hard to try to get a merger partner--

VICE CHAIRMAN THOMAS: Mr. Chairman, Mr. Chairman, I yield the gentleman five additional minutes.

COMMISSIONER HOLTZ-EAKIN: To go back, you mentioned you provided a backstop for money in the triparty--say that again?

WITNESS BAXTER: Yes. With respect to the--what we were doing when we started the week, Monday, September 15th, is Chase was lending intraday.

COMMISSIONER HOLTZ-EAKIN: Okay, so this is post-filing.

WITNESS BAXTER: Post-filing. And then the Fed was coming in and essentially taking the credit overnight.

Now we knew the consequences were going to be significant. We knew. That's what made Lehman systemic. And the idea was to try to put foam on the runway, if you will, to mitigate the consequences that we were concerned about.

And may I add, I think with respect to the U.S. Broker Dealer we did in fact mitigate the consequences. Because remember, on September 16th Barclays came back to the table, and we were able not only to move those accounts, but the employees and the business from the U.S. Broker Dealer to Barclays. And the situation would have been worse but for that mitigating action by the Fed and the government.

COMMISSIONER HOLTZ-EAKIN: Now I want to ask you the hypothetical, which is what we ultimately are always trying to imagine in thinking about this issue of intervention or not:

Suppose you had had the statutory authority, and had provided the naked guaranty to the trading for the Barclays merger, what would have happened in the marketplace?

WITNESS BAXTER: Well I think the market would have reacted well. The counterparties of Lehman would have been looking to essentially the Fed, the taxpayers, to back that guaranty. But as I pointed out in my full statement, in the event that there wasn't an affirmative shareholder vote, in the event that Barclays saw a way out of the deal that perhaps they didn't like, the American taxpayer would be on the hook for perhaps hundreds of billions of dollars.

And with respect--

COMMISSIONER HOLTZ-EAKIN: Would that have been-- but had you had the choice between it, if you had had the statutory authority, would you have done that instead of Plan B?

WITNESS BAXTER: Well the issue is the balancing. And whenever you approach one of these potential rescues you're thinking not only legal authority but also the potential cost to the American taxpayer.

And it has always been, in the 30 years that I have served the Federal Reserve, part of our orientation that we have to be good stewards of taxpayer funds. That is why we always want to be fully secured. And the history of the Fed is we haven't lost any money.

And the problem with stepping in and providing a naked guaranty in a situation where you can't force deal-certainty in a merger is it's an enormous risk of taxpayer funds.

So I realize I haven't answered your question--

COMMISSIONER HOLTZ-EAKIN: That's correct.

WITNESS BAXTER: --I think--I think the cost, the potential cost to the American taxpayer, had we had the legal authority--and we didn't have it--would have led us to say that's not something we should do.

COMMISSIONER HOLTZ-EAKIN: Okay. Last question.

Mr. Wallison raised it earlier, and it always comes up, the decision over Bear Stearns. And my question to you is:

In terms of the process of scrubbing options, communicating with potential merger partners, communicating with Bear Stearns, is that process identical for Bear Stearns and for Lehman Brothers?

WITNESS BAXTER: In some ways yes. In some ways no. The real risk for the government in this kind of situation with communicating with potential merger partners is the risk that that in itself becomes the trigger for the run; that if the government starts to talk about arranging a marriage with someone like a Lehman or a Bear, in the eyes of those it's talking to it is communicating something.

And so that can be the precipitating factor for a run. So in both Bear and Lehman, that was not done until the last possible moment, the point of no return, at least by the government. So that is one common situation in both of these.

With respect to Bear, we only had one suitor and that was JPMorgan Chase. In the Lehman weekend, we had two real suitors in Bank of America and Barclays. We lost Bank of America because it went to the next investment bank in the line--that was Merrill Lynch--and that left us with Barclays, and Barclays had this problem with the guaranty.

COMMISSIONER HOLTZ-EAKIN: Thank you,

Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you. Before we go to Mr. Georgiou, can I just ask one quick follow-up to Mr. Holtz-Eakin's line of questioning to you, Mr. Zubrow.

I want to enter into the record, this is a chronology of interactions between JPMorgan and Lehman in the--over the period of 2007-2008, and particularly in those critical days. It's a chronology which I will enter into the record. But I want to ask you specifically about one item.

On the 14th, which is that critical Sunday, Mr. Zubrow, apparently Federal Reserve staff person Parkinson told our staff that you told him and other Fed officials on the 14th that JPMorgan Chase would not unwind transactions and provide intraday credit to Lehman on 9/15 unless the Fed expanded the types of collateral that could be financed by the PDCF.

Is that accurate?

WITNESS ZUBROW: As I responded to Mr. Holtz-Eakin, we were very concerned that there would not be investors who would be willing to lend money to Lehman Brothers on the 15th such that if we did the unwind for the Broker Dealer on the morning of the 15th, then--

CHAIRMAN ANGELIDES: Right, but they had the collateral--

WITNESS ZUBROW: --we would have the interday exposure and no one would be there at night to be able to finance and take us out of that interday exposure.

CHAIRMAN ANGELIDES: Okay, but let me just continue this. Apparently Mr. Parkinson also told the Fed Board of Governors of your comments, and told Mr. Geithner to, quote, "tell those sons of bitches to unwind Lehman's trades." JPMC was, quote, "threatening not only to unwind Lehman's collateral, but any triparty collateral." Parkinson said, quote, "It would be unforgiveable not to unwind the triparty."

My question is, for you, you're saying pretty bluntly here, apparently, they ain't gonna do it on Monday unless the PDCF collateral is expanded. But it was expanded on Sunday. And therefore was that sufficient for you to be able to provide interday credit on Monday? You're saying that even with that--

WITNESS ZUBROW: On Monday morning we did the unwind in a business-as-usual manner--

CHAIRMAN ANGELIDES: Okay.

WITNESS ZUBROW: --and extended, you know, roughly $50 billion--or, actually, I think $86 billion worth of intraday credit to the Broker Dealer on that Monday morning. And our decision was based in part on the fact that the Fed on Sunday night had expanded the PDCF such that there was an outlet for investors.

CHAIRMAN ANGELIDES: I just wanted to get clarity. Okay. Thank you so much.

All right, Mr. Georgiou.

COMMISSIONER GEORGIOU: Thank you. And thank you, gentlemen, for coming today.

I wanted to try and finish up this point, if I can. We are not talking about this whole failure of Lehman resulting from somebody not checking their fax machine or something on Sunday. I mean, are you suggesting that this letter from the Fed reflecting the availability of PDCF funds went to Lehman on Sunday, but they chose not to exercise that authority, or to utilize that facility?

WITNESS BAXTER: No, I'm not saying that, because they did use that facility.

COMMISSIONER GEORGIOU: The next day, though.

WITNESS BAXTER: Yes, and that's what we were talking about, was the conditions going forward.

COMMISSIONER GEORGIOU: But, so they couldn't have exercised it on Sunday? They could not have accessed their-used their collateral to access the PDCF on Sunday?

WITNESS BAXTER: No. It wasn't available to them on Friday night, but they were being financed in the triparty arrangement through the weekend. And I think that's what Mister--

COMMISSIONER GEORGIOU: So that--so that collateral then was already bound up in the triparty arrangement over the weekend? Is that right? And is that true, Mr. Zubrow?

WITNESS ZUBROW: Yes. The collateral was bound up in the triparty arrangements over the weekend, and obviously the markets were closed over the weekend.

COMMISSIONER GEORGIOU: Right. And you would have continued to bind up that same collateral had you extended--I take it you used that same collateral on the Monday, is that right, to extend credit to the Broker Dealer on Monday? Is that right?

WITNESS ZUBROW: That's correct.

COMMISSIONER GEORGIOU: So really, then, there wasn't any additional collateral available for the PDCF loan on Sunday that wasn't otherwise encumbered. Is that your view, Mr. Baxter?

WITNESS BAXTER: I think that the misunderstanding is, Chase was financing Lehman intraday, Monday, and then Monday night the Fed came in and financed Lehman overnight.

COMMISSIONER GEORGIOU: Okay. And Chase, JPMorgan Chase had financed them overnight over the weekend?

WITNESS ZUBROW: So over the weekend, the investors in the triparty repo mechanism were financing

Lehman Brothers, the Broker Dealer. On Monday morning, in the ordinary course of business, there would have to be an unwind of those arrangements in which Chase would advance funds to Lehman Brothers such that Lehman Brothers could repurchase the collateral that they had had tied up over the weekend--

COMMISSIONER GEORGIOU: Right.

WITNESS ZUBROW: --from the investors, and the funds to be able to do that would be advanced by Chase.

COMMISSIONER GEORGIOU: And you would use what collateral--

WITNESS ZUBROW: And at that point in time we would use the collateral that the investors had been using over the weekend to secure our interday advance.

COMMISSIONER GEORGIOU: And I guess I need to now ask Mr. Fuld. Did you have--was that the collateral that you were going to--did you need additional money on Sunday, in addition to what had already been provided to you over the weekend by JPMorgan Chase, that you didn't have, that they regarded you--no one else--everyone else there regarded as you not having sufficient collateral to back up?

WITNESS FULD: I think there are two different pieces here. One is the funding for Monday after the fact, which is in fact after the fact, which to me is meaningless.

COMMISSIONER GEORGIOU: Right.

WITNESS FULD: The real question is: Did we have the collateral on Sunday, which I believe is the guts of your question.

COMMISSIONER GEORGIOU: Correct.

WITNESS FULD: Two pools of collateral. JPMorgan gets the collateral back from those investors, or triparty repo partners, that don't want the collateral. That clearly frees that collateral up. And then we put it to the Fed. And so that's just a swap of collateral--

COMMISSIONER GEORGIOU: Right.

WITNESS FULD: --from one institution to the Fed.

COMMISSIONER GEORGIOU: Right.

WITNESS FULD: Over and above that, we had collateral, as evidenced by the fact that we posted $50 billion--I actually found out now it's more than $50 billion, but I'll just settle for the fifty--within the Broker Dealer. So that additional $50 billion just didn't jump out of the night mysteriously. That was there.

So we had the collateral.

There's another piece, which I would like to address if I may, which is this question of Fed backing naked, or unsecured. In the first place, $600 billion balance sheet, 50 percent of it is a match book. That can get sold, hived off--

COMMISSIONER GEORGIOU: Right.

WITNESS FULD: --very easy. The remaining $300 billion, a lot of it is on-the-run securities, governments, corporates, equities. $69 billion of it was less liquid assets. Of that, close to twenty was residentials, not to get too far into the weeds, but those were--those had been marked so aggressively that a number of people said that if the rest of the Street had to mark their resi's where Lehman marked its resi's, there would be a lot of blood on the Street.

