****Preliminary Transcript****

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.

Committee Hearings

of the

U.S. HOUSE OF REPRESENTATIVES

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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:]

******** INSERT 1-5 ********

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 amount of leverage that investment banks could use, and Federal regulators were defunded and defanged, and they were reluctant to use the authority they had to protect taxpayers and investors.

Some believe that the root cause of the credit cost of this crisis was not only the leverage, but the excessive deregulation. And I would like to ask first, Dr. Wescott, and then others, if you'd like to comment. What do you think were the biggest mistakes or missed opportunities for regulators? And going forward, what do you think we should regulate? Do you think all of this deregulation that I listed was a mistake for protection for our taxpayers and our economy?

Mr. WESCOTT. Regulation is a--as Mr. Wallison said, is an extremely complicated matter, and it is very important that it be handled and that we get the incentives properly lined up here.

There is no question that the regulators did make a decision. The SEC made a decision in 2004, in April of 2004, to relax the leverage standards that the large $5 billion-plus investment banks would be allowed to operate under. And in my opinion, this decision did end up making the situation worse. And so I do--

Mrs. MALONEY. What about Glass-Steagall, Dr. Wescott? That is not complicated. It merely says financial institutions, bank safety and soundness should not mingle with risky activities. That is not complicated at all. It is very clear. Was that a mistake to roll that back, do you believe? Or I'd ask any other panelist to talk.

Mr. WESCOTT. I don't have a strong opinion on Glass-Steagall. I do think that there were risks involved in the mortgage-lending business that were greater than were appreciated by regulators and obviously by many of the investment banks themselves. The key thing was that they assumed there was going to be plenty of business, and that they could keep getting additional borrowers, and that they would not suffer credit quality loss as we went further and further down the list of applicants for mortgages.

Mrs. MALONEY. Thank you very much. My time is very limited. I'd just like to go down the line, starting with Dr. Zingales.

Do you think repealing Glass-Steagall, allowing banks to mix with risky investment banks that were leveraged in hedge funds, in some cases 1 to 30, 10 to 60, do you think rolling it back was a mistake, yes or no?

Mr. ZINGALES. No. I don't think it was a mistake.

Mrs. MALONEY. Yes or no. Mr. Wescott, you don't think it was a mistake?

Mr. WESCOTT. No at this point.

Mrs. MALONEY. Ms. Minow?

Ms. MINOW. I do think it was a mistake.

Mrs. MALONEY. You do.

Mr. Smith.

Mr. SMITH. It appears to be from this angle. I'm sorry. It appears to be from this angle.

Mrs. MALONEY. Mr. Wallison?

Mr. WALLISON. Not a mistake.

Mrs. MALONEY. Okay. So we're divided on that.

If the Fed and Treasury had not allowed Lehman to fail in default on its obligations, would this have prevented runs on other firms, and especially the money market funds, the run that began on that? Again, down the panel quickly. My time has expired. Quickly now.

Mr. ZINGALES. I think no. The proof is if we look at what happened when Bear Stearns was bailed out, I think that, for example, the price of the credit default swap was--an insurance on default as a measure of how risky borrowers are considered--went up the same amount it went up after the Lehman default. So I don't think that bailing out sort of Lehman would have--would solve the situation.

Mr. WESCOTT. I think that regulators in retrospect would now understand that there was more Lehman paper out there in money market accounts, and they might have made a different decision on that account.

Ms. MINOW. I think it would not have made an enormous difference.

Mr. SMITH. I think it was one piece of a much bigger puzzle.

Mr. WALLISON. It has no significant difference, I think.

Chairman WAXMAN. Thank you, Mrs. Maloney.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you.

This concerns the SEC. Both the Chairman and I were instrumental in shepherding through legislation that removed the Civil Service pay ceilings on the SEC employees because they were losing employees like crazy. They lost a third of their senior management because of the pay. We raised that, but we also held hearings on IT and their IT capacity. What were the limitations if SEC had wanted to do something? Were their systems up? Could they have done the appropriate job? Or are there limitations on their IT and personnel that probably limited their abilities? Does anybody have any thoughts on that?

No. Okay.

Ms. Minow, let me just ask you. You rated the corporate boards at Lehman. Did you ever rate the board in salaries at Freddie and Fannie?

Ms. MINOW. I'm sorry. Freddie and Fannie? Yes. We did give a high grade to Fannie Mae after they were--in 2002, when we began rating after they were cleared by the SEC and OFHEO. We, however, from the beginning gave poor ratings to Freddie.

Mr. DAVIS OF VIRGINIA. We should have seen this coming; don't you agree? I mean, I don't know if any of you are familiar with the Superior Bank. I just was looking at one--Superior Bank, the inspector general report. This was a Chicago bank owned by--the chief owner was Penny Pritzker, who happens to be, as I think many of us know, Senator Obama's finance chairman. But more importantly, when you look at the inspector general's report, it says that the bank became associated with the subprime lending business in '92. Beginning in 1993, Superior embarked on a business strategy marked by rapid and aggressive growth into subprime home mortgages. Federal bank regulators warned them in '93, '94, '95, '97 and 2000 to rein in their risky subprime lending businesses.

According to an independent investigation by the Department of Justice, the bank used improper accounting procedures to cover up their bad debts. Fifteen hundred of the bank customers lost large sums of money. But this was years ago. I mean, didn't--all the warning signs were there that these subprimes were a mess, wasn't there?

Ms. MINOW. Yes, there were. That's why one of my primary concerns is the obstacles to what I would consider the essential market oversight from institutional investors like the Colorado pension fund, if they could have responded as I think they would like to have. If the corporate community hadn't lobbied for so many restrictions on the ability of shareholders to respond to these indicators, then I think we would not need a lot of new regulation.

Mr. DAVIS OF VIRGINIA. Mr. Wallison.

Mr. WALLISON. Well, I would say that this is a very good example of the faith in regulation that is often misplaced. The regulators had the responsibility for looking at the risks that were being taken by these institutions, and they did not effectively do that. And I think that that is an important lesson for our Congress to understand, because regulation is not a solution to many of these problems, especially when the regulators have a great deal of difficulty understanding what is happening in these institutions.

The Superior Bank case is a perfect example of something that was starting in 2001 and beginning to build at that point with subprime loans. But I'm afraid that if a congressional committee or a regulator--let's put it this way: If a congressional committee had looked over the shoulder of the regulators and said, will you stop that from happening, I think the regulator would have been reluctant to do it. The institutions were making money from this. And once more, they were afraid of some of the political backlash that would come if they did try to stop this kind of lending.

There is a strong feeling in the United States that many people should have access to housing. And the question is, do you allow the regulators to interfere with a strong housing market, especially involving--

Mr. DAVIS OF VIRGINIA. Lower-income people were getting housing, so nobody wanted to stop that.

Mr. ZINGALES. I think that the problem is not subprime per se, it is a risky lending. But as Mr. Wallison said, it has beneficial effects.

Second, in some situations, a risky--might be profitable. I think that the problem is that the level of securitization this took place was not probably monitored. We have sort of an enormous market that has got completely sort of unregulating type of disclosure. I think we should have more disclosure, because today we don't know who owns what. And out of that, a lot of the problems we observe in the credit market is because banks don't know the losses of other banks. If they don't know the losses, it is because they don't know what is in their portfolio. And if they don't know what is in the portfolio--because if you look at the issuances, you cannot trace back easily what is in that package of loans. We don't know whether they are loans from California, we don't know whether they are from Florida. We don't know who has these loans. And this lack of transparency is one of the roots of the problem. It is not subprime, It is the lack of transparency.

RPTS JOHNSON

DCMN BURRELL

[11:04 a.m.]

Mr. WESCOTT. Just on the question of whether we should have known or did we know, I will just say that in looking at a full range of economic statistics in the summer of 2005, looking at the value of houses divided by median income and by many other measures, we knew that the housing prices were set for a fall. We were beginning to tell our clients in the autumn of 2005 that housing prices were set for a fall and the housing sector was ready for a decline. We were not alone. Many other economists were also giving similar warnings.

Chairman WAXMAN. Thank you, Mr. Davis. Mr. Cummings.

Mr. CUMMINGS. Thank you very much. Ms. Minow, when I went to church yesterday, it is interesting that almost everybody who came up to me afterwards was very upset. And it seemed like the thing they were most upset about was the compensation for these executives. As part of the committee's investigation the committee asked for copies of the e-mails that Mr. Fuld sent and received over the last 6 months. I want to read to you from an e-mail an exchange that involves Mr. Fuld, his executive committee, and senior executives at Neuberger Berman, a money management subsidiary of Lehman Brothers.

The first e-mail is sent in early June of this year. It is sent from Neuberger Berman executives to Mr. Fuld's executive committee. The e-mail begins, and I quote, as long-term employees and former partners of Neuberger Berman, we feel compelled to express our views on several matters to members of Lehman's executive committee, end of quote. In the e-mail, the Neuberger Berman executives write that Lehman had made, quote, management mistakes, and that, quote, a substantial portion of the problems at Lehman are structural rather than merely cyclical in nature, end of quote.

The e-mail then recommended two actions. And let me read from the e-mail. It says 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. And then it goes on to say, too, and this is a direct quote, do a partial spinout of NB. A partial spinout could be an attractive source of capital for Lehman at a time when the company needs capital. The officials also suggested that a partial spinout of Neuberger Berman would allow some employees to receive their equity compensation in the new Neuberger Berman shares instead of Lehman shares, which would reassure the Neuberger employees of their funds.

Question: Ms. Minow, what do you think of the recommendations made in this e-mail? And was the recommendations that senior management forego bonuses a sound one?

Ms. MINOW. Yes, it was.

Mr. CUMMINGS. And why is that?

Ms. MINOW. Because in my opinion, management gets paid last. You know, you pay the shareholders, you pay the employees, and then if there is any money left over you take it. But when the company is doing poorly, management should--management compensation should reflect that.

