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THE CAUSES AND EFFECTS OF THE LEHMAN BROTHERS BANKRUPTCY

Monday, October 6, 2008

House of Representatives,

Committee on Oversight and Government Reform,

Washington, D.C.

The committee met, pursuant to call, at 10:09 a.m., in Room 2154, Rayburn House Office Building, Hon. Henry A. Waxman [chairman of the committee] presiding.

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

Staff Present: Kristin Amerling, General Counsel; Caren Auchman, Press Assistant; Phil Barnett, Staff Director and Chief Counsel; Jen Berenholz, Deputy Clerk; Alison Cassady, Professional Staff Member; Brian Cohen, Senior Investigator and Policy Advisor; Zhongrui "JR" Deng, Chief Information Officer; Greg Dotson, Chief Environmental Counsel; Miriam Edelman, Special Assistant; Earley Green, Chief Clerk; David Leviss, Senior Investigative Counsel; Karen Lightfoot, Communications Director and Senior Policy Advisor; Jennifer Owens, Special Assistant; Leneal Scott, Information Systems Manager; Roger Sherman, Deputy Chief Counsel; Mitch Smiley, Special Assistant; Lawrence Halloran, Minority Staff Director; Jennifer Safavian, Minority Chief Counsel for Oversight and Investigations; A. Brooke Bennett, Minority Counsel; Brien Beattie, Minority Professional Staff Member; Molly Boyl, Minority Professional Staff Member; Larry Brady, Minority Senior Investigator and Policy Advisor; Alex Cooper, Minority Professional Staff Member; John Cuaderes, Minority Senior Investigator and Policy Advisor; Adam Fromm, Minority Professional Staff Member; Todd Greenwood, Minority Professional Staff Member; Patrick Lyden, Minority Parliamentarian and Member Services Coordinator; Brian McNicoll, Minority Communications Director; Nick Palarino, Minority Senior Investigator and Policy Advisor; and Mark Marin, Minority Professional Staff Member.

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

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

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

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

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

Federal Reserve Chairman Bernanke told us our financial system could handle the collapse of Lehman. It now appears they were wrong. The repercussions of this collapse have reverberated across our economy. Many experts think Lehman's fall triggered the credit freeze that is choking our economy, and that made the $700 billion rescue necessary.

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

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

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

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

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

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

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

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

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

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

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

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

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

America, and we are now all paying a terrible price.

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

[Prepared statement of Mr. Waxman follows:]

******** INSERT 1-1 ********

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We appreciate their being there.

Thank you, Mr. Chairman.

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

[The information follows:]

******** COMMITTEE INSERT ********

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

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

[The information follows:]

******** COMMITTEE INSERT ********

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

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. SHAYS. Thank you.

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

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

Mr. MICA. Mr. Chairman, parliamentary inquiry.

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

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

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

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

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

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

Chairman WAXMAN. The Chairman--

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

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

We have with us the following witnesses: Nell Minow, chairman of the board and editor of The Corporate Library; Gregory W. Smith, general counsel, Colorado Public Employees' Retirement Association; Robert F. Wescott, Ph.D., president of Keybridge Research LLC; Luigi Zingales, Ph.D., professor at the University of Chicago Graduate School of Business; and Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute.

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

[Witnesses sworn.]

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

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

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

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

STATEMENT OF LUIGI ZINGALES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[Prepared statement of Mr. Zingales follows:]

******** INSERT 1-2 ********

Chairman WAXMAN. Dr. Wescott.

STATEMENT OF ROBERT F. WESCOTT

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

In my opinion, there were three main contributors to the financial meltdown. The first was an environment of easy credit that existed in the first half of this decade. We simply left the monetary floodgates open too far and too long in the period 2002 to 2005. During this period, mortgage rates got as low as 2-1/2 percent, and families got an inflated sense of their capacity to afford housing. This cheap credit quickly got capitalized in housing prices, and housing prices doubled and even tripled in some neighborhoods in the span of just a few years. This caused a housing frenzy, and many Americans developed unrealistic expectations and assumed that housing prices could only go up.

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

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

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

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

The system boomed this way for many years. The problem came when the U.S. housing sector simply reached saturation. By early 2006, almost every American who wanted a home was in one. The Fed started raising interest rates to fight inflation, and suddenly housing prices leveled off and then began to fall. Some borrowers, especially subprime borrowers, began to miss their monthly mortgage payments, and the value of subprime mortgage portfolios began to decline.

Now, because of the high leverage in the investment banks, many simply did not have the cushion to fall back on.

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

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

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

Thank you.

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

[Prepared statement of Mr. Wescott follows:]

******** INSERT 1-3 ********

Chairman WAXMAN. Ms. Minow.

STATEMENT OF NELL MINOW

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

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

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

Here is a quote from our analyst's note on the company: Although the CEO's 2007 salary is well below the median for companies of similar size, his nonequity incentive compensation of $4,250,000 exceeded the 85th percentile. While typical target bonus is two times base salary, Mr.

Fuld’s was more than five times his base salary. Additionally, his total annual compensation of $71,924,178 ranks in the top 3 percent for similarly sized companies.

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

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

An additional indicator is the meaningful stock ownership by the board. It is a public statement of their confidence in a company and a powerful reminder and motivator for them as they deliberate issues like executive compensation and risk management. With the exception of the

CEO who sold the significant percentage of his stock, and the lead director, and the 23-year veteran on the committee, given their tenure, these directors did not put their money where their mouths were.