So I look at that twenty and say that that was okay. That leaves fifty, $50 billion of less liquid assets. It's not that they needed $50 billion to collateralize the trades. We did a trillion dollars of transactions a day.

The missing piece at the margin is for each of those transactions, could there have been market volatility that would have compromised that transaction at the margin. Not the full face amount.

COMMISSIONER GEORGIOU: No, of course. Obviously, right, some percentage of it. I understand.

WITNESS FULD: --percentages. You're talking about--

COMMISSIONER GEORGIOU: Okay.

WITNESS FULD: --a tiny fraction of what that would have been.

COMMISSIONER GEORGIOU: Right. Okay.

Understood. I just--I mean, I don't really want to use all my time on this point, but it seems to me that we don't have a resolution of this question here.

I mean, I would hate for us to end this hearing thinking that because of a bunch of misunderstandings and mistakes Lehman turned out to be the only investment bank that had to go down.

I mean, is that really where we're at here? Or was there some other resolution possible on this traumatic Sunday afternoon after the Fed had acted that could have rewsolved it, short of the bankruptcy?

And maybe Mr. Miller, do you have a view in this regard?

WITNESS MILLER: Yes, sir. It seems to me that there was an alternative available. As Mr. Fuld has pointed out, there were other assets that could have served as collateral. Maybe not under the PDCF standard of collateral, but there could have been an alternative to avoid systemic risk by at least the Fed or the Treasury standing behind an orderly wind-down of Lehman. Instead of the cataclysmic event of bankruptcy, which produced all kinds of loss of value.

COMMISSIONER GEORGIOU: Understood. But, okay, I guess I'm going to leave this because I've already used half my time, which was not my intent.

I am actually more interested--I mean, it's interesting why it is that Lehman was not--had to file bankruptcy and others were rescued. And I guess the others being Bear, Merrill, Goldman Sachs, and Morgan Stanley, all of your principal competitors. And that's a nice and interesting question, and I leave it to historians to figure it out.

What I think is more fundamental is under what circumstances you got to the position, Mr. Fuld in your institution where you needed to be bailed out, or where you needed some government assistance to survive. And that seems to be a more fundamental question for this panel in connection with this particular inquiry.

Maybe you could address, if you would, what mistakes you made, what things you would have done differently to have not placed yourself in a position to have needed that assistance on that fateful weekend.

WITNESS FULD: I clearly made mistakes. I talked about it: too much commercial real estate, but we addressed that. Less liquid assets. We cut by 50 percent. We addressed that. Capital. We got to 11 percent Tier One ratio.

So--

COMMISSIONER GEORGIOU: But you still were, but even with those actions you still weren't able to secure adequate credit facilities to operate your business, correct?

WITNESS FULD: You are correct, a hundred percent. We could not stem the tide of the uncontrollable--and that's why I talked about it--of the uncontrollable market forces, and the false rumors that swirled around the firm.

And as I also talked about, once a bank is in seige and loses the confidence in the marketplace, I don't believe that any bank can exist. And we saw that. Right after Lehman, the market lost a ton of confidence. We saw it right on down the line. Morgan Stanley, Goldman Sachs. Had it not been for the Fed and Treasury stepping in with the huge capital injection to put a stiff arm right there to say, okay everybody, stop; we're behind it, that would have continued.

Having said that, you asked me another question. Did we do everything right? We clearly did not. As I say, we had too many commercials. I did not--I, myself, did not see the depth and violence of the crisis. I did not see the contageon. I believe we made poor judgments in timing for the assets that we bought, and for the businesses that we supported.

Would I love today to be able to reach back and take those? Yes. Did I say in the very beginning I take full and total responsibility for the decisions that I made? I only made those decisions, though, with the information that I had at the time. That's the only way we can ever make decisions.

COMMISSIONER GEORGIOU: And we understand that. But--go ahead.

WITNESS FULD: I could have, and in retrospect should have, closed all of our mortgage origination platforms.

COMMISSIONER GEORGIOU: Right.

WITNESS FULD: Instead of doing it in the middle of '07, I probably should have done it in '05 or '06. People would have looked at us and said that's a really irrational move. I would have had to say I have a crystal ball, I see what's going to happen.

COMMISSIONER GEORGIOU: Well in retrospect it clearly wouldn't have been an irrational move, because that same difficulty afflicted a whole number of other institutions that were exposed to those bad mortgage originations in the first instance, and the multiplication of those effects that occurred when those mortgages were told into mortgage-backed securities and collateralized debt obligations, and CDO-squared, and synthetics, and so forth, and so on.

I mean, I want to ask you a couple of questions relating to that that I've harped on through a whole variety of these hearings.

Do you think that there has been an erosion of market discipline and market diligence in the origination of some of these mortgages and the securities based on those mortgages by the ability of investment bankers like Lehman Brothers to earn fees at the front end essentially with regard to the consequence of outlying results with regard to the origination of those mortgages, or the ultimate performance of the securities, whether they performed as represented to investors and so forth?

It seems to me that by earning all your fees up front, as did the mortgage originators, as did the credit rating agencies, as did the auditors, and the others that participated in the offerings, with no reserves essentially of those revenues against the possibility of failure of those securities, no clawbacks of the compensation that resulted from those originations, that all the investment banks and a whole variety of other institutions were placing them at risk of failure because their margins were so narrow with regard to those things that ultimately suffered significant losses.

Can you speak to that?

WITNESS FULD: We had two parts of our mortgage origination business. One was the actual origination where we owned the origination platforms. And the second where we acted as a conduit, where we went to other mortgage originators and bought their production.

We believed at the time, very clearly, that we had proper due diligence for the mortgage origination platforms that we bought. We came in and we changed management. We changed the standards. We changed the types of mortgages that we would allow. And we packaged and securitized mortgages clearly that we thought were safe, given low interest rates, the huge availability of capital that was in the marketplace, and the individual homeowners' ability to pay those mortgage payments given those low interest rates, that those loans were secure.

COMMISSIONER GEORGIOU: Well it turned out now--

WITNESS FULD: They turned out not to be, very clearly.

COMMISSIONER GEORGIOU: Right. And the ratings--our evidence shows that some 92 percent of the tranches of mortgage-backed securities that were rated by the agencies as AAA have been downgraded since.

So I guess--and I suspect that this hearing is actually probably not the right forum, but let me just ask one final question, if I could have another minute or two.

CHAIRMAN ANGELIDES: Take two, but stay with it, and then we'll move on.

COMMISSIONER GEORGIOU: The focus here is on the question of too big to fail. Your principal gripe here, if I could say that, today Mr. Fuld is that your institution was the one that was permitted to fail, and just about everybody else that you either did business with or competed with was permitted--was rescued, or assisted in some significant instance to continue to survive, or some merger, assisted merger was negotiated.

But isn't the fundamental question I guess under what circumstances any institution ought to be permitted to fail? I mean, some might argue here that really it ought to have been the rare instance when there was a rescue, and not the rare instance that there wasn't a rescue, as was the case with your institution. And do you--can you share with us your views whether and under what circumstances the government ought to place taxpayer funds--utilize taxpayer funds to assist institutions like yours?

WITNESS FULD: First off, it's not that we were "permitted" or "allowed." We were "mandated."

COMMISSIONER GEORGIOU: Well you had no choice. Unless somebody gave you the lifeline, you had to-- bankruptcy was your option, basically. Is that not right? I mean, I'm looking at Mr. Miller and he's nodding his head.

I mean, I don't know what else you could have done. You couldn't have opened for business on Monday morning.

WITNESS FULD: If we really had access--

COMMISSIONER GEORGIOU: Pardon?

WITNESS FULD: If we really had had access to that window as described, I can't tell you Lehman was--

COMMISSIONER GEORGIOU: But that would have been taxpayer dollars. I'm saying that in the absence of extension of that lifeline by the taxpayers, your option was to file bankruptcy, which you did, with all the consequences to your shareholders, and creditors, and the system, and so forth. Correct?

WITNESS FULD: Correct.

COMMISSIONER GEORGIOU: Okay, now the question I guess I'm asking you is: Don't you think that's what ought to happen in the basic capitalist system that we all operate under?

WITNESS FULD: Unfortunately I'm going to give you a convoluted answer, and I'll apologize to begin with.

Capitalism works--

CHAIRMAN ANGELIDES: If you could do this for us, just because of time, try to give it as brief as possible and follow up with a longer written answer. I know it's convoluted, but try to hit it hard.

WITNESS FULD: I apologize. Capitalism works within a finite range of standard deviations of volatility.

When I talk about uncontrollable market forces, we were way outside.

Had the Fed totally ignored everything, Treasury ignored everything, in a pure capitalistic free market 'let it happen as it falls,' not only would you have lost Lehman, Morgan Stanley quickly, and Goldman Sachs thereafter.

What other countries did, very quickly, they stepped in. They said, no more. We're guaranteeing. We're going to stop this irrational sense of panic and put confidence back into the marketplace.

COMMISSIONER GEORGIOU: Okay. Well, I'm going to--

CHAIRMAN ANGELIDES: Well, let's--

WITNESS FULD: --that would have--

COMMISSIONER GEORGIOU: Well let's leave it there. I mean--

VICE CHAIRMAN THOMAS: There are other Commissioners who I think will--

COMMISSIONER GEORGIOU: That's fine. I mean, obviously if there's other time at the end I'd like to follow up, but that's fine. Thank you. Thank you, very much.

CHAIRMAN ANGELIDES: Mr. Hennessey.

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

VICE CHAIRMAN THOMAS: Mr. Chairman, at the beginning could I yield the gentleman five additional minutes, so you've got ten to work with and we don't have to play the time game.

COMMISSIONER HENNESSEY: Thanks. Based on your testimony and other things I've heard, I think I want to stipulate that there was a liquidity run, even though there may be differing views as to why there was a liquidity run. And it sounds like sometime around the 8th or 9th of September, you have Fannie and Freddie, and then shortly thereafter you have this whole sequence of events.

I'm interested in the time before that. So before the liquidity run begins. And, Mr. Fuld, the story that I see from all the different stories, from all the different elements of testimony and the staff work that we've seen, is that Lehman invests too heavily, especially in commercial real estate in '06 and '07. At the beginning of '08, you--sometime in the late '07, early '08, you recognize this and you start to address it.

You start to wind down your various portfolios where you're too highly leveraged. I think after Bear you go out and you start raising equity capital. And so you've got a problem and you're working as quickly as you can to solve it.

In the post-Bear world, there are questions being raised by counterparties and others in the market as to whether what you're doing is sufficient. You've said several times: Look at all the things that we were doing to solve the problem.