Mr. CUMMINGS. Yeah, because when I talk to the people in my block, they tell me--you said something that was very interesting. You said paying people based on volume as opposed to quality is just the wrong way to go. And the people in my block in Baltimore, if they perform poorly, they get fired.

Ms. MINOW. Yeah.

Mr. CUMMINGS. They certainly don't get a bonus.

Ms. MINOW. That is how it works in my company.

Mr. CUMMINGS. And Mr. Fuld is going to come in here in about an hour, and you know what he is going to say? He is going to say it is everybody's fault but mine, but he was the chief guy, is that right?

Ms. MINOW. He was. He was the captain of the ship.

And you are familiar with the expression "the buck stops here." You know, unfortunately it did stop with him. He took all the bucks.

Mr. CUMMINGS. One of the recipients of that e-mail was George W. Walker. Mr. Walker was Lehman's global head of investment management at the time. And if the name sounds familiar, that is because Mr. Walker also happens to be President Bush's cousin. Within 15 minutes, Mr. Walker writes a follow-up e-mail to the other members of the executive committee. And let me read that to you, because it is extremely interesting. He said sorry, team. I am not sure of what is in the water at 605 Third Avenue today. The compensation issue she raises is hardly worth the EC's--executive committee's that is--time now. I am embarrassed and I apologize. Mr. Fuld also mocked the Neuberger executives. And his response was don't worry. They are only people who think--listen to this--they are only people who think about their own pockets.

Ms. Minow, I see you shaking your head. What do you think of Mr. Fuld's response? I can imagine what you are going to say, because it is clear that he was thinking about his own pockets as he made millions upon millions.

Ms. MINOW. You are exactly right, Congressman. I am horrified by that. I am absolutely horrified. And I am thinking about--I am thinking about what you could possibly say to him when he arrives here to make him understand his responsibility.

Mr. CUMMINGS. I wonder how he sleeps at night. Mr. Smith, do you have a comment on that? I see you shaking your head, too. You talked about all the employees you represent.

Mr. SMITH. Well, it is of interest to me that nowhere in that conversation, nowhere even in their way of thinking does the shareholder have any role whatsoever. And that is who their duty is to.

Mr. CUMMINGS. Thank you very much. I see my time is up.

Chairman WAXMAN. Thank you, Mr. Cummings.

Mr. Mica.

Mr. MICA. First of all, I think it is very important that our committee investigate how we got into this financial mess. I believe Americans want to know who caused this outrage, how it happened, and who will be held accountable. If it is wrongdoing by AIG or Lehman, in fact I saw one of these signs out here with Code Pink, and they said no bail, jail. And which I agree with. In fact, at the conclusion of these hearings I intend to consult with my colleagues to ask for a special counsel to investigate this matter. The announced hearings, however, today and the ones that we have before us selected by the chairman only cover Lehman, AIG, and several regulators. Unfortunately, I think this is a clever sequencing of these hearings, which is obviously organized to deflect attention from government-backed financial institutions, and also deflect from Congress any blame, and put it on Wall Street, or blame it on executive compensation.

Any hearing or real oversight that does not start with Fannie Mae, Franklin Raines, who walked away with over a hundred million dollars in executive compensation and bonuses, and also hearing from his accomplices, any hearing will be a sham. This is like investigating the Great Train Robbery and only talking to the dining car stewards. Instead of a balanced panel today, we will take testimony from academics, and no one from Fannie Mae or Freddie Mac. Rather clever.

The fact is that our Nation's current financial crisis began back in 1992, with the concerted effort to expand government-sponsored enterprises Fannie Mae and Freddie Mac to include loans to marginally qualified borrowers and get into a whole host of speculative investments. Last week Speaker Pelosi incorrectly and partisanly attributed the responsibility to the Bush administration's failed economic policies. Chairman Waxman in his opening statement is trying today to direct focus on Wall Street and regulators. Last time I checked, none of those folks had a vote in Congress.

In fact, it was in 1999, and we heard some reference to this already, I have a copy of the vote here which we will put in the record later, the Congress voted to repeal the Glass-Steagall Act, allowing banks to engage in speculative ventures. And Wall Street followed. In fact, long before Bush took office, the stage was set for the current financial meltdown of the housing and finance industry. In fact, in 1999 the Clinton administration and Fannie Mae Director Raines lowered policy standards and increased subprime loans to new, more dangerous levels.

As quoted in the New York Times that year, Raines said, and I quote from Raines, Fannie Mae has expanded home ownership for millions of families in the '90s by reducing down payment requirements, yet there remain too many borrowers whose credit is just a notch below what our underwriting has required who have been regulated to paying significantly higher mortgages in the so-called subprime market. Wall Street followed.

The New York Times article continued, in moving even tentatively into this new era of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulty during flush economic times, as we saw, but the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan associations, end quote.

In fact, in 2004, Raines and Freddie Mac CEO Richard

Syron told an ABA meeting, and quote, we push products and opportunities to people who have lesser credit. In fact, testimony before the House Financial Services Committee on Capital Markets and Insurance and Government Sponsored Enterprises on October 6, 2004, Raines termed some of these loans riskless. That is his quote.

In fact, Raines by rule change lowered Fannie Mae's cash reserve requirements from 10 to 2.5 percent. In fact, after fraudulently cooking Fannie Mae's books so Raines and Jamie Gorelick and others could boost earnings to rob millions in bonuses, congressional Democrats chose to ignore the findings. During a House Financial Services hearing on September 10th, 2003, the top Democrat at the time, Barney Frank, said the more people in my judgment exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury, which I do not see. I think we see entities that are fundamentally sound and withstand some of the debt disaster scenarios. Representative Maxine Waters demanded to know why if it ain't broke, why anybody would want to fix Fannie Mae. More incredibly--

Chairman WAXMAN. Thank you, Mr. Mica.

Mr. MICA. --Frank said a few days later, I want to roll the dice a little bit more in this situation.

Chairman WAXMAN. Mr. Mica, you can put the rest of the statement in the record, but your time has expired.

Mr. MICA. Well, since our side is gagged from either giving a statement or--

Chairman WAXMAN. Mr. Kucinich, it is your turn to ask the questions.

Mr. MICA. --having the opportunity to not ask questions, I won't get to ask my questions.

Chairman WAXMAN. I thought you asked a lot of brilliant questions here. Mr. Kucinich, your turn to ask questions.

Mr. KUCINICH. I thank the gentleman. Mr. Wallison, in your testimony you said voters are justifiably angry about the $700 billion rescue plan just adopted by Congress. Why?

Mr. WALLISON. Because much of the problem that--

Mr. KUCINICH. You want to speak closely to the mike?

Mr. WALLISON. Because much of the problem that this plan is intended to address was caused by a lack of regulation of Fannie Mae and Freddie Mac.

Mr. KUCINICH. Okay. Thank you, sir.

Mr. WALLISON. The bad assets that are now on the books of banks and securities firms all over the world came from a market that they stimulated between 2005 and 2007.

Mr. KUCINICH. Thank you, sir. Thank you for your answer. I am going to go on with the rest of my questions.

I want to say that I agree with you that the American people are angry. I voted against this bailout. And I think that I have to say that, with all due respect to our Chair, who really was given a mandate to hold hearings after the fact, I am sorry that these hearings are taking place after we voted on the bailout. I mean how much better we would have been, how much better informed we would have been if we had had these hearings before the bailout. And I think that it would have--that takes nothing away from Mr. Chairman, who I have the greatest admiration for, but this is a decision that was made by our congressional leaders. We should have had these hearings first and then taken a vote on a bailout later.

Now I want to get into the questions of why didn't Secretary Paulson save Lehman. We all know about the implications of the collapse. That is what we are here to discuss. But you know, my question is why Secretary Paulson decided to bail out AIG and other companies but not Lehman.

Gretchen Morgenson in the New York Times wrote a column about the decision to rescue AIG. She said that Secretary Paulson, a former CEO of Goldman Sachs, made this decision after consulting with Lloyd Blankfein, the current CEO of Goldman Sachs. She also wrote that Goldman Sachs could have been imperiled by the collapse of AIG because Goldman was AIG's largest trading partner. She said Goldman had a $20 billion exposure to AIG.

Now I would like Professor Zingales, when you hear about that, you know, a decision was made to let Lehman go down. Goldman Sachs is still standing for sure. Are you concerned, given these facts, that there is an apparent conflict of interest by the Treasury Secretary in permitting a principal of a firm that he was a CEO with to be involved in these discussions about the survival of Lehman?

Mr. ZINGALES. Yes. I am certainly concerned by that. But I have to say that I think that the reason--and I am not saying it wasn't the right decision--I think the reason to go to the AIG bailout is that AIG was a major player in the credit default swap market. And I think that not only Goldman was very heavily involved with that, J.P. Morgan, to the best of our ability, J.P. Morgan has a notional amount of $7 trillion in the credit default swap market. Most of that is hedged. And since they buy and sell insurance at the same time, so if everybody is holding up, there is no risk. But if AIG went under, all of a sudden J.P. Morgan would have found itself probably on edge for a significant fraction of that sort of a $7.1 trillion. Now--

Mr. KUCINICH. Let me ask you this. You throw Lehman Brothers overboard. Does that help what competitive position may remain with respect to Goldman Sachs?

Mr. ZINGALES. I think it is clear that Goldman Sachs benefits from Lehman Brothers going under, yes.

Mr. KUCINICH. I want to ask Ms. Minow to answer the question that I asked. Is there an apparent conflict of interest here?

Ms. MINOW. Yes, there was.

Mr. KUCINICH. You want to elaborate on that?

Ms. MINOW. You know, that is part of the problem of regulating and deal making and bailing out in the financial sector. You know, we do regressions about the relationships between the various boards of directors. And overwhelmingly, that is the most tightly knit.

Mr. KUCINICH. I want to thank you for that. Because see, what we are confronted with is that bailout legislation gives Secretary Paulson the ability to direct assets over the entire economy, changing forever the idea of a free market and putting him in a direct position where he can benefit the people that he worked with while he was CEO of Goldman Sachs. Does that concern you?