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

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

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

Thank you.

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

[Prepared statement of Ms. Minow follows:]

******** INSERT 1-4 ********

Chairman WAXMAN. Mr. Smith.

STATEMENT OF GREGORY W. SMITH

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

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

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

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

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

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

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

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

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

Thank you.

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

[Prepared statement of Mr. Smith follows:]

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Chairman WAXMAN. Mr. Wallison.

STATEMENT OF PETER J. WALLISON

Mr. WALLISON. Thank you, Mr. Chairman and members of this committee. I'm really pleased to have this opportunity to address the question of regulation and its role in the current financial crisis.

There are cases where regulation is necessary and cases where it is harmful. It was necessary in the case of Fannie Mae and Freddie Mac. These two companies were seen in the market as backed by the Federal Government. As a result, investors did not worry about the risks of lending to them since Uncle Sam would bail them out if the companies got into financial trouble. Investors have been proved right. In cases where investors see themselves as bearing no risks lending to a private, shareholder-owned company, strong regulation is essential. That is the only way that government can protect itself against loss. Yet Congress resisted--

Chairman WAXMAN. Mr. Wallison, could you pull the mic a little closer? Some Members are having--

Mr. WALLISON. Oh, I'm sorry.

Yet Congress resisted reforming regulation of Fannie Mae and Freddie Freddie until it was too late. And even then the reform legislation wouldn't have been passed unless it had been attached to a housing bill that Congress wanted to adopt before going home for the August recess.

The failure by Congress had serious consequences. An article in yesterday's New York Times makes clear that reckless buying of junk loans by Fannie Mae and Freddie Mac bears a large part of the responsibility for the financial crisis we are now in. Voters, justifiably angry about the $700 billion rescue plan just adopted by Congress, should recognize who is responsible and act accordingly.

Incidentally, since some issues of compensation have come up, I ought to mention that Fannie was very generous in its own compensation. Franklin Raines, who was its Chairman for several years, 4 or 5, made $90 million during the time he was there, and there was little outrage expressed in Congress at that time.

Bad or weak regulation is often worse than no regulation at all. Another article in the New York Times on Friday of last week recounted the SEC's failure to devote sufficient resources to the regulation of the major investment banking firms that have now all collapsed, been taken over, sold themselves to big banks or sought shelter under the Federal Reserve's wings as financial holding companies. According to the article, the SEC assigned a pitifully small staff to regulating these huge investment banks, and as a result they took imprudent financial risks that ultimately led to their losses.

A chart accompanying the article shows that these institutions took increasing risks every year from the time they entered the SEC's supervisory regime. This is important. It demonstrates the effect of regulation in creating moral hazard. Immediately after the SEC took over the supervision of their safety and soundness, the market discipline to which they had previously been subject began to relax. Investors thought the SEC was minding the store, but it wasn't. That is why weak regulation can be worse than none.

Regulation itself is no panacea. Even strong regulation may not be effective. Regulation of commercial banks in the United States is a case of strong regulation failing. Congress imposed a strong regulatory regime on commercial banks when it adopted FDICIA in 1991. Still, even though IndyMac, WAMU, Wachovia and dozens of smaller commercial banks were regulated by one or another agency of the Federal Government under strict FDICIA requirements, they all failed or had to be taken over just like the weakly regulated investment banks.

Calling for more regulation as a solution to the financial crisis is, therefore, somewhat simplistic.

Regulation's track record is ambiguous. There is no question that it is the only protection we have when the government is exposed to risks created by companies it backs, like commercial banks, which have deposits insured by the FDIC, and like Fannie Mae and Freddie Mac, which were seen as backed by the Federal Government without any limit.

But the regulation of the investment banks by the SEC was a mistake. They were not seen as backed by the government in any way until the SEC was given authority to supervise their safety and soundness. Then their risk-taking took off. If they had been left free of government oversight, they would not, in my view, have been able to borrow the funds that created their extraordinary leverage.

If our solution to today's crisis is to regulate hedge funds, private equity funds, finance companies, institutional lenders, pension funds, leasing companies and insurance companies and anyone else who participates in the capital markets without any government backing, we will simply be assuring ourselves of many more financial crises in the future.

Many thanks, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Wallison.

[Prepared statement of Mr. Wallison follows:]

******** INSERT 1-6 ********

Chairman WAXMAN. I want to thank all of the members of the panel for your presentation. We'll now recognize Members to ask questions for a 5-minute period. We'll start with Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman and Ranking Member Davis and all of the panelists.

We are facing what has been called the most serious financial crisis since the 1930s. And the potential cost to taxpayer is staggering: $29 billion to J.P. Morgan to buy Bear Stearns; $85 billion to AIG; $200 billion to Fannie and Freddie; $700 billion rescue package; $300 billion to the Fed window opening it up to investment banks; $50 billion to stabilize the money market funds. A staggering $1.7 billion potential cost to taxpayers.

Now, Professor Zingales, you seem to believe that this may have been caused by the staggering leverage that was put in these firms, but others see it as the deregulation that has taken place in Congress over the past decade. In 1990, Congress passed the Financial Stabilization Act, which took away the protections of the Glass-Steagall Act that had served and protected our economy for 80 years. This allowed the banking a safety and soundness standard to be able to merge and be lowered, with risky speculative activities. And then during this period, Congress prohibited the regulation of risky derivatives. The SEC loosened rules governing the