I haven't herd anyone dispute that you were taking aggressive actions. I have heard people saying, and I've been reading people saying we're not sure if it's enough; we're not sure if the firm is still healthy.

Now in your testimony you say there was no capital hole at Lehman Brothers. I want to start with the other three here. Pre-liquidity run, was there a capital hole at Lehman Brothers?

Mr. Miller, I saw you saying of course Lehman's challenges were very serious. They suffered from capital deficiency, liquidity drain, and a low level of market confidence.

Mr. Zubrow, I've heard you talking about your liquidity concerns and the counterparty right in those final days. Let me start with you.

Did JPMorgan have solvency concerns about Lehman before this liquidity run began?

WITNESS ZUBROW: As I've said in my written testimony and in the oral testimony, one of the things that we focused with all of our triparty repo clients going back to the Spring of '08 was our concern about the composition of those books, the character of the assets that were being financed on an overnight basis, and whether or not there was appropriate haircuts being applied by investors to reflect the character of those assets.

And so I think that it is clear that throughout that whole period there were a number of concerns that we were raising with our broker dealer clients in general, and Lehman Brothers in particular, about the character of their financing, and that obviously, you know, magnified itself as we went through towards the end of the Summer and the beginning of September.

COMMISSIONER HENNESSEY: I'm going to cut you off because my time is limited. If I could go back in time into that April to August time period and ask you privately, do you think Lehman is solvent, what would you have said at that point in time? Yes? No? Or I'm not sure?

WITNESS ZUBROW: I think that Lehman clearly had capital at that time that was supporting its businesses. So from a pure accounting standpoint, it was solvent. But it obviously was financing its assets on a very leveraged basis with a lot of short-term financing. So I do not think that--our own view, from a credit standpoint would be that, you know, they had a very thin, you know, cushion of error with the way they were financing their balance sheet and what the character of the assets were on the balance sheet and the way they were being financed.

COMMISSIONER HENNESSEY: Mr. Baxter, do you have a view on this?

WITNESS BAXTER: First, the Fed was not the supervisor of Lehman.

COMMISSIONER HENNESSEY: Understood.

WITNESS BAXTER: But one of the lessons of the crisis for us is that there wasn't enough capital in the banking system, either, to withstand the kind of effects that we felt in 2008.

COMMISSIONER HENNESSEY: I'm trying to figure out whether the liquidity run in fact may have had some substantive justification because the marks were bad, or their balance--you know, maybe Mr. Fuld was wrong. Maybe they didn't have sufficient capital before the run started. Do you have a view on that?

WITNESS BAXTER: Well where I was going with that is, I think one of the things we learned during the crisis is that there needed to be more capital to withstand this kind of shock. And that's why on Columbus Day of 2008 that the nine major financial holding companies were urged in a meeting at the Treasury to raise more capital.

And then as we went into 2009, the Fed led the Supervisory Capital Assessment Program, which developed a capital buffer to come on top--

COMMISSIONER HENNESSEY: Understood, but that's after the fact. I'm trying to figure out--Mr. Fuld, I think I know your answer, which is there wasn't a capital hole. Why did you have such a tough time convincing others that your accounting was good, that you were sufficiently transparent, that your marks were good, and that the firm was viable?

Why was the decreasing confidence? The Valukas Report specifically is citing the two consecutive quarters of lost earnings, and then is talking about market participants raising concerns about your marks and about your transparency.

Can you talk about that from your perspective, pre-mid September?

WITNESS FULD: First quarter, typical quarter, I believe we were positive net income of about $500 million. That was shortly after--I think we reported shortly after Bear Stearns.

With Bear Stearns there had been a huge number of rumors, and I know nobody likes to hear about naked shortsellers, but I believe that there are enough institutions that suffered from naked shortselling, and there's been a ton of testimony around that that you don't need to hear it from me, there is no coincidence about stock price performance and naked shortselling. I'll just leave that alone.

We were the next smallest. I think there were a number of rumors, incorrect rumors, that talked about mark-to-market, talked about misrepresentation of certain assets. There were some hedge funds that talked about mortgage CLS and CDOs that we were carrying on the balance sheet that we weren't disclosing.

We went to full disclosure. They were not mortgages. They were not real estate related. They were corporate asset-backed financings. We went live with that. We dug deeper into our explanations and were even more transparent. That did not resolve it.

And once you get a bank on the run having to defend itself time and time again, you lose--not "you," "we"--we lost credibility. You're asking me a question: Why was I not able, or why were we not able to put a stake in the ground and say this is where we are. Believe it, and let's go on. And I do not know.

Because we did have a number of analysts. We did have the agencies--the agencies had their own problems--come out and say why was Lehman a single A. They had taken $25 billion in writedowns. They had the capital. They had the liquidity. And they had a strong set of operating businesses.

I do not know.

COMMISSIONER HENNESSEY: Okay, let me then follow up--

WITNESS FULD: I do not know why we were unable--

COMMISSIONER HENNESSEY: Two questions. I assume we agree that post-bankruptcy filing there was a capital hole? I mean, the senior unsecured debtholders were getting 8 or 9 cents on the dollar.

WITNESS FULD: It wasn't post-bankruptcy. It was within six hours.

COMMISSIONER HENNESSEY: Okay, but your argument then is that that was entirely the result of the liquidity run?

WITNESS FULD: It was taking our entire derivatives swap structured transaction book. Those that owed us money, because of bankruptcy didn't have to pay. Those that had collateral didn't have to return it. And that only heightened the crisis, because what they did was they sold out collateral, which meant that there were more assets in the marketplace looking for a new home, which further depressed prices.

COMMISSIONER HENNESSEY: Okay. I want to come to one other point. The point which you said you sort of set aside, the rumors, the whisper campaign that's out there to talk down Lehman--those are my words, not yours--from our perspective we heard a similar story from the former heads of Bear Stearns: We were a fundamentally solvent company; there was no reason for people to stop providing us with liquidity; but there were people out there whispering.

And I'll just say from my perspective it is a plausible story that there are people out there talking down the value of the firm. I'm happy to believe that there are people who would do that, for whatever reason.

Until and unless someone is able to actually point to someone and accuse them and say, I think this person was doing it, what's going to happen is we're going to spin round and round like we always have done. Which is, someone like you will assert there are people who were trying to bring down my firm by whispering lies about it, and then the investigators, whether it's the SEC or somebody else, will say, well, we went around and talked and we couldn't find anybody.

So setting aside and saying there are unnamed people out there who are spreading these rumors doesn't help convince at least me that that's the case. Point to someone and say here's a hedge fund manager who was talking down my firm, so that someone with the subpoena authority, whether it's this Commission or the SEC, can go after them and say: What did you say about Lehman Brothers?

I want to come now to the question of the weekend and the bridge loan. And the bridge loan that you were looking for, the bridge funding that you were looking for, that was a bridge to what?

What we have heard from Mr. Baxter, what we heard from Mr. Alvarez, what we've heard from then president Geithner, and Chairman Bernanke, and Secretary Paulson, is that the problem is there wasn't a buyer. There was the Korean Development Bank, which said no. Barclays fell through. BofA went with Merrill. So, suppose that Mr. Baxter was wrong. Suppose there was some legal path to provide you with short-term financing.

What would that have bought you time to do? Who was going to be your partner?

WITNESS FULD: BofA clearly was not. Barclays remains to be seen. Please remember that we were forced to pre-release our earnings on September 10th, whatever it was. That was about 10 days to 2 weeks earlier than we had planned.

We were having a number of conversations--when I say "number," I don't mean two or three, I mean closer to eight or nine--with potential capital providers, or larger, to support the firm.

Even KDB was literally on its way to New York on that Wednesday of that week, whatever it was, September 7th, 8th, 9th, and 10th, when they were called back by their Finance Minister. They were on their way to see us.

Nomura subsequently stepped in. I can't look at you today and tell you I had two or three people that would have bought the firm. All conjecture. You wouldn't be able to prove otherwise. But you asked me a question. My view. I can't do that. But at least we would have been in a position where, had we gotten through that Sunday, we would have been able to have had at least an orderly wind-down. It may have wiped out a good part of the equity value; I'm not sure of that.

I believe it would have protected the creditors and debtholders; would have held in place the derivatives, swaps, and structured transactions; and also, may have given--"may"--have given us an opportunity to have then consummated a transaction which would have taken Lehman into somebody else's corporate forum--that was ridiculous--a merger.

COMMISSIONER HENNESSEY: Okay, and just from the way I'm hearing it, the Fed guys are saying: Look, we didn't see any possible buyer out there. Right? After BofA and Barclays fell through, there was nobody there lined up, and that's why this was fundamentally different from JPMorgan and Bear Stearns, why it was fundamentally different from Citi and Wachovia.

What I hear you saying is: Fed, give us some time, at a minimum to wind down in an orderly manner, and maybe someone else will be out there to buy it. That second part, that "maybe somebody will be out there to buy us," sounds consistent with what the Fed guys are saying, which is that over the course of that weekend there wasn't a buyer. There wasn't a viable candidate.

So if from their perspective the entire sphere of government action was contingent on there being a potential buyer out there, it sounds like the two of you agree that over that weekend there wasn't. The clock ran out on you. The liquidity run was in place. You didn't have a buyer. And if you believed the Fed's perspective, they're saying we don't have a legal authority to do it. And others are saying, well, maybe there was some other motivation.

Can you comment on that?

WITNESS FULD: All right--

CHAIRMAN ANGELIDES: Why don't we go ahead and--

VICE CHAIRMAN THOMAS: I've given him five more minutes. He's had ten.

CHAIRMAN ANGELIDES: Okay.

VICE CHAIRMAN THOMAS: One minute to finish up on the response.

COMMISSIONER HENNESSEY: Two minutes?

VICE CHAIRMAN THOMAS: Two minutes to finish up on the response.

CHAIRMAN ANGELIDES: Which would make it four minutes. We're fine.

VICE CHAIRMAN THOMAS: Two minutes.

COMMISSIONER HENNESSEY: Thank you.

WITNESS FULD: I believe we did have a buyer in Barclays. I believe they did want the entire entity. I believe that they wanted to hive off certain assets, and I believe our competitors had put together a consortium to have financed those assets. So I believe we did have a buyer. We needed some pieces of assistance, but I believe we had a buyer. Nomura stepped in 24 hours later. And I can tell you that, I said it before, we were having four or five other conversations.

It wasn't just a buyer. It was a potential capital provider, because the question was did we have the capital to fund SPEDCO, which was SEC-approved? Yes, we did. Because the capital that would have gone to SPEDCO was the same capital that was supporting those commercial real estate assets on our balance sheet. So, yes, we did.