Ms. MINOW. It concerns me greatly, Congressman. And that is why I think it is very important, even though the legislation was already passed, to have these hearings right now, because as you well know, the implementation is going to tell the story here. And even though the legislation is now significantly longer than the original proposal sent over by the administration, there is still a lot of room to make it right or make it wrong. And I think it is going to need a lot of oversight.

Mr. KUCINICH. Thank you very much.

Chairman WAXMAN. Thank you, Mr. Kucinich.

Mr. Turner.

Mr. MICA. Mr. Chairman, I have a unanimous consent request.

Chairman WAXMAN. The gentleman will state his unanimous consent request.

Mr. MICA. I would like to ask unanimous consent to submit for the record the final vote results of roll call 570, which is the Glass-Steagall repeal, which you actually and I voted no on.

I would like unanimous consent to insert in the record H.R. 4071, which Mr. Shays asked me to cosponsor as a cosponsor, to register and regulate the Federal securities laws to include housing-related government-sponsored enterprises in March 20th, 2002.

And I would like unanimous consent to submit into the record the legislation entitled Federal Housing Finance Reform Act of 2005, sponsored by Richard Baker, voted for by myself and others--you weren't with me on that one--that would have resolved this. And also the vote of that I think are important to include in the record.

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

Mr. MICA. Thank you.

[The information follows:]

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

Chairman WAXMAN. Mr. Turner?

Mr. TURNER. Thank you, Mr. Chairman. I also voted against the bailout package. And I voted against the bailout package because I believe that it did nothing to prohibit the types of practices we are going to discuss today. It provided no real relief to communities or homeowners who are impacted as a result of these practices. And I believe it does no real understanding of what the requirements will be for administering such a program as we look to the underlying mortgages and the number of housing and house units that is there. And I also don't believe that the value is ultimately going to be there when they take a look at the mortgages and the mortgage-backed securities that they are going to be acquiring.

Dr. Wescott, you said that--you gave us about four or five points as to how this happened. Easy credit, housing prices escalating, securitization of mortgages, houses becoming ATMs. And Ms. Minow, you indicated also excessive CEO compensation. Well, I am from Ohio, and we are one of the leaders, unfortunately, in the area of foreclosures. And I want to tell you a little bit about what our experience is. And I would like to get your thoughts on this.

In 2001, I was serving as mayor for my community. And then city commissioner Dean Lovelace, who was a leader in our community of trying to advocate for people who were victims of predatory lending, brought to the attention of the city commission and ultimately legislation, which we passed but were not able to enforce, attempting to prohibit predatory lending practices in our community. We then began working with the Miami Valley Fair Housing Center in our community to work directly with people who were impacted. And our community in the past 2 years has had 5,000 foreclosures on an annual basis in a county of about 500,000 people. The State of Ohio I believe is clipping along at about 80,000-plus foreclosures.

And Dr. Wescott, we are not seeing the housing price escalation as the problem. Ohio is not a State that saw wild fluctuations in housing values. In fact, the Miami Valley Fair Housing Center, Tim McCarthy, the director there, tells me that this is what we experienced. Houses that are probably valued between 75, $80,000, people who found the American dream, who got a traditional lending product, were convinced to refinance their house by unscrupulous lenders, predatory lenders, subprime lenders, convinced that the property value was worth a hundred thousand, many times capitalizing the fees, giving the ultimate homeowner a small portion of the cash in the refinancing, the homeowner then facing many times interest rates or payment schedules that they are either not familiar with or not prepared to make; in any event, finding perhaps hard economic times or other circumstances where they realized that the value of the property is below the actual mortgage value. And ultimately, this property going through foreclosure becomes abandoned in my community. Sitting with a leaking roof, broken windows and many times is now worth $20,000, requiring tens of thousands of dollars for it even to be habitable. We are seeing that scourge around our community. And when I see that, I don't see bad loan choices, I don't see people who just were stretching for the American dream but could not afford it. I see someone having stolen the American dream, where there was a homeowner and a family that were sitting there that were convinced to them what they thought was the most regulated transaction in our country, protected by the Federal Government and rules and regulations, caught in a cycle of refinancing.

But there is someone who knew. The person who originated this loan knows that the value of the property isn't there. They know that this homeowner is not going to be able to make it. And ultimately, as we now know, they take that loan, securitize it, and sell it back likely to the bank that had the first mortgage to begin with that wouldn't have given them a loan like that. Again, I believe these people stole. And I believe it was systematic stealing at such an unbelievable and grand scale that it is going to be very difficult for us to unwind this.

In those circumstances, I would like your thoughts on that very process.

Mr. WESCOTT. Mr. Turner, you described very eloquently a second type of housing problem that we are having in this country. We really have two housing problems. We have the credit-oriented problem that is heavily focused in Florida, California, Las Vegas, and so on. And because this part of the economy, because the housing sector of the economy started weakening, we have actually eaten into real disposable income. We have hurt consumer spending across the country. And what that has done is that has lowered demand for automobiles, for industrial goods, and so on. And that is the core part of the problem in the State of Ohio. It is the same in Michigan. These are regions that have lost hundreds of thousands of industrial jobs, as you well know. And so the fundamental problem in Ohio is the loss of jobs and the fact that many people just don't have the income they did 2 years ago or 4 years ago.

Ms. MINOW. Mr. Turner, I want to repeat that one of the most important factors in creating this problem was pay plans that rewarded the executives on the basis of the number of transactions rather than the quality of transactions. And as I said the last time I spoke to this committee, of course we could never pay Congress what you are worth, but if we were paying you based upon the number of laws rather than the quality of the laws, I think you see what the result would be. And when we created these pay packages so that they were benefited by just generating as many transactions as possible, chopping them up, sending them all over the place in a form that could no longer be valued accurately, to me that is one of the key sources of this problem.

Mr. TURNER. As we talk many times about falling housing prices, it is going to be interesting when we actually get into these mortgage-backed securities and look at these mortgage transactions, because I think we will find that many of these loans were given on housing prices where the value wasn't there to begin with.

Ms. MINOW. I agree. And I understand that in some cases even the title searches were not completed.

Mr. TURNER. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Turner.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman. I want to thank all of our panel for testifying today. I know we are going to have this hearing and about four other hearings trying to understand the process that got us into this situation. And today we are focusing on Lehman Brothers. Over the weekend we all got a chance to look at Mr. Fuld's proposed testimony for today. And in looking at that, it appears that he blames just about everyone and everything except himself and the other executives for the downfall of Lehman.

So I wanted to begin by asking this panel for a full diagnosis of just what went on. What were the factors that went into this? Mr. Fuld said it was a litany of destabilizing factors: Rumors, credit agency downgrades, naked short attacks. He says ultimately lack of confidence, and in the end he was overwhelmed. So I want to ask each of you whether or not you agree with that, that Mr. Fuld was a victim of the circumstances or whether or not he and his fellow executives made mistakes, causing the collapse of the company and eventually putting all of us in jeopardy.

Ms. Minow, if I could begin with you. Do you agree with Mr. Fuld's diagnosis?

Ms. MINOW. No. I think it is horrific. I can't believe that he would have the chutzpah to say something like that. I hold him completely responsible. I hold him responsible and his board responsible for the foreseeable consequences of the decisions they made.

Mr. TIERNEY. Professor Zingales, what are your views on that?

Mr. ZINGALES. I think he is definitely responsible for having a too aggressive leverage policy, too much short-term debt that makes the firm sort of at risk of a background that is exactly what happened, and to have not controlled the risk that the firm was taking during this boom period.

All this said, it is also true that we are in exceptional circumstances, and I think that the system is suffering of lack of liquidity. And so it is possible that a lot of banks and firms that in normal times would not be insolvent today find themselves insolvent. The example is suppose that we had no mortgages, what would be the price of your house? And we are in the situation right now. The banks are not lending. And if the banks are not lending, we don't know what the prices of anything is. And at those prices it is very easy that a lot of firms, a lot of banks are insolvent.

Mr. TIERNEY. Thank you. Mr. Smith, you are the only investor on the panel. What are your views?

Mr. SMITH. Well, certainly I hold him responsible, but I think it goes beyond that.

Chairman WAXMAN. Is your mike on?

Mr. SMITH. I am sorry. I certainly hold him responsible. I certainly think they made conscious decisions to take risks that went far beyond the interests of the shareholder. But I also look at the directors, and I look at their responsibility for overseeing management. And I look at the regulatory system that denies investors the opportunity to hold directors accountable. So there are multiple pieces to the puzzle. But I don't believe that he has any safe ground to stand on.

Mr. TIERNEY. Thank you. Professor Zingales and Ms. Minow, if I were to put you or you were to put yourself in Mr. Fuld's position, in 2007 Lehman Brothers paid out nearly $5 billion in bonuses. He himself got a 4 million cash bonus. But at the same time they did that, they spent over $4 billion buying back shares of stock. They paid out $750 million in dividends. Were those actions, almost $10 billion of capital dissipated in that sense, were those wise decision under the circumstances?

Ms. MINOW. No. I don't think they were. And I will say that I am a real radical on the subject of CEO stock sales. He was also selling a lot of his stock at that time. And I don't believe that CEOs should be allowed to sell stock while they are still with the company.

Mr. TIERNEY. Dr. Zingales.

Mr. ZINGALES. No, it was not a wise decision. He should have increased the equity base, not reduce it at that moment.

Mr. TIERNEY. I noticed that in June of 2008 the Lehman Brothers had a $2.8 billion loss on their books, and that sent everything--stunning the markets, sent everything spinning. If they had that $10 billion that had gone to bonuses and to dividends and buybacks, it certainly seems that they might have avoided that situation as well.

Do you know, Dr. Zingales, what the amount of money that

Mr. Fuld was seeking from the Korean Development Bank toward the end?

Mr. ZINGALES. No, I don't know the exact amount.

Mr. TIERNEY. Do you, Ms. Minow?

Ms. MINOW. No, I do not.

Mr. TIERNEY. I believe it was probably $6 billion or less. And my point was again, if you take that $10 billion off the books, you lost that opportunity to do something substantial in terms of saving that company and saving our economy on that. But we can explore that further with Mr. Fuld.