We had internal capability to create capital: change the preferreds to common, bring down the balance sheet. So we had other opportunities to create $7 to whatever it was $10 billion of capital.

Any one of those would have bridged that gap. Some internally created, some external.

COMMISSIONER HENNESSEY: Okay. One other--I think I'll finish with a comment here, which is:

On the extensive amount of time we spent with Mr. Alvarez and Mr. Baxter debating whether the Fed's nonaction was a choice, or was the only option that they had, I think that there is a burden upon those who argue that it was a choice to describe what the other option was. And part of that other option is the "who was the buyer?" option; but the other piece of it that I have not seen is: What was the other legal path?

I have still not seen in the, what, two years since this happened, any lawyer describe: If I had had Mr. Baxter's job, here's what I would have advised the president of the New York Fed to do. Here's the legal authority that he could have used to provide this stream of funding to either the broker-dealer, or the holding company pre-bankruptcy filing to then facilitate the transaction here.

For there to be a choice, there have got to be two options. I've heard one option described. I've heard some people say there may be nefarious motives about what that option was, but until someone describes the other option, there isn't a choice.

And I'm still waiting for someone to tell me what was that other option that president Geithner and Chairman Bernanke supposedly rejected.

VICE CHAIRMAN THOMAS: I want 15 seconds.

CHAIRMAN ANGELIDES: All right, thank you. I just have one, though, comment, which is I don't think anyone has implied nefarious motives. I think what we are trying to get to is what exactly happened, why it happened, why the decision was made.

Obviously the Fed has their position. They've stated it well. There's information we have which people can review and come to their own conclusions about. I think we're just trying to get to what happened.

VICE CHAIRMAN THOMAS: Just a quick--

CHAIRMAN ANGELIDES: And the only thing I might add on that, and I'm not--I'm saying I'm trying to find out what happened. I see a number of motivations at work in the chronology, since you raised this.

I also note that on September 23rd and 24th, when Chairman Bernanke was called before Congress to talk about the Lehman failure/bailout, legal authority was never mentioned in that testimony. So I just wanted to point out that the chronology seems to indicate multiple item considerations at work, and that was my only point.

Now, Mr. Vice Chairman.

COMMISSIONER HENNESSEY: Could I respond to that at some point, after the Vice Chairman?

VICE CHAIRMAN THOMAS: We'll see.

CHAIRMAN ANGELIDES: You're in your mother's arms.

VICE CHAIRMAN THOMAS: All I want to do is underscore from the first panel the comments from Mr. Corston about his concern was focused on the FDIC, and not having the FDIC at risk in terms of its Fund. And that's why with Wachovia they were more than pleased to have the Treasury issue a change in a tax provision which gave them an out that didn't cover them.

Mr. Alvarez also made the point that the Fed wasn't exposed, so that was a pretty good deal. I just want to thank you, Mr. Baxter, for three times mentioning that if they had only had access to additional funds, A, B, or C would have occurred. And then if they had only had additional access to funds, D, E, or F would have occurred.

You said that you couldn't sustain the taxpayer exposure to allowing additional time to see if something else could happen. So on behalf of the taxpayers, I want to appreciate your understanding that whatever euphemism is used, "government," "FDIC," "Federal Reserve," it's all the taxpayers' money.

And at some point, if that was going to be a relief to give you the ability to do something else, you just ran out of time. And the taxpayers have certainly run out of dollars.

CHAIRMAN ANGELIDES: Thirty seconds.

COMMISSIONER HENNESSEY: Thirty seconds.

CHAIRMAN ANGELIDES: Then I would like to move on, yes.

COMMISSIONER HENNESSEY: Just to respond to your point, I agree that it is important to understand all the motivations of all the actors involved. On this particular issue, I think the legal question is dispositive.

We have Mr. Baxter and Mr. Alvarez who are testifying under oath that they believed there was only one--there were only these particular legal paths.

CHAIRMAN ANGELIDES: Let's do this--

COMMISSIONER HENNESSEY: If they are in fact--

CHAIRMAN ANGELIDES: You and I can debate this, and we'll have a lot of time between now and December to discuss this. I'm just going to observe that there's a legal opinion from Mr. Alvarez. There's facts on the table. And why don't we just--I understand your point.

I said, as one member of the Commission, we put facts on the table. And I think part of our job is to digest those, but also let the public digest those.

COMMISSIONER HENNESSEY: Thank you.

CHAIRMAN ANGELIDES: Yes. Senator Graham.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman. I would like to ask my first question of Mr. Baxter, not individually but as a representative of the New York Fed.

Has there been an evaluation made of the consequences of the failure of Lehman?

WITNESS BAXTER: I think not just by the New York Fed, I think we all in the Federal Reserve understand that the Lehman bankruptcy had significant consequences and was one of the accelerants for what we experienced in the last quarter of 2008.

COMMISSIONER GRAHAM: And is there a written document, either from your office, the New York Fed, or some other place that puts some numbers behind the consequences?

WITNESS BAXTER: None comes to mind, Commissioner, but let me go back and check with my colleagues. If there is such a document, we will provide it to the Commission.

COMMISSIONER GRAHAM: Mr. Miller, do you know of any evaluation of the consequences of the failure of Lehman?

WITNESS MILLER: No, sir, nothing in writing--

VICE CHAIRMAN THOMAS: Your mike.

WITNESS MILLER: No, sir, there's nothing in writing that I have seen.

CHAIRMAN ANGELIDES: About the bankruptcy?

WITNESS MILLER: The bankruptcy has had severe consequences for the creditors, and the stockholders, and it has ancillary waves of problems for the companies that were relying upon financing from Lehman who ended up in bankruptcy.

COMMISSIONER GRAHAM: I mean, the whole rationale for governmental intervention is that there are consequences to failure that are not only unacceptable to the institution directly involved, but to the larger financial and economic community.

This seems to be the most significant case study to test that theory. So I would think someone would have done an analysis of what were the consequences of the failure of Lehman as a means of evaluating the seriousness of the consequences of nonintervention in other analogous cases.

I am particularly interested in the future. And that is, what can we do in order to avoid getting into this Sunday night situation with future institutions?

We had a list of items from the earlier panel as to what has been done through things like the Dodd Act, and one of those was to enhance risk management standards.

Mr. Zubrow, as the risk manager for one of America's largest financial institutions, what have you done to enhance risk management since September of 2008? Or what do you anticipate being done?

WITNESS ZUBROW: First of all, Commissioner, I would note that obviously throughout the crisis we feel that JPMorgan Chase performed extremely well.

We had the benefit of what we think was very good risk management practices, you know, that started with a very strong risk culture and tone at the top. There's no question that, you know, leading up to the crisis, you know, we made some mistakes, and there are things that, you know, we have certainly changed in terms of the way we think about risk management.

As I look forward, I think that some of the most important things that people have to focus on in large complex institutions is making sure that there's a comprehensive risk culture in the institution. That risk culture has to start with a very strong tone at the top, from both the CEO and the board and percolate throughout the whole organization. And there has to be the right comprehensive, you know, measurement devices to be able to assess what the risks are that the institution is taking to measure them, to monitor them, and to obviously mitigate those risks that are deemed to be excessive.

COMMISSIONER GRAHAM: In your corporate governance structure, is risk management a responsibility of the audit committee? Or is there a separate entity of the board that has a broader responsibility for risk management?

WITNESS ZUBROW: There's a separate committee of the board. It's our Director's Risk Policy Committee. And, you know, I certainly feel that I'm accountable to that

Committee.

Obviously I report directly to the CEO, but in addition the entire Risk Management organization of the Bank reports to me, is independent of the different lines of business that they monitor or control, and that independence is a very important part of the type of risk culture that I talked about.

COMMISSIONER GRAHAM: You've said, and I believe there is external support for this, that Morgan Stanley has had a reputation for a strong risk management process--

WITNESS ZUBROW: I believe you mean JPMorgan?

COMMISSIONER GRAHAM: I mean JPMorgan, I'm sorry, JPMorgan. But do you anticipate any changes to further augment your risk management?

WITNESS ZUBROW: We certainly constantly review how we do risk management in our different businesses. There are certainly things that we've changed.

One of the things that we've certainly emphasized over this period of time is greater stress testing, not only of our trading books but also of our other lending books. We certainly have changed a number of the limit structures under which we allow our businesses to operate.

And so we view risk management as very much of an evolutionary process. We try to learn from mistakes in the past, both ours as well as others'.

COMMISSIONER GRAHAM: Mr. Fuld, you listed some of the mistakes that you thought Lehman had made. Was moral hazard the sense that there would be an ultimate governmental support if things went as bad as they ultimately did, was that part of the mistakes of Lehman Brothers?

What was your level of expectation that you were going to have government assistance in the extremis situation?

WITNESS FULD: I had no expectation that the government would help us. And I think that that precedent was set after Bear Stearns, where there was so much lashback on bailout, and crisis, that it was clear that the government could not do that again.

So I walked into not only that weekend but also the month before knowing that we had to create our own solution.

COMMISSIONER GRAHAM: One of the other items you raised was your mortgage origination operation. By the mid part of the last decade there were some signals that residential mortgages were weakening. The pace of acceleration of housing values had stalled, and then started to decline. Some of the ratings--

CHAIRMAN ANGELIDES: Two minutes, Senator?

COMMISSIONER GRAHAM: Could I have thirty seconds?

CHAIRMAN ANGELIDES: Yes.

COMMISSIONER GRAHAM: Do you think that--why didn't Lehman become aware of this decline in its residential mortgage asset portfolio earlier than you indicated it did?

WITNESS FULD: I said that we closed our platforms in the middle of '07.

COMMISSIONER GRAHAM: Yes.

WITNESS FULD: Toward the latter part of '06, we began to hedge our mortgage positions. And even spoke about it in our 2006 filing to indicate that we had started to hedge those positions.

At that point, though, I did not believe that it was going to escalate to the point that it did. But even in the early part of '07, we began to cut back on the commitments that we made to securitize. And then eventually closed the platform altogether.

COMMISSIONER GRAHAM: Thank you.

WITNESS FULD: So it went in a chronology of '06 hedging, '07 cut, early '07 cutback, securitizations, mid-'07 close the platform.

COMMISSIONER GRAHAM: Thank you.

CHAIRMAN ANGELIDES: All right, thank you. Very quickly members, we have received a copy--and I guess we could make a copy for all the members--of the letter to which Mr. Baxter has referred. As you may remember, Mr. Baxter said there was a letter offered on September 14th which made it clear that the expanded collateral was available to Lehman Brothers. This is what I think Mr. Baxter might refer to as "the smoking letter."