But I do want to just cover an e-mail exchange between Mr. Fuld and one of his top executives, David Goldfarb, that was dated May 26th of 2008. In that, Mr. Goldfarb reports that a possible deal with the Korean Development Bank would provide several billion dollars worth of new capital to Lehman. Mr. Goldfarb describes what he would like to do with the money, and he writes as follows. It feels like this could become real. If we did raise $5 billion, I like the idea of aggressively going into the market and spending two of the five and buying back lots of stock and hurting Einhorn bad. Now, in the e-mail Mr. Goldfarb was referring apparently to David Einhorn, who at the time was publicly critical of Lehman and was shorting its stock. Mr. Fuld wrote in a short response, I agree with all of it.

So here is how I read this e-mail. Lehman was dangerously low on capital, and possibly found an investor willing to give them billions of dollars. And what they wanted to do with it, however, was buy back stock and punish a short seller. Mr. Smith, what are your views about that e-mail exchange, being an investor?

Mr. SMITH. Well, horrified. When you know that you are low on cash, when you know that you have exposed your company to what I have heard as ranging from 35 to 70 times leverage, and you are giving away your cash with a motive of punishing someone rather than benefiting your shareholders, that is the ultimate breach.

Mr. TIERNEY. Thank you.

Chairman WAXMAN. Thank you, Mr. Tierney.

Ms. Watson?

Ms. WATSON. I really think this is the most important hearing we have had in this particular Congress. I thank the experts for coming out this morning. I just returned from California, the largest State in the Union, 38 million people. It was a turnaround for me. And I tell you, they followed me out of church, they followed me at several dinners, political dinners. Everyone was outraged over the $850 billion of their moneys to bail out people who have shown nothing but corporate greed. And I am hoping that as a result of the six hearings we are going to have that we can come out with a policy that will really curtail this greed out of control.

Now, looking at Lehman Brothers and trying to get to the bottom of what caused this economic crisis that we are in, the makeup of the board may provide some insight with what went wrong. Seven of the 10 board members were retired. Many of them lacked Wall Street experience. And the Lehman board members included the former head of Telemundo, who was a retired Navy Admiral, and a theater producer.

And so I am directing this to Ms. Minow. You are an expert on corporate governance. Do you have concerns about the effectiveness of the Lehman board? And let me just mention one board member, Mr. Roger Berlind, the theater producer. He has been on the board for 20 years, and sits on the audit and the finance and risk committees. What are your concerns about having a board full of people like Mr. Berlind?

Ms. MINOW. Thank you, Ms. Watson. As I said in my testimony, we rank boards based on the decisions they make, and not on their resumes. And I will say in fairness to Mr. Berlind that yes, he is a theatrical producer, he does have a background in finance, and was the co-founder of a Wall Street firm at one time. However, I think it is clear that the members of this board had no clue about the kinds of securities and other issues, the derivative securities and the credit default swaps that we have heard about today. And the fact that the risk committee met only twice 2 years in a row I think tells you everything you need to know.

So I rank this board very, very poorly. They currently get an F from us.

Ms. WATSON. I see one of the biggest problems in corporate governance is how entrenched the board can become. And under current law, there is no effective way for shareholders to challenge an incompetent or negligent board. And in the bailout bill, Chairman Barney Frank tried to address the problem of these entrenched boards. And he said that shareholders should be able to propose their own candidates for the board. The theory behind this reform is that if the board gets too close to management, as the Lehman board did, the shareholders can vote in a new board with more independence and oversight. Unfortunately, Secretary Paulson insisted that this corporate governance reform be dropped from the bill.

So I would like to ask you first, Ms. Minow, was this an important reform? And then Mr. Smith, do you have a view on this? And Mr. Zingales, what you think. In that order, please.

Ms. MINOW. This is a crucial reform. Mr. Smith mentioned it in his testimony. I have got it in my written remarks. At this point, you know, I always love bringing this up when I am speaking to the committee because one thing that you all understand very, very well here, very intimately is the concept of an election. And yet we call it an election for a corporate board, and only one person runs, no one runs against them, and management counts the votes. It is a pretty good system. We have got to have some way--this is exactly what I am talking about when I say we need to remove the impediments to oversight from investors so that we can remove directors. There are currently more than 20 directors serving on boards today who did not receive a majority vote from their shareholders. Shareholders did everything they could to say we don't want you and they are still serving. So we definitely need to improve that system.

Thank you.

Mr. SMITH. Yes, that certainly is one of the biggest reforms I would like to see. It is the only place I have ever seen where--

Chairman WAXMAN. Is your mike on?

Mr. SMITH. Pardon me?

Chairman WAXMAN. Is your mike on?

Mr. SMITH. Yes, it is. Who are our representatives, the shareholders' representative is not picked by the shareholders and the shareholders have nothing to say about who they are, and they are not accountable to the shareholders. Their presence in the board room is dependent upon management and whether or not management puts them on the slate. That is not a good connection for the shareholders to have their voice heard in a board room, and it has failed us.

Mr. ZINGALES. I completely agree with you. In fact, there are very few things that the United States can learn from Italy, but Italy has a law that allows representatives of institutional investors to be elected on board. And I happen to be one of those. I sit on the board of one of the largest companies in Italy, Telecom Italia, as representative of institutional investors. And I sit on their compensation committee, and I can actually argue about their compensation. And I can tell you that last year I wasn't particularly polite in some of the conversation. And if I was appointed by management, I would not have been renewed. But I was renewed because I am appointed by institutional investors and I represent shareholders on that board.

So I think that would be a very important reform that we could pass.

Chairman WAXMAN. Thank you, Ms. Watson.

Ms. WATSON. Thank you so much.

Chairman WAXMAN. Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chairman. Just a couple of thoughts. Virtually every recession or severe economic downturn originates in excesses in the financial economy.

And then they go on to ruin the real economy. I think the recent financial crisis is consistent with that. And I find in my review of the facts four basic abuses: A lack of transparency, excessive leveraging, conflicts of interest, and most egregious, the probability of dishonesty and deceit.

Lehman Brothers didn't just collapse on September 15th. Its financial situation has been getting increasingly dire with each passing quarter. But Lehman's executives kept telling shareholders and public investors that its finances were in great shape. In September 2007, Lehman's chief financial officer told investors, quote, our liquidity position is stronger than ever. In December 2007, CEO Richard Fuld said, quote, our global franchise and brand have never been stronger. In March 2008, Lehman fired its chief executive officer and hired a new one. The new chief financial officer told investors, quote, I think we feel better about our liquidity than we ever have. In June 2008, CEO Richard Fuld told shareholders, quote, our capital and liquidity positions have never been stronger. And on September 10th, 5 days before Lehman filed for bankruptcy protection, Lehman made upbeat comments to investors and research analysts.

Mr. Smith, you represent a state pension fund. Your fund manages retirement assets of public employees in the State of Colorado. What do you think about these statements by Mr. Fuld and others at Lehman? Were they giving you an honest assessment of what was going on inside the company?

Mr. SMITH. Well, clearly, they were not giving us an honest assessment of it. And unfortunately, neither were the books, neither were the auditors. There was no piece of the puzzle that allowed us--we are big boys and girls. We invest billions of dollars. We understand how to invest. We understand how to do due diligence. But you have to have the tools to do that. And you have to have people who are going to be honest enough to tell you the facts, or at least have you have the ability to go mine the facts yourself. And in today's situation, and for many years now we have been unable, we have been impaired in our ability to do that.

Mr. HIGGINS. Professor Zingales, what is your view? Could Mr. Fuld have been truthful when he said in June of 2008 that our capital and liquidity positions have never been stronger?

Mr. ZINGALES. It is hard to imagine that it was never stronger than that. I think that it is clear that was a moment of crisis, and it is clear that he didn't have a good understanding of what the situation was. If it is true, as was said, that he was indicating that they would buy back stocks in order to punish the analysts, I think--I am sorry, the short sellers, this is a typical situation of overconfidence by a CEO that doesn't see the problems as they should be. And he thinks that the responsibility is all on the market that gets it wrong. It is all on the short sellers, the short sellers of stocks, and they don't see the problem coming.

Mr. HIGGINS. Mr. Fuld had a vested interest in painting a rosy picture at Lehman. If he had disclosed its precarious situation it could have put more pressure on the company. That is why I believe the disclosure rules are so important. Investors shouldn't have to rely on the rosy assessment of corporate executives. They should be able to verify those statements in reviewing public filings of the company. Mr. Smith or Dr. Wescott, what are your views about disclosure rules?

Mr. SMITH. Well, I was just mentioning I should have hit transparency a little harder in my answer. I appreciate the loop back, because that is what we believe was lacking with the off balance sheet opportunities, with the loosened accounting rules, with the obfuscation of the leverage that they were actually imposing on the assets of the organization that were in large part undetectable by an investor. Didn't have much of a fair shot at assessing our risk when we got into that.

Mr. WESCOTT. A quick comment. Basically, there are two ways you can go if you are going to regulate an industry. You can have very, very tight regulation. At the limit, you can imagine a regulator basically working full-time in the institution looking at every number every day. And that is one way you could go. The other way is to back off and to allow--to have less day to day, minute to minute regulation. If you are going to go that way, though, you have to--the key building block is disclosure and transparency. And that is--if you don't have this very minute level of regulation, you have to have disclosure and transparency.

Chairman WAXMAN. Thank you, Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chair.

Chairman WAXMAN. Ms. McCollum.

Ms. MCCOLLUM. Thank you, Mr. Chairman. I want to go back to September 10th, because that is 5 days before the bankruptcy filing. It is my understanding that the chief financial officer held a conference call for investors. And that was reported in the Wall Street Journal. And in fact, some of the bankers even advised them not to hold this call because there were going to be too many open questions. And I would like to know from the panel, to your understanding is this accurate?

Ms. MINOW. I don't have any information about that, sorry.

Ms. MCCOLLUM. My understanding is at the time that they were making this call they were trying to raise capital through new investors or by off selling assets. Dr. Wescott, Dr. Zingales, any comment on that?

Mr. WESCOTT. Unfortunately, I don't know the details of what was going on.

Mr. ZINGALES. Neither do I.

Ms. MCCOLLUM. One of the concerns that I had, Dr. Zingales, from your testimony, you talked about how there were three issues kind of involved to Lehman's collapse. One of them that we haven't spoken about very much was the whole idea of the credit market swap that was involved in here. So irrespective of whether or not they were making good investments, and they definitely were not in the home mortgage securities, could you elaborate on Lehman Brothers' role in the credit swap?

Mr. ZINGALES. Actually, the role of Lehman in the credit default swap market is relatively limited. There is a table in my long testimony, I think it is table 5, that reports the best numbers we have regarding sort of the amount of credit default swaps in place. And Lehman is 25th in the list. So they definitely had some sort of play in the market, but not a huge play in that market.

Ms. MCCOLLUM. But when there is lack of confidence in the market, to what degree did these--I mean they were out there hustling for cash, looking for something. They knew that they had problems with the loans that they had accrued. The fact that they got even involved in doing this credit swap, does that bring any--from my research, that does not bring any stability to a company. In fact, it adds to destability.

Mr. ZINGALES. It depends what position they take, because if they were hedging their risk by taking insurance along the way, this should in principal have reduced their risk. Of course if they were selling insurance, that would have been crazy, but I don't think at that time people would have bought the insurance because they were sort of rumored to be in difficulty. So you don't want to buy insurance from an insurance company that you are not sure is going to be around to pay when your house is in trouble, for example.

Ms. MCCOLLUM. Could I ask each one of the panelists, there was great discussion about privatizing Social Security. And as we have heard from the gentleman from Colorado, a lot of pensions had their security assets in fact involved in these types of products. Could you tell me what, in your opinion, privatizing Social Security would have meant for Americans today had that plan gone through?

Mr. SMITH. Well, the beauty in our view as a pension system, and particularly a hybrid defined benefit pension system is that we are able to pool at least some of these market risks for our members. The members in our system who were within a year or so of retiring and faced this crisis probably still have the ability to retire, because we have a long-term ability to provide those benefits. If they were on their own and they were in individual accounts that were under their control and their responsibility, they would be left with only that, and that would be inadequate to provide for them in these times. And this cycle would have caused them to go back to work for years into the future. So it would be devastating to have individuals--in my view, to have individuals and individual accounts out there trying to survive in what is a market that lacks transparency.

Mr. WESCOTT. Just there are many different proposals of how to do a privatization of Social Security. There is carve out, there is add on, and so on. So it is difficult to know exactly which type of plan we would be talking about. The key for insuring safe retirements for Americans is diversification, a blend of income, some coming from Social Security, some coming from company plans, some coming from private 401(k) plans or individual plans. What we really want is to have a blend of money so that you have multiple sources, each of them subject to different risks.

Chairman WAXMAN. Thank you very much. Did anyone else wish to respond to the question? Thank you, Ms. McCollum. Mr. Van Hollen?

Mr. VAN HOLLEN. Thank you, Mr. Chairman. I thank all of the witnesses for being here today. I just want to pick up on a point that Ms. Minow raised in her testimony regarding the link between executive compensation and overall performance. We are looking at Lehman Brothers as a case study today. We have AIG tomorrow. And then we will go on to some of the more systemic issues. But I think what we are seeing today, just looking at Lehman Brothers, is a good case study of the fact that you don't have this alignment between pay and performance. In fact, as my colleague Mr. Cummings was saying, unlike the rest of America, where pay for performance means you get rewarded when you do well, but you actually get--there are disincentives, you get cut in pay when you do poorly, the fact of the matter is on Wall Street you do well when they do well, and you do well when they are doing poorly. And that clearly is a mismatch. And I think it is important to look at this to make the recommendations you have talked about in terms of what we can do legislatively to better align stockholders' interests with those of the executives who are making decisions. And one problem I think is the fact that people are urged to take big risks to maximize short-term pay and bonuses at the expense of longer term well-being of the company and the stockholders. And I think one of the reasons that happens is because people think that when they make bad decisions they are going to still get bailed out.

I want to talk to you briefly about a memo that was written at Lehman Brothers by the compensation committee on

September 11th. That is 4 days before Lehman Brothers declared bankruptcy. And it is a recommendation from Lehman Brothers to the compensation committee of the board. It discusses a number of the separation payments, including one of them to Andy Morton. Mr. Morton was the head of Lehman's global head of fixed income. He was the person who was responsible for the leveraged investments that were a good part of what drove Lehman into bankruptcy. Another was Mr. Benoit Savoret, a member of Lehman's executive committee. It says that they both had been involuntarily terminated. They have been fired. And so you would think, you know, when you get fired, bad performance, no pay. But it goes on to recommend giving them cash separation payments combined of $20 million, 16.2 million for Mr. Savoret, and 2 million for Mr. Morton. And it calls--in the memo they describe these as special payments. And they come up with a rationale for providing these kind of last minute bailouts to these guys. Is this part of the mentality of sort of an insatiable, you know, insatiable sense of entitlement on Wall Street that suggests that even when you do badly someone is going to be there to bail you out?

Ms. MINOW. I couldn't possibly have put it as well as you did, Congressman. That was perfect. I had to laugh, though, when you said this was a good case study. I wish it was the only case study. It is just replicated over and over and over and over again. And you are right, they are so completely out of touch, that on the upside they always say I am responsible, it is a market test, I am Michael Jordan, I am A-Rod, I deserve this. But on the downside, it is never their fault. And if we don't have better shareholder oversight, if we don't have better market response to them, then they are never going to get the message.

Mr. VAN HOLLEN. Let me just read to you their description of why these are apparently justified in their view. They say these executives are, quote, very experienced senior executives with valuable business skills and experience that the corporation may wish to leverage. Again, these are the guys who helped obviously contribute to the downfall. It also says, and I quote, the corporation would face significant impacts if the terminating executives should fail to provide appropriate transition assistance, solicit clients, or engage in other behavior that may be detrimental to the corporation.

Now that you have heard the rationale, does that pass the common sense smell test?

Ms. MINOW. Not at all. But this goes back to a point that I made earlier where I said I take a very hard line. I don't believe they should be allowed to sell their stock until after they leave their company. And if that doesn't motivate them adequately, then they are not paying attention.

But I think it is hilarious that they use the term "leverage." Because one thing we have learned about this company is they didn't understand leverage at all.

Mr. VAN HOLLEN. Mr. Smith, as somebody who entrusts these individuals with lots of decisions, is that the kind of pay for performance that you would want to see?

Mr. SMITH. Certainly not, and certainly highlights our desire to have say on pay as a shareholder, to be able to be in the board room or have a representative in the board room that actually is looking at those payments and saying how is this going to bring value to my shareholders? And I would contend that there is categorically no way those payments could bring value to the shareholders.

Mr. VAN HOLLEN. Thank you. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Van Hollen.

Mr. Cooper?

Mr. COOPER. Thank you, Mr. Chairman. I would like to explore the role of excessive leverage in the downfall of Lehman Brothers. Professor Zingales starts his whole testimony by saying the downfall of Lehman Brothers is the result of its very aggressive leveraging policy. Could you help the public understand how leverage magnifies gains or losses?

Mr. ZINGALES. Sure. Let me make sure that you all understand what we are talking about. When you buy a house and you put a 10 percent down, you are basically buying something that is worth 10 times what you put down. So your ratio is 10 to 1. That is the leverage. What Lehman was doing was 30 to 1. So it was much more than what most people do in buying their house. And this exposes you enormously to fluctuations in the value of the underlying assets.

As I said in my testimony, if you have a drop of only 3.3 percent in the value of your assets, your entire value of the equity is wiped out, and so you are insolvent. And this system, as was mentioned by the chairman, is very rewarding on the upside, so that when things go well you have very high sort of earnings, you have very high return on capital, and this allows you to pay very large bonuses. On the downside, this is very dramatic. And so especially given sort of the situation in which we were, the risk on their assets and the risk of a downturn in the housing market, it was not sort of not foreseeable, I think their leverage policies should be much more cautious. But also it is not only the leverage, it is also how much of that leverage is short term. Because when you have a problem, the short term lenders can leave you and create a situation of insolvency, which is exactly where Lehman was. And before the beginning of the crisis, 50 percent of that leverage was made of short-term debt, which is very profitable in the short term because short-term debt, especially in the current environment, is much cheaper than long-term debt but exposes more to a risk of a run, and that is exactly what happened.

Mr. COOPER. So Lehman was levered I think at the start of Dick Fuld's tenure at 27 times, and then it went to 37 times. And now that there are no major investment banks left on Wall Street, even Goldman Sachs and Morgan as I understand are down to about 10 times leverage. So it has been a substantial contraction of the leverage ratios.

Dr. Wallison, could you tell us what you think an appropriate leverage ratio would be for investment banks, assuming we have major investment banks return to America one day?

Mr. WALLISON. I don't think, Congressman, that you can give a number. It depends very much on the risks that they are encountering in the market at a given time. It is obvious, it should have been obvious to the management of Lehman and any other management that when things can't continue, as Herb Stein once said, they will stop. And as a result, a provision should have been made for a downturn. But there isn't a number that is the right number under any circumstances.

Mr. COOPER. But it is sounding today, since no firm, major firm left in the country is leveraged at 30 to 40 to 1, that that must be too much, right? Another point about leverage is the fulcrum on which the lever rests, the capital, the equity that Lehman thought it had on its balance sheet. And Professor Zingales, didn't you say in your testimony on the day they went bankrupt it supposedly had $26 billion on its balance sheet?

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[12:02 p.m.]

Mr. ZINGALES. Yes, $26 billion in book value of equity. The problem is the market value of the equity depends crucially on the value of its assets; and the uncertainty that was created in the value of the assets in part by lack of transparency, in part by the liquidity crisis made it impossible to know exactly what it was. And when the market becomes nervous, that is the moment they pull out their money. That is the reason why adding a lot of short-term debt is not wise, because in that situation you can have literally a bank run, and that is what happened.