Mr. Holtz-Eakin has a couple of questions on this letter, and some information from the Valukas Report. I think it would be helpful to inform the members here.

COMMISSIONER HOLTZ-EAKIN: Just briefly.

VICE CHAIRMAN THOMAS: Does Mr. Baxter have a copy?

COMMISSIONER HOLTZ-EAKIN: Mr. Baxter is welcome to mine.

VICE CHAIRMAN THOMAS: Is your memory that good?

COMMISSIONER HOLTZ-EAKIN: It doesn't matter. I'm not going to read from the letter. The only question--

VICE CHAIRMAN THOMAS: Let him have it.

COMMISSIONER HOLTZ-EAKIN: The copy we have--take one down--the copy we have shows no acknowledgement of receipt by Lehman. If you've got a copy that shows they actually got it, we would like to see that. It must be in the file somewhere of someone.

WITNESS BAXTER: We will look. I don't, obviously--

COMMISSIONER HOLTZ-EAKIN: Thank you.

WITNESS BAXTER: --have it with me.

COMMISSIONER HOLTZ-EAKIN: I know. I mean, that's for later. Here's what I want to understand.

This is from the Valukas Report, and it says that on the 14th the Federal Reserve issued a press release stating the expansion of collateral pledged at the PDCF, letter informs recipients of that, and then, quote:

Upon learning of the expansion of the PDCF window, Lowitt and Fuld initially believed that Lehman's problem was solved and that Lehman would be able to open in Europe by borrowing from the PDCF. However, Lehman soon learned that it was not eligible to use the window. The Federal Reserve Board Bank of New York limited the collateral Lehman Brothers could use for overnight financing to the collateral that was in Lehman Brothers box at JPMorgan as of Friday, September 12th, 2008. That restriction was referred to as 'the Friday criterion.' And the source of the Friday criterion information is in fact the same Christopher Burke who is the author of this letter.

Is that correct?

WITNESS BAXTER: I have met with Mr. Valukas in a trip to Chicago in June to talk about this issue with respect to--this and other issues with respect to the letter, and I don't have an answer as to, you know, to clarify, other than the letter seems to speak for itself.

I, you know, have the utmost confidence, and I think the Valukas Report is an excellent report. That doesn't mean that I think every single detail is correct. And this is one of those details that I think our record and the record of Mr. Valukas are different. And I can't reconcile those differences for you.

I will go back and see whether we can come up with our best understanding as to explaining this, but I don't have an explanation right now.W

COMMISSIONER HOLTZ-EAKIN: We don't have time right now, but I would ask, very much, that you would not just give your best effort, but please reconcile the various accounts of what was eligible to be pledged by Lehman prior to their filing at 2:00 in the morning on the 14th.

CHAIRMAN ANGELIDES: What I would like to do, with your permission, Mr. Holtz-Eakin, is to enter the letter into the record, and the relevant portion of the Valukas report, if there's no objection.

And the only other thing I want to put a punctuation mark on is the last sentence you read was attributed to the Examiner's interview of Mr. Burke. So this was not the Examiner. This is the Examiner's interview of Mr. Burke.

So we will follow up at the staff level, or the staff will follow up at the staff level, on this issue. All right, thank you.

Ms. Born.

COMMISSIONER BORN: Thank you very much, Mr. Chair. And I'd like to start by asking Mr. Baxter a question.

You testified that the Federal Reserve, at least the Bank of New York but I think you meant the entire Federal Reserve Board, was aware in the runup to the Lehman Brothers bankruptcy that Lehman Brothers was systemically important, and that its failure would have systemic negative effects? Is that correct?

WITNESS BAXTER: That's correct.

COMMISSIONER BORN: And you also said that one of the things you were aware of was that it's failure would cause disruptions in the derivatives market. Is that correct?

WITNESS BAXTER: Yes.

COMMISSIONER BORN: Were there disruptions in the derivatives market when Lehman Brothers failed?

WITNESS BAXTER: Yes.

COMMISSIONER BORN: What were those disruptions?

WITNESS BAXTER: Well I'm probably not the best person, being a lawyer, to describe them for you, Commissioner Born, but I do understand that there were problems with netting arrangements. Some of those problems occurred also because of what we were trying to deal with during this most extraordinary week.

Remember that on September 16th we had a problem with AIG as well. So it's hard to say what was cause and what was effect, particularly at that point in time. And this is another very significant point with respect to causation.

The month begins with a conservatorship of Fannie Mae and Freddie Mac. Then we have Lehman file on September 15th. We have an extraordinary event with respect to AIG on September 16th. And then to cap it off, on the weekend after Lehman weekend, Morgan Stanley and Goldman Sachs become bank holding companies.

So, you know, an extraordinary series of events in a short series of time. There were disruptions across all markets, including the derivatives market. So it's very hard to say that it was the Lehman that caused that disruption rather than one of the other many events that we were trying to deal with, many of the other fires that were burning at the time.

COMMISSIONER BORN: Are you aware of any studies or reports or information at the Fed, or another government agency, dealing with the disruptions in the derivatives markets at that time?

WITNESS BAXTER: I believe there are reports. I can't cite you the economist who wrote them at this particular point in time, but let me go back and see if we can identify them and make them available to the Commission.

COMMISSIONER BORN: That would be very welcome, and I request that you do so.

We have had some people tell us that the Lehman Brothers failure did not in any way involve problems with derivatives; and that that was an illustration of how small a role derivatives played in the financial crisis.

So I wanted to ask Mr. Miller whether or not there were problems or concerns with derivatives involved in the bankruptcy of Lehman Brothers, to your knowledge.

WITNESS MILLER: Yes, there was, and there continue to be major problems with unwinding derivatives transactions. The effect of the filing on September 15th was to create an event to default under--most of these derivatives were under, is the contracts. And because of the event of default, the counterparties were entitled to give notice of termination.

And from Friday to Monday, as I understand, Lehman was in the money. And when we got to the week of the 15th, Lehman was out of the money. And many of the counterparties gave notice of termination, proceeded to liquidate collateral, and because of the provisions in the

Bankruptcy Code a bankruptcy court has no jurisdiction over that.

In 2005, Congress passed legislation which safe-harbored all these transactions. So Lehman took very, very substantial losses in connection with the derivatives markets. And a major portion of the administration of the estate in terms of personnel, even to this day, involves trying to unwind the still-remaining derivative transactions.

There are over almost 250 people who work on the Lehman Estate who work on nothing but derivatives. These transactions are extremely complex. They're multiple. There all all types of transactions. It's a very complex area. And it's all interconnected all across the globe.

COMMISSIONER BORN: Interconnections among financial firms?

WITNESS MILLER: Yes, ma'am. Financial firms in all of the Lehman global operations. On September 15th, because of the bankruptcy of Lehman Holding, within 10 days we had 80 foreign proceedings. And every one of those proceedings has either a receiver, or an administrator, and the very major operation in London, Lehman Brothers Europe, which was one of the biggest broker-dealers in London, when that entity went into administration under the UK Insolvency Laws, and administrators were appointed from PWC, the first thing they did was close down the system, the accounting system.

That accounting system, which was a global system, operated excellently while Lehman was operating. By closing down the system, we lost track of all the transactions. And we had to re-create the entire accounting and reporting system.

So to this very day, derivatives remain a very big part of the administration of the Estate.

COMMISSIONER BORN: Is there any document that you are aware of that describes in detail the problems of derivatives in the Estate?

WITNESS MILLER: I believe that the International Society of Derivatives Association has done a number of studies on the effect of not only Lehman's bankruptcy, but generally the contraction in the markets. I think there have been a number of reports that it has prepared.

COMMISSIONER BORN: Do you have any of those reports?

WITNESS MILLER: I'm sure we can have access to it.

COMMISSIONER BORN: It would be very valuable if you would try and get access to those and provide them to us.

WITNESS MILLER: I will do so.

COMMISSIONER BORN: Mr. Zubrow, let me just ask you a question, since JPMorgan was a major counterparty, derivatives counterparty, as well as the triparty repo clearing bank for Lehman Brothers.

In your testimony you indicated that Lehman Brothers had asked--that JPMorgan had asked Lehman Brothers for $5 billion in extra collateral on September 9. And you said that a primary reason for that was because of JPMorgan's derivatives exposure related to Lehman Brothers.

Could you explain what that exposure was? What kinds of things did that consist of?

WITNESS ZUBROW: As I said in my testimony, both written and oral, there were two--several primary sources of our credit exposure to Lehman. One was obviously the triparty repo book that we've talked about.

In addition, in order for us to continue to be supportive of Lehman in the marketplace we would be taking on derivatives exposure either by directly trading with Lehman, or trading on behalf of prime brokerage clients.

And then in addition, many counterparts of Lehman during that week sought to close out their derivatives positions with Lehman and extinguish any credit exposure that they might have in the failure of Lehman, and they would come to us and ask us to step into their shoes in a process that's called a novation.

And in order for us to continue to be supportive of Lehman in the marketplace, to continue to accept those novations, to not back away from them as a counterpart, we asked for that additional collateral.

COMMISSIONER BORN: And did you consider--just one very--

CHAIRMAN ANGELIDES: Sure. Absolutely. Take two minutes.

COMMISSIONER BORN: --very small follow-up.

CHAIRMAN ANGELIDES: No, take two minutes.

COMMISSIONER BORN: I assume the requests for novation were essentially an aspect of the run on Lehman Brothers at that point?

WITNESS ZUBROW: That would be correct.

COMMISSIONER BORN: Thank you.

CHAIRMAN ANGELIDES: That's it?

COMMISSIONER BORN: Yes, that's it.

CHAIRMAN ANGELIDES: Okay. Ms. Murren.

COMMISSIONER MURREN: Thank you, Mr. Chairman. A question for you, Mr. Zubrow, and it really follows down this line of inquiry.

A lot of your testimony and also your commentary has been very specific to Lehman Brothers. But I was wondering if you could provide us some context for that?

You have been around risk management for a long time through a number of different business cycles, and could you talk a little bit about how you typically deal with your clients in those situations where there may be more uncertainty in the markets in the past?

And then also, specifically in this instance in this crisis, other clients that you might have had to take similar actions with with regard to collateral or reducing your exposure, and whether in any way Lehman stood out as an outlier in that regard or whether it was part of an overall strategy that you had in dealing with the markets at the time?

WITNESS ZUBROW: Thank you, Commissioner, for that question. Certainly as we talked about, but let me emphasize, one of the things that we were very focused on in looking at all of our triparty repo clients, you know, was the question of what was the character of their triparty financing book.