Mr. COOPER. So a contraction in credit because of excessive leverage crushed $26 billion in capital, which we question the value of anyway, because, apparently, mark-to-market rules didn't necessarily apply quickly enough in this case. And I think that leaves a lot of folks back home wondering whether this is Wall Street or a casino.

Because, as you conclude your testimony, Professor Zingales, you say Lehman did not find itself in this situation by accident. It was the unlucky draw of a consciously made gamble. That doesn't sound like an investment. That sounds like gambling.

Mr. ZINGALES. I think, as I said in my testimony, they were too aggressive in their leverage; and that is the reason why I think they should not have been bought out. My major concern is that if we bail out everybody who took those gambles, we are going to create incentives to have more gambles down the line. And I think that there is a strategy on Wall Street to sort of take a lot of gambles on the outside and then walk away when things don't work out. And if you don't get punished when things don't work out, everybody will play that gamble over and over again. So I think we have to be very careful on what we do now, because I think that what we are doing now will define incentives for a generation to come.

Chairman WAXMAN. Will the gentleman yield? Just for me to point out that the regulation of commercial banks is that the leverage is no more than four to one. So I guess every--all the banks are now commercial banks. But there is a spelling out of it--of a leverage number.

The next person to question would be Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

Of course, we have all alluded to the fact that there is a lot of people who are angry out here in the country. I expect that when we are done with these five hearings they are going to be a lot angrier, because they had deep suspicion about this culture of greed and recklessness on Wall Street. Now they are going to have plenty of proof positive of it once we are done with these hearings.

I don't think there is any surprise to be found in the huge either golden parachute packages or compensation or salaries that these folks got used to thinking they should have. When you look at the amount of money they are playing with--and I use the phrase "play with" rather than "manage" because that's where it seems things seemed to get. So you put it in that context, and they lose all perspective. They are not living really in the same world that everybody else is living when they are dealing with these kinds of dollars under these sorts of conditions.

And I have got to go back to what Congressman Higgins was asking about before. Because if you're Richard Fuld, I mean, how do you lose all commonsense? I'm looking at these statements that he made. Late in the game, like right before this thing falls apart, our global franchise and brand name--our brand have never been stronger. In June of 2008, still in this year, our capital liquidity positions have never been stronger. This is a no-win statement from him. Because either he has lost all perspective and is completely clueless in a statement like that or he is quite savvy but he is deceiving people affirmatively.

You could pull anybody out of any coffeehouse anywhere in this country who are small businessmen and you could lay out for them the basic metrics of what was happening to this company at that moment in time and they would say, are you kidding me? Are you kidding me that this was a strong position? I mean, anyone would recognize that.

So here is my question. How does this happen? Talk to me a little bit about the culture, the external culture--in other words, if you're Richard Fuld, you've got your company's culture that you're dealing with, and then you have got the larger culture. So what happens that makes him lose such perspective? Or, if you want to look at it another way, think he can get away with this kind of public pronouncement. Is it the parties you're going to? Is it the fact that the analyst division of your own company suddenly evaporates and stops doing its job? I mean, what is happening to get you to this point? Anybody. Yes.

Mr. WESCOTT. Let me take the first cut at this.

Think of the--you're having a monthly management meeting of your management team, you have the heads of your profit units there, and you're giving--if you're the CEO, you're giving them their profit targets, let's say, for the quarter. This trading desk, you're expected to have $100 million of profit; that trading desk, $50 million; and so on. In the room, you have the corporate risk officer; and these companies--all of the investment banks have risk officers. Their job is to be looking at the financial developments, at the trends of housing prices, subprime loans and so on. And when you're sitting around the table, the profit managers are explaining what their prospects are for hitting that profit target.

Presumably, the risk officers there are saying, we are getting kind of nervous here, because we're now pushing the envelope in this area. I think maybe we need to cut back the profit target for that--let's say, that trading activity or whatever activity, because it is starting to feel risky.

Ultimately, that is what the CEO is being paid for. He is being paid for that judgment, hearing the debate that is going on. And probably in many of these cases, the risk officers were not speaking up quite loudly enough.

Ms. MINOW. Mr. Sarbanes, I always say when I look at boards of directors, more than being a financial analyst, more than being a lawyer, I'm an anthropologist. Because I think you have to look at kind of the anthropology of the board room. And when you have got a CEO who picks his board to make sure that it is a bunch of retirees who barely know what a derivative is and have a risk committee that meets only twice in a year, you have kind of an emperor's new clothes problem. Nobody wants to tell him the truth, and he intentionally surrounds himself with people who are complicit.

If you look at the part of my testimony where I talk about the related party transactions, these are people who were getting side payments from the company. They had no incentive to provide any kind of independent oversight, and that is why it is so important to let shareholders like Mr. Smith throw some of these people out.

Mr. SARBANES. Well, they called Mr. Fuld the gorilla, right? So maybe they should have had Jane Goodall in there doing an analysis from an anthropol--thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Sarbanes.

Mr. Welch.

Mr. WELCH. Thank you. Thank you, Mr. Chairman. I thank the witnesses.

Mr. Wallison, I happen to agree with some of your criticism about Fannie Mae and Freddie Mac and the walk-away bonuses to the folks who ran that company, those public enterprises, into the ground are pretty despicable. And, you know, frankly it is mystifying to me why somebody would get over $100 million for essentially buying and selling mortgages. It is not that complicated.

They, as a public entity, are now prohibited from lobbying. I have a question of you. Do you believe that, in view of the fact that the taxpayers now have $700 billion in the game, that restriction on lobbying should apply to banks or other agencies that choose, choose to participate in the benefit of this taxpayer bailout?

Mr. WALLISON. No. The restriction on Fannie Mae and

Freddie Mac from lobbying comes from the fact that they are now controlled by the Federal Government. There isn't any need for them to come to Congress and inform Congress in particular. Lobbying serves a very valuable function, in my view, of informing Congress of what the legislation will actually do.

Mr. WELCH. Let me just clarify it. The distinction between a paid lobbyist and then representatives on the actual payroll of Fannie Mae and Freddie Mac coming in, for which I have no objection.

Mr. WALLISON. I don't see a difference, really, between those two, whether you are salaried by the company or whether you are retained outside. Lobbyists have a valuable function; and Congress should consult with, listen to lobbyists. You have to discount them appropriately, listen to both sides. But it is a very dangerous thing for Congress or anyone else to wall yourself off from the information that the companies themselves can provide about the effect of your legislation.

Mr. WELCH. All right. Let me rephrase the question a little bit. I do agree with you that lobbying is a very valuable activity for people that come in and petition. My question is whether taxpayers should help pay for it.

Mr. WALLISON. Sure. Of course. For individual companies--Mr. Congressman, if I can just finish the question--this is very important for them to make sure that Congress people who are making decisions on legislation that could affect them substantially are well informed and that directly affects the shareholders.

Mr. ZINGALES. I agree with you, Congressman.

Mr. WELCH. And the question--I just want to rephrase it, because I don't want to turn this into lobbying or not. But the question really has to do with the fact that there is $700 billion of taxpayer money in this bailout effort. And should any of that money be allowed to be used for lobbying activities?

Mr. ZINGALES. Yeah. I think that you are right. It should not be used for lobbying. But, most importantly, I think that lobbying does serve a useful purpose, but it is also true that it is an unfair game. Because clearly sort of financial firms have much more power than the public interest. So the public interest always loses out in lobbying.

Mr. WELCH. Okay. I mean, we've heard--I'll ask Ms. Minow. You look like you want to weigh in on this.

Ms. MINOW. Thank you very much, Congressman. There is one point that I would like to make.

I would hope that the committee would take a look at Bethany McLean's article in Fortune Magazine about Fannie Mae. Because it wasn't just the lobbying. It was the fact that their foundation had events in all of the congressional districts that--for their Oversight Committee that I think played a very big role in it. So it is more than just lobbying.

Mr. WELCH. All right. Mr. Smith, do you think if we had stronger shareholder representation on the board so that the policies that were then being advocated by the company, if we had those stronger shareholder representatives on the board of governance, that would help address this issue?

Mr. SMITH. Absolutely. I think that that is the key to--it is really the solution. Because I think to cut off lobbying does isolate you. And what we need to have is a balanced opportunity to be heard by the interested parties, and I think that is the piece that is lacking or has been lacking.

Mr. WELCH. Okay. Dr. Wescott, do you have anything to add to this?

Mr. WESCOTT. No.

Mr. WELCH. You know, we have been asking a little bit about this corporate pay an awful lot because it is the symbol of outrageous excess and abuse.

Mr. Prince was in here before. He got $38 million when he walked away, lost about $20 billion in two quarters.

Mr. Mozilo of Countrywide, another great American entrepreneur, was given $120 million; and he ran his company into the ground.

Mr. O'Neal from Merrill Lynch got a walk-away package of $161 million. Also, in the last 2 quarters before he left, they lost about $20 billion for the shareholders.

And all of us think that is a bit odd. Do you believe there should be a right of the taxpayers to have whatever rights would be available to the company to claw back some of that rip-off walk-away money in the event those companies choose to participate in this bailout?

Mr. ZINGALES. Yes.

Mr. WELCH. Mr. Zingales? Mr. Wescott?

Mr. WESCOTT. Yes. If the government is part owner of the firm, it should have the rights of a part owner.

Mr. WELCH. Okay. Mr. Wallison, how about you?

Mr. WALLISON. Yeah. If the compensation was, in fact, not properly earned, the shareholders, the company should be able to get it back.

Mr. WELCH. Yeah. And would we all basically agree that these guys got out of dodge before the house of cards collapsed?

Ms. MINOW. Yes.

Mr. WELCH. But it put in place the rot in the beams that led to its falling down.

Ms. MINOW. Congressman, if a private entity were participating in some kind of a transaction of owning distressed securities, they would insist on those rights and the taxpayer should certainly insist on them as well.

Chairman WAXMAN. Thank you, Mr. Welch.

Mr. WELCH. Thank you, Mr. Chairman.

Chairman WAXMAN. Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

I want to apologize. I'm going to make some reference to my statement. I had been hoping that I could do that earlier, because it has context to the questions that I want to ask. I'd like to know your response to what I'm about to say.

At the center of our financial crisis is the collapse of the housing market. So it is surprising to me we are not taking a close look at Fannie Mae and Freddie Mac. But what is also glaringly missing from these hearings is an intense investigation about the role of Congress in this disaster, particularly as it relates to Fannie Mae and Freddie Mac. Together, these two giant financial institutions scrutinize half of our Nation's $12 trillion mortgage market.

Clearly, Wall Street bears significant responsibility for this crisis. The leaders of these financial institutions need to explain how overleveraging, undercapitalization of peak accounting and minimal investor disclosure ever seemed like sound business practices. Every part of the financial market broke down. Wall Street accumulated far too much debt; consumers lived on credit, often refinancing their homes to get it; lenders lured buyers into houses they couldn't afford; investment firms did not disclose the risks associated with their products; the rating agencies seemed oblivious to shaky financial instruments and the companies that bought and sold them; and the Federal Government, including Congress, failed to properly regulate. The regulatory structure was failing, and we in Congress refused to do anything about it.

In the interest of truth, it must be said we are not confronting the 800-pound gorilla in the room. What we're not confronting is the role of Fannie Mae and Freddie Mac in this debacle. Combined, these two companies not only scrutinized half of the Nation's mortgage market but one train alone in subprime loans. Yet they are not required to disclose the risk these mortgages posed to the solvency of their balance sheets.

Why? Because we in Congress have not required the same registration reporting requirements of Fannie and Freddie as we do with all other publicly traded companies.

The efforts of a few of us in Congress to address this situation are a matter of public record. Our efforts can be found in legislation, in hearings and debates and votes in committee and on the floor of the House.

When it came to Fannie and Freddie, lobbyists effectively manipulated both sides of the aisle. Fannie and Freddie hired lobbyists to advocate for their position and kept countless lobbyists on retainer to prevent them from arguing against their position. Congress stood idly by as Fannie and Freddie played with trillions of dollars under a different set of rules with little capital to protect their balance sheets from sudden losses.

There is no way to explain it. The reason--there is no other way to explain it. The reason we haven't scheduled hearings on these two institutions and haven't requested documents from either is because their demise isn't someone else's fault, it is ours; and we don't want to own up to it.

Mr. Chairman, the alarm bells were sounded more than 4 years ago. I requested transcripts of these public discussions. I request that the transcripts of the following committee and House debates be placed in the record for today's hearing:

July 1st--23rd, 2002, Financial Services Committee hearing, OFHEO Risk-Based Capital Stress Test for Fannie Mae and Freddie Mac.

July 23, 2003, Financial Services Committee markup, H.R. 2420, the Mutual Funds Integrity and Transparency Act.

September 25, 2003, Financial Services Committee hearing, H.R. 2573, the Secondary Mortgage Market Enterprises Regulatory Improvement Act and the Administration's Proposals on GSE Regulation. That was September 25, 2003.

October 6, 2004, Financial Services Subcommittee hearing, the OFHEO Report: Allegations of Accounting and Management Failure At Fannie and Freddie.

April 6, 2005, Financial Services Committee hearing, Additional Fannie Mae Failures.

October 26, 2005, floor debate, consider Mr. Royce amendment to H.R. 4161 to strengthen the OFHEO regulator.

Getting to the bottom of this--that's my motion, that we introduce these into the record.

Chairman WAXMAN. If the gentleman would permit, I would suggest that we make reference to all of those, and people then can link into those, rather than spend taxpayers' money to reproduce all of those records, if that is acceptable.

Mr. SHAYS. That is acceptable.

Chairman WAXMAN. Then, without objection, that will be the order.

Mr. SHAYS. Getting to the bottom of this, whatever that takes, is our obligation but requires us not to just look at CEOs of Lehman or AIG but at ourselves and the wretched manipulation by Fannie Mae and Freddie Mac of the Congress of the United States.

With the limited time I have left, I would like--I have no time left.

Chairman WAXMAN. If the gentleman would permit and yield to me, we have five hearings scheduled on the issues of where we are in the economy and what has happened with Wall Street, and the gentleman raises issues about Freddie Mac and Fannie Mae. Our staff is already looking into some of the documents relating to them, and we may well add additional hearings. We are not restricted to those five hearings, and I appreciate the concern that has been raised.

Mr. SHAYS. Will the gentleman yield?

Chairman WAXMAN. Yes, sir.

Mr. SHAYS. Given that the housing market is what brought down everyone else, why wouldn't we start with Fannie Mae and Freddie Mac, given they were exempted from the 1934 law, the 1933 law and given that we all know that they hired lobbyists to work their will in Congress? Why would we not be looking at Congress? Why are we looking at everyone else but Congress?

Chairman WAXMAN. Well, I have no reason not to look at Congress. We'll be happy to look at Congress. It has been controlled by the Republican party for a 12-year period; and during the 2 years the Democrats have been in control, it has been controlled by a Republican administration. We ought to look at the politics of why we haven't gotten further.

But trying to understand where we have been and where we are now and what the causes were and what reforms are necessary is the objective of this committee. And you can't do everything all at once. We'll start with the first hearing today, and we'll go on to the next one tomorrow, and we'll go on from there.

We have completed all of the members who sought recognition. Mr. Mica--

Mr. MICA. Mr. Chairman, given the importance of this hearing and again asking for fairness for both sides, I would ask unanimous consent that each side be given an additional 10 minutes to be distributed by the Chair and the acting ranking member for additional questions of this panel.

Chairman WAXMAN. The Chair is going to object to that. We have had a very long time with this panel, and we have Mr. Fuld waiting. But the Chair will note that there are many more Democratic members here than Republican members, and I will allocate 5 minutes to the Republicans between the two of you to ask any further questions that you wish to pursue of this group. Who should control that time?

Mr. SHAYS. I will control it and yield to my colleague 3 minutes. Thank you, Mr. Chairman.

Chairman WAXMAN. Okay.

Mr. MICA. Well, actually, I'm quite disappointed. I was--

Mr. SHAYS. I'd be happy to yield my colleague 5 minutes.

Mr. MICA. I was berated by the Chair in the bipartisan matter in which I conducted my subcommittees. I'm the ranking member of the largest committee in Congress. I chaired the subcommittee--Aviation Subcommittee for 6 years, never once denied a single Democrat or Republican the opportunity to fully participate in offering an opening statement or asking a question. I'm really--I'm really saddened by the way this is being conducted, because this is an important hearing and there are important questions that the people want answered. And if he wonders why people aren't on this side, if you can't participate, why the hell should you be here? But that's another matter.

I have a couple of questions of my remaining time.

So now that we have no major investment banks, Mr. Wallison, what do we do in regulating them?

Mr. WALLISON. Well--

Mr. MICA. That's a rhetorical question.

Mr. WALLISON. Nothing to regulate at the moment--firms, incidentally, all of which could become investment banks over time.

Mr. MICA. Yeah. Well, I think that some of the things that were raised here, transparency, leveraging, would you say that by Fannie Mae reducing its reserves from 10 percent to 2.5 percent, that others in the private sector--people don't understand that we had a government-backed securities operation, which was Fannie Mae, and they were backed by the

United States Government. Lehman, AIG and the others are private--were private investment activities; is that correct?

Mr. WALLISON. Yes, it is.

Mr. MICA. Okay. Not that they should be precluded. But when you have ones reduce their reserves, then what happens? Wall Street follows usually to compete. Isn't that what happened?

Mr. WALLISON. No. Actually, Congressman--

Chairman WAXMAN. Is your mic on?

Mr. WALLISON. Sorry. The capital of Fannie and Freddie were set by statute. That was one of the regulatory problems that are associated with those two enterprises.

Mr. MICA. My point, though, is that, in most of this, Wall Street followed.

Now, of course, Raines only took off with $100 million in compensation, and we have--and that was a government-sponsored activity. That is absolutely outrageous. Mr. Shays tried to bring that under control. He introduced legislation. I was a cosponsor in 2002.

And then people in Congress--and we don't have anyone from Fannie Mae here to start this out. This is ridiculous. Fannie Mae--who was the biggest private mortgage lender in the country? Wasn't it Countrywide, Mr.--

Mr. WALLISON. Countrywide, yes.

Mr. MICA. Countrywide. Okay. How is this, Mr. and Ms.

America? Franklin Raines received a 5.1 percent loan for 10 years for almost a million dollars in refinancing. Jamie Gerlach received 5 percent for a $960,000 refinancing, both employees. This is a government activity, outrageous. And they walked away with millions of dollars, and we are not looking at that.

Then the guy that writes the bailout package in the Senate gets--he got one of these VIP Countrywide mortgages for himself, and we are just trying to blame Wall Street. Is that fair? I want everyone to--

Mr. WALLISON. There has been greed all around, I would say. Greed all around.

Mr. MICA. Okay. Was it greed, Mr. Smith, or just a good deal for the few elected officials and somebody behind a government mortgage company who was ripping folks off?

Mr. SMITH. I would certainly say it is not actions in the best interest of the shareholders.

Mr. MICA. Ms. Minow.

Ms. MINOW. Sorry. I think there are profound conflicts of interests, and I hope that there is oversight of Fannie and Freddie and Congress.

Mr. MICA. Doctor.

Mr. WESCOTT. There is plenty of blame to go around. The truth is that Fannie actually lost market share in some of these mortgage areas in the years in question.

Mr. MICA. To the private sector competing with trying to keep up with what the government was doing.

Mr. WESCOTT. Right.

Mr. MICA. What government-backed activity was doing. Thank you.

Mr. ZINGALES. Conflict of interests are always dangerous, whether they are in Wall Street, in Congress or in a political opposition. It is always dangerous.