And going back to the end of '07 and into the spring of '08 following the Bear Stearns situation, we went to all of our triparty clients and felt that the character of their book had changed materially over the last period of time.

The triparty business was originally a business designed to help broker-dealers finance government and agency inventories. And we I think collectively woke up as an industry and found at the end of '07, beginning of '08, that much of the financing, or a significant portion of the financing that was being done by the broker-dealers had shifted into less liquid, harder-to-value securities that typically were not cleared through the Fed Wire or Fed Systems, but rather cleared across DTC. And so we tended to refer to those as DTC-eligible securities. But they shared a characterization of typically being less liquid, obviously less secure because they were not government or agency bonds, and we were concerned that investors were not providing the right credit analysis and view of that collateral and applying the right haircuts in their relationships with the broker-dealers.

During the spring and summer of '08, we worked collaboratively with a number of the large broker-dealers, large clearing, or large banks, as well as other investors through the Counterparty Risk Management Policy Group to try to articulate, among other things in that group, a series of best practices for the triparty repo business.

We did that in a collaborative way. We articulated those best practices through that report, which I believe you have a copy of. And we also did so very much in consultation with the New York Fed, recognizing that some of the best practices that we were suggesting in that report would have an impact on the financing of the broker-dealer community, the need for them to provide additional haircuts, and ultimately to try to finance some of their inventory investments through other types and means.

COMMISSIONER MURREN: So then there were others that you had made similar requests of, other than Lehman Brothers, in that arrangement?

WITNESS ZUBROW: We had discussions with all of our triparty repo clients about the need to implement the types of best practices that I talked about. And in particular, to move to making sure that during the intra-day financing that JPMorgan Chase provided through the triparty mechanism, that we move to a situation where we were retaining at a minimum the full amount of the investor haircut from the overnight financing arrangements.

But we also had discussions with each of our clients about the need to move to more of a robust risk-based haircut mechanism which would better take into account the character of the securities that were being financed, and in particular what the liqudation risks of those securities were in the event of a dealer default.

COMMISSIONER MURREN: Thank you. On Lehman specifically, could you talk a little bit about other areas where you may have reduced your exposure to the firm?

WITNESS ZUBROW: In fact, I think that throughout the period of late August-September, we were actually increasing our exposures to them by continuing to accept novations from, you know, other counterparts, continuing to trade with them on behalf of broker-dealers.

So as part of our efforts to continue to be supportive of them in the marketplace, in addition to the daily unwind that we were doing in the triparty repo book, we were taking on additional exposures to them by accepting these novations and doing this other trading activity.

COMMISSIONER MURREN: And could you comment briefly on the notion that there were participants in the market that were engaged in manipulation of the markets? And not just in Lehman Brothers, but also perhaps in the securities of other financial firms? And I would echo Commissioner Hennessey's request that, if there is specific information that you can share with this Commission, it would be very helpful to try to ferret out the merit of some of these allegations that have been made.

Because it has been made by many, many of the witnesses that have come before us and we are curious to see if we can pinpoint the merit and the validity of some of these claims.

Is it your observation also that there was market manipulation at work in the activities of some of these securities of the financial companies, Bear Stearns, Lehman Brothers, others?

WITNESS ZUBROW: I certainly have not made that observation. What I would say is that it's clear that when you look at the market spreads for Lehman Brothers during this period of time, there is clearly a widening of their credit spreads. And obviously the price of their stock was declining, but I don't have any speculation as to whether there was any manipulation or other activities that were going on such as you reference.

COMMISSIONER MURREN: Thank you.

CHAIRMAN ANGELIDES: Your timing is always impeccable. Anyway, Mr. Wallison?

VICE CHAIRMAN THOMAS: Mr. Chairman, prior to turning it over, I would like to add five minutes to the Commissioner's time, which doubles your time.

COMMISSIONER WALLISON: Thank you. That doesn't quite do that, but--

VICE CHAIRMAN THOMAS: Five and five.

COMMISSIONER WALLISON: --in any event, I don't know that I'll need it all.

CHAIRMAN ANGELIDES: Take eight.

VICE CHAIRMAN THOMAS: You take it all.

COMMISSIONER WALLISON: I now have 13. There we are.

All right, I want to follow up in an area that we haven't really discussed, either this morning or this afternoon, and it's entirely possible that I am confused or maybe not up-to-date, but my understanding of the discount window would suggest to me that the discount window, at least from what we've heard, should have been a useful option for both Wachovia and for Lehman.

And I would like to understand a little bit about why that was not true. Now the discount window, as I have always understood it, was for the purpose of allowing financial institutions, banks--only banks, not bank holding companies, as we were told this morning by the General Counsel of the Fed--but banks, to address runs, withdrawals, things of that kind, if they are solvent.

And the Fed would take good collateral and monetize it, in effect, so that they could continue to meet the obligations that they were facing when depositors were taking their funds out because of panics, or fears, or things like that.

In fact, the whole idea for establishing the Federal Reserve was to overcome the problems that arise in the case of runs.

Now let's start with Wachovia. Wachovia, a bank certainly, and I'll address this to you, Mr. Baxter, if I can, why was the possibility of saving in effect Wachovia, or at least making it able to deal with what we were told was liquidity difficulties, not used, not actually available, or not a factor in the Wachovia case? Everyone seems to have been looking for another bank to acquire them.

Now that would only be true, it seems to me, if Wachovia was in fact insolvent. If it was simply illiquid, then the discount window was supposed to be the cure.

Mr. Baxter, can you fill us in a little bit on that, and then we will turn to the Lehman case?

WITNESS BAXTER: Commissioner Wallison, I can't speak about Wachovia, which is not located in the Second Federal Reserve District, but in another Federal Reserve District, so I am not familiar with the facts associated with that.

I know Mr. Alvarez was here earlier. I can speak about--

COMMISSIONER WALLISON: What was one of the questions I didn't get to with Mr. Alvarez--

WITNESS BAXTER: Some of the general philosophy with respect to the discount window, you're quite correct that under Section 10 of the Federal Reserve Act the discount window is normally used for handling liquidity problems in depository institutions, banks, roughly defined.

There are different programs under that section of the Federal Reserve Act as a primary credit program for banks that are in good shape. And then there's a secondary credit program for banks that are in not such good condition.

So there is a different type of lending done at the discount window for institutions that are not as sound as others. It is intended principally for liquidity problems. It is not intended for a capital problem. And you're correct that where there is a capital deficiency in an institution, often the supervisors, Fed included, will look to other solutions to deal with those types of problems, including mergers.

COMMISSIONER WALLISON: So in the case of Wachovia, you cannot speak directly to that, but there must be some knowledge within the Federal Reserve about something as significant as the Wachovia case, which we've spent so much time on this morning.

Were you of the understanding that Wachovia was insolvent at the time it was considered for some sort of special takeover by Citi, and ultimately taken over by Wells Fargo? Were you of the view that it was insolvent?

WITNESS BAXTER: I don't have personal knowledge of the Wachovia situation.

COMMISSIONER WALLISON: Okay. I guess we will try to address this question to the Chairman when he is here. That's a question I will save for him.

Now let me just turn to the Lehman case, because it raises the same issues. Lehman was eligible for the discount window, as I understand it. And I cannot get clear, even from all the exchanges we've had, whether we are talking only about LBI, the broker-dealer, or we are talking about the holding company. I thought that the Fed had opened the discount window to the holding companies before Lehman failed. And in that case, Lehman, at least the holding company, was eligible for discount window access.

Is that your understanding? Or am I wrong about that?

WITNESS BAXTER: That's not correct. I'll try to explain it, and I hope not to sound too much like a lawyer.

The discount window is used by lay people to refer to lending programs of the Federal Reserve broadly. The normal Federal Reserve lending program is the one under Section 10(b) of the Federal Reserve Act to depository institutions.

When we got into the credit crisis, and we got into 2008, we started to think of using a statutory power that had not been used since the Great Depression. And I'm talking about Section 13, subdivision 3 of the Federal Reserve Act which enables the Fed to lend to an individual, a partnership, or a corporation, not a bank.

And the first usage of that Section 13.3 power occurred on March 11th of 2008 when we introduced the Term Securities Lending Facility.

The second time we used that extraordinary power was on March 14th when the Board of Governors authorized the New York Fed to lend to Bear Stearns through JPMorgan Chase to carry Bear Stearns through the weekend.

Now that's a special type--

COMMISSIONER WALLISON: Yes--

WITNESS BAXTER: --of power used only--

COMMISSIONER WALLISON: Right.

WITNESS BAXTER: --in extraordinary and unusual circumstances.

COMMISSIONER WALLISON: But why would that power not be of the same kind and purpose as the discount window itself? I mean, the use of the discount window term is just a broad phrase for the same kind of lending.

The purpose of the discount window I described before, the purpose of 13.3 was to make the same kind of facilities available to nonbanks. So does the Fed have different rules? Is there some different purpose for 13.3 other than simply to liquify institutions that are otherwise solvent?

WITNESS BAXTER: The statute is different in a couple of significant respects. If you look at the statutory language, for example, you will see in Section 13.3 that that lending is to be done only when the lending Reserve Bank finds that there is no adequate credit accommodations available to the putative borrower elsewhere.

Now that doesn't exist in Section 10(b). So banks can come to the window even though they can get credit elsewhere.

Under Section 13.3, the--and I'm speaking as 13.3 before it was amended by Dodd-Frank--those institutions were institutions that couldn't find credit elsewhere. So we're talking about extraordinary situations, borrowers who can't get credit--

COMMISSIONER WALLISON: But in Lehman--I'm sorry to interrupt, but in Lehman we did have a firm that couldn't get credit elsewhere. So why was it excluded in under 13.3 when the whole idea is to provide liquidity to solvent institutions?

WITNESS BAXTER: This might be a long answer. It was not--Lehman's broker-dealer was not excluded under 13.3, because it was eligible to borrow at the Term Securities Lending Facility. It was eligible--

COMMISSIONER WALLISON: I'm not talking about the broker dealer. Can we focus only on the holding company?

WITNESS BAXTER: With respect to the holding company, a couple of things would need to happen. We would need a new finding by the Board of Governors under Section 13.3 that authorized the Federal Reserve to lend to the holding company.

That never happened. That resolution was never promulgated by the Board. It was never promulgated by the Board--

COMMISSIONER WALLISON: Can I--may I interrupt for a--oh, yes, I'm sorry, for reasons that? That's my question.

WITNESS BAXTER: --for reasons that we were getting into earlier today, that that would ahve been a loan, a bridge to nowhere. And I think Commissioner Hennessey had a framing of that that was very elegant and right. And we would have been lending to the parent in the face of a run. And it was inconsistent with the contingency plan that we were executing after Plan A fell apart and we couldn't find a merger partner.

COMMISSIONER WALLISON: Well the fact that you had a different contingency plan can't be a factor. The important question has to be, if the institution is solvent--and Mr. Fuld has said it was solvent; and I haven't heard anyone actually contradict that yet--if it was solvent, then it doesn't matter what other plans you had in mind. It seems that the Board could have adopted a resolution that made Lehman Brothers eligible for the use of 13.3--that is, the parent company eligible for the use of 13.3.

Was it only the absence of a Board resolution that stopped that from being accessible to Lehman Brothers, the holding company?

WITNESS BAXTER: No, Commissioner. It was felt that that kind of bridge loan was a bridge loan to nowhere, because the management of Lehman had worked, I think as diligently as possible, to find a solution to their problems in the runup to Lehman weekend.

We had worked through Lehman weekend to find a solution to those problems. The market no longer had confidence in Lehman. The market was no longer willing to trade with Lehman--

COMMISSIONER WALLISON: I'm going to interrupt again. I'm sorry. But that is a characteristic of a liquidity run, and that is the market has no confidence.

The purpose of the Fed liquifying or monetizing the assets of a company that otherwise has unsaleable or assets for which there isn't a liquid market, the purpose of that is to say to the market: this is a solvent company. We are going to lend as much as it needs in order to maintain its ability to meet its obligations, because otherwise it is solvent. That is the purpose of the discount window.

You're sending a signal. And eventually, the run stops because people say, well, the Fed has concluded that this is a solvent company; there's nothing for me to worry about; there's plenty of money to meet my obligations.

Now I don't quite understand yet why the Fed didn't make this--didn't come to this decision and allow Lehman Brothers to use that facility.

WITNESS BAXTER: We saw no end to the run.

COMMISSIONER WALLISON: If they're solvent, if they're solvent then there is always an end to the run.

WITNESS BAXTER: Commissioner Wallison, one definition of "insolvent" is failure to pay your debts as they come due. And that was the situation that Lehman was experiencing at the end of Lehman week. And it couldn't pay its debts as they come due. No one would extend credit to it.

COMMISSIONER WALLISON: May I have a few more minutes?

CHAIRMAN ANGELIDES: Well, let's do this, because I think he accorded five more minutes--

COMMISSIONER WALLISON: I already got five.

CHAIRMAN ANGELIDES: Let's go to Mr. Thompson and then swing back.

VICE CHAIRMAN THOMAS: I should have given you two, and then two, and then you've have felt really good.

(Laughter.)

CHAIRMAN ANGELIDES: Let's do this. It's a good line of questioning, but I would like to accord Mr. Thompson the opportunity, and then maybe we can round back up. All right?

COMMISSIONER WALLISON: Sure. Good. Thank you.

COMMISSIONER THOMPSON: Thank you, Mr. Chairman. And, gentlemen, thank you for being with us.

Mr. Fuld, there's been much said about the mistakes that you made, or the firm made. There's been conversation about the risk management techniques or practices at JPMorgan Chase.

Obviously those practices weren't the same, or the systems weren't the same, at Lehman Brothers. Can you talk a bit about the risk management practices at Lehman Brothers, and why you didn't see this coming?

WITNESS FULD: Lehman very much prided itself in a strong risk management culture. That's how I grew up in the firm. The executive committee was in fact the risk committee.

A number of my senior executives had a majority of their net worth tied up in Lehman Brothers. I'm not going to say 100 percent of our employees, but a huge percent owned stock in the firm. So I looked at it that we had 28,000 risk managers.

Our risk management philosophy was no surprises. Never get yourself on the end of a limb where you can't come back. Do not rely on risk modeling. And always make sure you have an exit strategy.

We had executive committee meetings, formal ones, every single Monday. The number one piece on the agenda was always risk and risk management. Our risk, senior risk officers, were at those executive committee meetings.

We had presentations to the board about risk and risk management. We had presentations to the agencies about risk and risk management.

COMMISSIONER THOMPSON: But what failed? Something obviously didn't work. And so that's what I'm trying to get at. What failed?

WITNESS FULD: What failed in the beginning I believe was rectified in the end. But what failed in the beginning was the sense that the dislocations and disruptions in the mortgage markets mostly around residentials was in fact contained. And we weren't the only one that had that view.

That contageon spread to other asset classes. I believe that we reacted, not because there were one or two people floating around the firm; it was because the risk management committee said other asset classes are being affected, and that is what drove that reduction in less liquid assets. That was our focus.

It was not about bringing down governments. It was not about bringing down corporates, or on-the-run equities. It was where are we vulnerable? Where can we be most affected in the P&L which will eventually then hurt our capital?

That was around less liquid assets, commercial real estate, residential mortgages, leveraged loans. Those are the things we focused on. That's what we brought down almost 50 percent.

Did it fail in the beginning? Let's just say that we had--we made poor judgments as far as timing on building some of those businesses. We had poor judgments and timing on making some investments. We made those mistakes, addressed those mistakes, and as I said I believe in both my written and oral, by the time we got to the third quarter we were in a solid position.

Did I answer that?

COMMISSIONER THOMPSON: Yes. So, Mr. Miller, you were the one who said, if Lehman is allowed to fail it would be financial armageddon. Can you talk about what's happened to the counterparties in many of those transactions and how that armageddon has manifested itself post-Lehman?

WITNESS MILLER: Yes, Commissioner. There, as Mr. Fuld has pointed out, there are many different classes of assets, and businesses that Lehman operated.

In connection with the derivatives, that's largely outside the sphere of the bankruptcy proceeding, except for the contracts that are still open. And that's consuming an enormous amount of time.

Lehman suffered tremendous losses in derivatives because the counterparties took advantage of the contracts, closed out those contracts, liquidated the collateral in a failing market, so they have some very substantial claims against the Estate.

There were many commercial real estate loan transactions, and real estate loan transactions where Lehman was a member of the syndicate, or the lead lender, and was not able to fulfill its obligations in terms of financing. And those entities, many of them, ended up in a bankruptcy proceeding.

Overseas, many of the Lehman Global offices, as I said, have now been subjected to insolvency proceedings. In those cases there were notes sold individually in those countries. There are huge claims in that connection.

I think I pointed out there are 66,000 claims that have been filed against Lehman. In a gross amount, $830 billion. There are many claims that are on file today that are unliquidated because they haven't been able to calculate the damages.

Those are the direct results of the bankruptcy. I think there are a lot of incidental results of the bankruptcy that nobody may have contemplated.

In the week that followed September 15, on I think it was Wednesday, Chicago Mercantile Exchange closed out all the Lehman accounts. That resulted in a loss to Lehman of approximately $1.4 billion. All of Lehman's positions were auctioned off at very reduced values.

The commercial paper market froze up on Wednesday. And major U.S. corporations were unable to redeem, or they thought they would be unable to redeem commercial paper or sell commercial paper, and there were questions raised as to their ability to meet their obligations.

Banks were concerned about backup lines on commercial paper. What you had is almost a whirlpool of failures. What was created was a crisis of confidence.

You have to remember that prior to Lehman's failure there was a growing expectation that, no matter what happened, somebody would intervene and save the situation. And I think that was accentuated by the Bear Stearns situation. And many people in the market just assumed, and in the public, that if there was a crisis of some kind there would be some intervention.

And remember, in all of those situations, and going even back to what Mr. Baxter referred to as long-term capital management, no creditor was hurt, and creditors were always paid.

So while there was, yes, a contraction of credit, most everybody, at least in my world, thought that there would be some bailout of some kind.

COMMISSIONER THOMPSON: So in your opinion there could have been actions taken that could have mitigated the aftermath of the Lehman collapse, or even--

WITNESS MILLER: I believe so. And I understand Mr. Baxter's position, but as Mr. Fuld points out there were assets there. Even if this was a bridge to nowhere, just an orderly wind-down with those assets serving to back up, let me call it the unlimited guaranty of the Fed, over an orderly period of time the values that were inherent in the balance sheet were there.

What happened to them, they were basically liquidated at distressed prices. So you lost all of that value which, putting aside the ancillary effects of the bankruptcy, that could have been recaptured with an orderly wind-down.

COMMISSIONER THOMPSON: Sure--

WITNESS MILLER: Now I look at it, you know, when somebody comes into the emergency room and is on the operating table and hemorrhaging, you don't ask "can you pay the surgeon?" You save the patient.

I look at Lehman as being a patient. And if there was a calculation that the systemic risks were so great, somebody had an innovative way of avoiding those systemic differences. Somebody found a say in the automobile industry. They could have found a way in this industry.

COMMISSIONER THOMPSON: Mr. Zubrow, can you talk about the consequences for others in the industry who weren't counterparties to Lehman? I mean, what happened?

WITNESS ZUBROW: Well I think Mr. Miller has summarized a lot of the other knockon effects post the Lehman bankruptcy. Certainly, you know, there continued to be concerns in the marketplace over the creditworthiness of other broker-dealers.

Mr. Baxter has talked about the other extraordinary efforts that the New York Fed and the Fed took with respect to other enterprises, but I would just say that as a general matter in the marketplace following the bankruptcy of Lehman, there continued to be a contraction of credit availability and a concern about lending to many financial institutions.

COMMISSIONER THOMPSON: So, Mr. Fuld, your view would be that Lehman was too big to fail and somebody screwed up?

WITNESS FULD: I never really--I never really thought about the too big to fail. In retrospect, the big mistake that was made was that Lehman as a sound company was mandated to file for bankruptcy. That was the first mistake.

The second mistake was the fact that it was forced to file for bankruptcy, and the knockon effect not only in this country but also throughout the world, that was the second mistake.

COMMISSIONER THOMPSON: Thank you very much, Mr. Chairman.

CHAIRMAN ANGELIDES: All right, a couple of quick, just very quick questions I had on the remaining part of my time, just very quickly.

Mr. Zubrow, as I said I entered into the record a chronology earlier on about the interrelationship between JPMorgan Chase and Lehman Brothers.

One of the things we didn't have a chance to talk about today is the relationship, extensively, even though some members did, between counterparties is quite fascinating to see how many counterparties actually did stick around; how many did believe Lehman would be saved.

Your relationship was a very special one because of the triparty repo. And I just wanted to ask you just two very quick questions.

On September 9th you demanded $5 billion in collateral, and I believe over the next couple of days about $3.6 billion was posted. Correct?

WITNESS ZUBROW: That's correct.

CHAIRMAN ANGELIDES: And then again on September 11--by the way, this is after a series of amendments to the existing agreements--on September 11th, you demanded another $5 billion, and made it clear that if you didn't receive the $5 billion we intend to exercise our right to decline to extend credit to you under the Clearance Agreement, which means essentially the next day Lehman couldn't operate.

Is that true? That basically you said post the $5 billion or we're not going to provide inter-day credit?

WITNESS ZUBROW: On September 11th, we asked for $5 billion of cash collateral. That followed an analysis that we had done in light of the changing market conditions of collateral that they had previously posted to us.

As I said in my testimony, much of the collateral that was previously posted to us was very much dependent upon the Lehman credit itself, as well as certain structured transactions.

We did not think that that collateral had the value that Lehman ascribed to it, and we, on the September 11th collateral call, you know, asked, and Lehman agreed, for cash collateral.

Following that agreement with Lehman, we did send them a notice that you referenced, but it was following their agreement that they had already told us that they would post the cash collateral, and we had every expectation that they would.

CHAIRMAN ANGELIDES: One more question on this. And that is, that according to our interview with Mr. Fuld, he approved the posting of the $5 billion after Mr. Black said that Lehman would get it back the next day. We sent interrogatories and received them back from Mr. Black. We're in the process of, we've sent them to Mr. Dimon. This is a matter we haven't had a lot of time to talk about today, but we continue to look at.

Was it your recollection that there was a promise to return the collateral?

WITNESS ZUBROW: No. It is my recollection that there was no such promise.

CHAIRMAN ANGELIDES: All right. Mr. Fuld, very quickly, to what extent was this $8.6 billion draw on your liquidity a death blow?

WITNESS FULD: I was really only aware of the Thursday conversation on the--

CHAIRMAN ANGELIDES: Meaning the 11th.

WITNESS FULD: On the 11th, that I participated in. I believe the call was already going. I forget who it was, Ian Lowitt, Paolo Tonucci, asked me to participate. I believe Jamie Dimon, Steve Black, were on that call.

CHAIRMAN ANGELIDES: And Mr. Zubrow.

WITNESS FULD: In all fairness, I was not aware that Mr. Zubrow was part of that call then, but whatever.

They asked for the $5 billion. I looked at Ian. He nodded his head. I said, fine. I said, but as in all inter-day, I assume I get this back tomorrow. My recollection very clearly is that they said, yes.

CHAIRMAN ANGELIDES: All right. Do you remember Mr. Tonucci saying, during this conversation, when Tonucci asked why JPMorgan wanted the collateral a participant, perhaps Dimon responded "no reason." When Tonucci further asked, "What is to keep you from asking for $10 billion tomorrow?", that participant, who may have been Mr. Dimon, according to these notes, said nothing, maybe we will.

I guess my question is: How fundamental were these calls at the end to your liquidity run? Were they-- and were they the trigger point? Were they the death knell, yes or no? Or was this just one of many of a series of adverse events happening during those days?

WITNESS FULD: The clearing banks ended up with $16 to $17 billion of additional collateral out of the thirty of liquidity that we lost in those three days. Had we had that collateral, I think that would have made a huge difference.

CHAIRMAN ANGELIDES: All right. The only other comment I want to make, and see if other members have wrap-up questions here, is, I just have a context comment today, which really is about our two panels today.

One of the things that strikes me is we've heard about Wachovia which suffered a run when WaMu wasn't saved. And today we focused on Lehman that wasn't saved, and the consequences of that. And I think all of us are very mindful that, while we spent our day on the exception, it's the exception that proves the rule: that this was an era of massive and extensive bailouts.

And I just wanted to make that comment, because we focused on these two instances where there was the aberration, and what apparently became a sweeping policy. At a certain level, that old adage got turned on its head and it became: If at first you don't succeed, then fail, fail, fail again. And it became kind of the motto of that era. And I just wanted to put today's hearing in context.

Let's do this. Additional comments. Byron, and I think Peter Wallison, maybe one question each. And, Doug, did you have a question? And then the Vice Chairman may want to wrap up. One question each, so we can proceed--I

COMMISSIONER GEORGIOU: I just wanted to comment on your comment, Mr. Fuld, about you had a sound institution that basically was compelled to file bankruptcy.

And I guess that really goes to the fundamental, one of the fundamental questions we're here to answer is whether, you know, these were extraordinary events that occurred kind of out of nowhere that put a whole bunch of sound institutions into a position where their liquidity was inadequate to meet their normal obligations. And there were failures, certain failures, and other institutions required liquidity to prop them up until circumstances developed?

Or, was there certain fundamental unsoundness within the institutions which is what led your creditors to make greater demands and insist upon greater collateral and require greater haircuts on the triparty repos and the short-term financing?

I mean, I guess it's more of a comment, I suppose, than a question. That really is, at the end of the day, one of the major things we have to resolve, is whether these were just a bunch of sound institutions who faced the stress of an economic crisis, or a financial crisis that was shortlived, or really were embedded within those institutions many, many unsound assets which have to find themselves deleveraged out of the system in order to get back to more fundamentally sound institutions.

So I understand from your perspective you regarded your institution as sound. I respect that. You devoted your life to it, your career to it, and you would have that perspective regardless. But it's not entirely free from doubt because, as Mr. Zubrow said, one of the definitions of insolvency is the inability to meet your obligations when they come due, and you couldn't do that, given the circumstances.

WITNESS FULD: Is that a statement? Or is that--

COMMISSIONER GEORGIOU: It's a statement, and--

CHAIRMAN ANGELIDES: I think it was a statement.

VICE CHAIRMAN THOMAS: I think it was a statement.

COMMISSIONER GEORGIOU: It's really a statement.

CHAIRMAN ANGELIDES: All right, Mr. Wallison--

WITNESS FULD: May I give an answer, though?

CHAIRMAN ANGELIDES: A quick one, yes, sir.

COMMISSIONER GEORGIOU: A quick one, sure.

CHAIRMAN ANGELIDES: Quick, concise, right to the point.

WITNESS FULD: You know me well by this point.

VICE CHAIRMAN THOMAS: Thank you. Thank you.

WITNESS FULD: All I can say is, right after us came two other investment banks. Had they not been addressed with some form of support, they would have gone.

COMMISSIONER GEORGIOU: But that doesn't answer the question, because there may have been unsoundness within those institutions as well. And I suspect that is part of what our charge is, is to identify whether there were causal--whether there were causes that swept across the range of institutions that found themselves in jeopardy during this period that we could avoid on a go-forward basis to avoid that kind of circumstance occurring again. That, rather than it being sort of a God-created flood that threatened to sweep over all these institutions, you know, you could say that there were human-created problems within the institutions as well.

CHAIRMAN ANGELIDES: I'm getting soft in my old age as Chair--

VICE CHAIRMAN THOMAS: I'll buck you up, let's go.

CHAIRMAN ANGELIDES: Okay, very quickly. Mr. Wallison, one question, then Mr. Vice Chairman for closing remark, and then we will adjourn.

COMMISSIONER WALLISON: One question. And this is for Mr. Fuld, and I don't want to put words in Mr. Baxter's mouth, but I took away from our discussion that if the Fed had adopted the appropriate resolution under 13.3 that would have allowed them to take your illiquid assets and monetize them, as they might do with a solvent bank, if that had occurred would Lehman have been able to survive?

WITNESS FULD: I believe so.

COMMISSIONER WALLISON: Thank you.

CHAIRMAN ANGELIDES: Mr. Vice Chairman.

VICE CHAIRMAN THOMAS: Mr. Baxter, on the 13.3 decision, was that a discretionary decision on the part of the Federal Reserve?

WITNESS BAXTER: The decision by the Board?

VICE CHAIRMAN THOMAS: Yes.

WITNESS BAXTER: Yes.

VICE CHAIRMAN THOMAS: Well, I mean when you have a discretionary decision, you look at the consequences of the decision and you basically focus on 'what if?' So that if you go ahead and make that decision, what have you done and what are the consequences following that?

So if there's a required, or an automatic discount window for banks where the law says you have to do it, then I understand there's no discretion. Where there's discretion, you have to weigh the facts as you know them in terms of making that decision.

Did Heather want to intervene? No? I just have to tell you folk, it's interesting what we're going to be doing for the next couple of weeks.

Basically what I've heard here is wudda/cudda/shudda, you know, if ifs and buts were candy and nuts we'd all have a merry Christmas. We're talking about billions of dollars. Hundreds of billions of dollars.

If I'd of just had another $70 billion, we might of been able to make it another week.

We're going to go out and we're going to listen to people who are not in need of billions, or hundreds of billions, they just need a few thousand. They're facing foreclosure. They're facing the inability to get assistance on restructuring a loan, a bridge, to save their houses.

And if any of them are still watching after they've listened to these discussions about gee, another $50 billion here, another $100 billion there and we might have been able to hang on, and they're sitting there saying: What world are these people in?

If you took the hundreds of billions and allowed us as we go out to the communities across America, listening to people say "I could have made it. They told me they were restructuring. I never got the call back. And when I found out we were in foreclosure, I asked them why didn't they get back to me?" I've heard that over, and over again.

So as you have your arguments about which hundred billion was needed when, you've really got to get out there and take a look, or at least listen, or maybe watch what we're going to be hearing from people who just don't get it. When do they get a bridge to somewhere? When do they get a modification on the loan?

And it isn't the extreme example of a guy who runs a taco truck who got a loan and was living in a $450,000 home for a month. That's not the problem out there. It's real people, who have real jobs, who had real homes, who are making real payments, and needed a little bridge. Not a trillion dollar bridge. Not a hundred billion dollar bridge. Not even a billion dollar bridge. A $25,000 bridge. A $15,000 bridge.

And we're going to go listen to them. Finally, we're leaving Washington. We're leaving New York and Wall Street and we're going to go talk to some people who would like to have their say about what has and hasn't happened. And I just wish I could have you all along so that you could appreciate and understand why this coming election in November is under a whole lot more turmoil than anyone thought it was going to be.

So thank you very much for your testimony. Our job is to try to understand and explain what happened. And some of it is learning what didn't happen. And obviously there's arguments about what happened, but I think there are a whole lot more arguments about what didn't happen.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Members? Anything more?

(No response.)

CHAIRMAN ANGELIDES: I want to thank the panel members for coming here today, for your written testimony. And as the Vice Chair says, we probably will be following up with you, as we are, as I mentioned, with JPMorgan on some issues. And I want to thank you all very, very much.

Thank you. We will recommence here at 9:00 a.m. tomorrow morning with Chairman Bernanke.

(Whereupon, at 3:42 p.m., Wednesday, September 1, 2010, the meeting was recessed, to reconvene at 9:00 a.m., Thursday, September 2, 2010.)