Mr. MICA. How again do you bring this under control--and go down the panel--given the cards that we are currently dealt? That is my question.

Mr. WALLISON. Well, there was an excellent bill that came out of the Senate Banking Committee in 2005. That bill would have allowed a regulator to control their capital which would have immediately reduced their risks and controlled their portfolios, which are a major source of their risks. That was a partisan vote. All Republicans voted for it; all the Democrats voted against it.

Mr. MICA. And then who was chairman and--who was chairman and then who blocked it as the ranking member?

Chairman WAXMAN. The gentleman's time has expired.

Mr. MICA. Excellent.

Chairman WAXMAN. The chairman will now take his 5 minutes. And I don't think we ought to use these hearings as an opportunity to be partisan, because Freddie and Fannie had people in charge when Clinton was President that got excessive salaries and bonuses, but so did Mr. Mudd, who was appointed by President Bush.

But what we're starting to look at in these series of hearings of how we got into this mess is what has happened with one of the companies that has actually gone bankrupt and for which many people have told us this started in a direct line to the $700 billion that the Congress has now approved to give to the Treasury to help stabilize our economy. To start off with Lehman I think is perfectly appropriate. To look at Freddie Mac and Fannie Mae is also appropriate. And we should look at all of these issues.

But what struck me from your presentation today--and I thank the panel very much for what you had to tell us--is that there seems to be almost no accountability to the people who own the corporations. They are the ones who own it, and they are the ones who take the loss when the company goes bankrupt. There seems to be no transparency in what is going on.

It appears that the CEO controls the decisions with a board that is hand picked in many circumstances, and it certainly appears to be the case with Lehman Brothers. And the CEO can play with other people's money. And not just play with other people's money, he can borrow a lot of money to leverage the money he has to play with. And if times are good, that leverage can bring in enormous amounts of profit. But if times are bad, then he can lose his footing for his corporation very, very quickly.

It does seem to me that ordinary people play by a different set of rules than they do on Wall Street because ordinary people in this country--many of them have lost their jobs, have lost their homes. Everyone has seen their health care costs go up, if they're lucky enough to have health care insurance. And if they're not, when they go to see a doctor to access the system, they know how expensive it all is, especially if they buy drugs. And if they fail in their jobs, they are held accountable. They don't get the promotions. They don't get the bonuses. And, in fact, they get fired. Even if they have done a good job they get fired if the corporations run into troubles.

But the CEOs seem to always come out on top. They win when the corporation wins, and they win when the corporation tanks. And there is something that is fundamentally troubling about that, because there is no accountability and there is no consequence.

So as we look at how to reform the system, I think we--we need more transparency on Wall Street. We have a vast explosion in new investments, complex financial instruments like credit default swaps, derivatives, collaterized debt obligations. There is no way for an investor to discipline firms that invest in these derivatives because there is so little disclosure. And as I heard you, Mr. Smith, it is hard for you to do anything--as representing a good number of investors to do anything about what a corporation's actions are because the corporation is so closed. Is that an accurate statement?

Mr. SMITH. Yes, it is.

Chairman WAXMAN. So I think as we look at how we got into this situation. We have to recognize that there have been people who have been able to play games with other people's money and never had to face the consequences themselves or failure. There is not enough transparency as to what they are doing, there is not enough control by even their shareholders, and the regulators are toothless either because the laws don't allow them to regulate or they are just not regulating because they are short on their budget or short on their commitment.

So maybe we can say everybody is responsible, everybody is to be blamed. But I know one thing. The $700 billion is now going to be paid for by taxpayers in hopes that we stabilize our financial markets.

There is no guarantee that we are going to return to health right away. We hope we can do that. But what this committee is trying to do is to understand how we got into this situation and give some recommendations. Not that we have the jurisdiction--out of our legislation--but to those committees that do have the jurisdiction, to think through whether there ought to be a limit on the amount of money that they can leverage, there ought to be limits in transparency, there ought to be limits on shareholder--limits on CEO pay, and whether there ought to be a lot more openness to shareholder influence in the companies that they presumably own.

I thank you all very much for your presentation; and we are going to now move onto the second panel, which will be Mr. Fuld. Thank you.

Let's take a few minute recess while this panel leaves, and then we are going to have Mr. Fuld take his place. Let's have a 3-minute break.

[recess.]

Chairman WAXMAN. The committee will come back to order.

We have Richard S. Fuld, Jr., Chairman and CEO of Lehman Brothers. He has been the Chairman and CEO of Lehman Brothers since 1993, and we are pleased to have Mr. Fuld here to testify.

Mr. Fuld, it is the practice of this committee that all witnesses that testify do so under oath. So if you would please stand and raise your right hand.

[Witness sworn.]

Chairman WAXMAN. The record will indicate that Mr. Fuld answered in the affirmative.

We are anxious to hear from you. We have your prepared statement. It will be in the record in its entirety, and we will--we'll give you whatever time you want. But be mindful of the fact that your whole statement is already in the record. So go ahead with your oral presentation.

We usually ask witnesses to stay to 5 minutes, but I don't want to limit you to 5 minutes if you feel you need more time. There is a button on the base of the mic. Be sure it is pressed and pull it close to you.

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

Mr. FULD. Chairwoman Waxman, Ranking Member Davis and members of this distinguished committee, today there is unprecedented turmoil in our capital markets. Nobody, including me, anticipated how the problems that started in the mortgage markets would spread to our credit markets and our banking system and now threaten our entire financial system and our country.

Like many other financial institutions, Lehman Brothers got caught in this financial tsunami. But I want to be very clear. I take full responsibility for the decisions that I made and for the actions that I took. Based on the information that we had at the time, I believed that these decisions and actions were both prudent and appropriate.

None of us ever gets the opportunity to turn back the clock. But with the benefit of hindsight, would I have done things differently? Yes, I would have.

As painful as this is for all of the people affected by the bankruptcy of Lehman Brothers, this is not just about Lehman Brothers. These problems are not limited to Wall Street or even Main Street. This is a crisis for the global economy.

We live in a world where large investment--large independent U.S. investment banks are now extinct, where AIG and Fannie Mae and Freddie Mac are under government control and where major institutions are being rescued and where regulators are engaged in a daily struggle to stabilize the financial system. In this environment, it is not surprising that the media coverage of Lehman's demise has been rife with rumors and inaccuracies. I appreciate the opportunity to set the record straight for this committee and to be as helpful as possible in explaining why we ultimately could not prevent a bankruptcy filing. And then I want to respond to your questions.

I'm a Lehman lifer. I joined as an intern in 1966 and got a full-time job as a commercial paper trader while earning my business degree at night. In 1994, when Lehman Brothers was spun out of American Express as a separate company and I became the CEO, we were a small domestic bond firm. By 2007, we had built Lehman into a diversified global firm with 28,000 employees. I feel a deep personal connection to those 28,000 great people, many of whom have dedicated their entire careers to Lehman Brothers. I feel horrible about what has happened to the company and its effects on so many, my colleagues, my shareholders, my creditors and my clients.

As CEO, I was a significant shareholder; and my long-term financial interests were completely aligned with those of all the other shareholders. No one had more incentive to see Lehman Brothers succeed. And because I believed so deeply in the company, I never sold the vast majority of my Lehman Brothers stock and still owned 10 million shares when we filed for bankruptcy.

As I said, following the spin-off of Lehman Brothers from American Express, our business was almost exclusively at a fixed income. We recognized the need for diversification, and over the subsequent 14 years we built and acquired significant equity and asset management businesses. We established a presence in 28 countries. We also continually strengthened our risk management infrastructure.

Lehman Brothers did have a significant presence in the mortgage market. This should not be surprising, though. U.S. residential mortgages are an $11 trillion market, more than twice the size of the U.S. Treasury market and a serious participant in the fixed-income business, had a significant presence in the mortgage market.

As the environment changed, we took numerous actions to reduce our risk. We strengthened our balance sheet, reduced leverage, improved liquidity, closed our mortgage origination businesses and reduced our exposure to troubled assets. We also raised over $10 billion in new capital. We explored converting to a bank holding company. We looked at a wide range of strategic alternatives, including spinning off our commercial real estate assets to our shareholders.

We also considered selling part or all of the company. We approached many potential investors, but in a market paralyzed by a crisis in confidence none of these discussions came to fruition. Indeed, contrary to what you may have read, I never turned down an offer to buy Lehman Brothers.

Throughout 2008, the SEC and the Federal Reserve conducted regular and at times daily oversight of our business and our balance sheet. They saw what we saw in real time as they reviewed our liquidity and our funding, our capital risk management and our mark-to-market process.

As the crisis in confidence spread throughout the capital markets, naked short sellers targeted financial institutions and spread rumors and false information. The impact of this market manipulation became self-fulfilling as short sellers drove down the stock prices of financial firms, the rating agencies lowered their ratings because lower stock prices made it harder to raise capital and reduced financial flexibility. The downgrades in turn caused lenders and counter parties to reduce credit lines and then demand more collateral, which increased liquidity pressures.

At Lehman Brothers, the crisis in confidence that permeated the markets led to an extraordinary run on the bank. In the end, despite all of our efforts, we were overwhelmed.

However, what happened to Lehman Brothers could have happened to any financial institution and almost did happen to others. Bear Stearns, Fannie Mae, Freddie Mac, AIG, Washington Mutual and Merrill Lynch all were trapped in this vicious cycle. Morgan Stanley and Goldman Sachs also came under attack.

Lehman's demise was brought on by many destabilizing factors: the collapse of the real estate market, naked short attacks, false rumors, widening spreads on credit default swaps, rating agency downgrades, a loss of confidence by clients and counter parties and buyers sitting on the sidelines waiting for an assisted deal.

Again, this is not just a Lehman Brothers's story. It is now an all-too-familiar tale. It is too late for Lehman Brothers, but the government has now been forced to dramatically change the rules and provide substantial support to other institutions.

I greatly appreciate the opportunity to speak with you today; and if I can be helpful to this committee in any way to understand how we got here and what our country can do to move forward, I am happy to do so. Thank you, sir.

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

[Prepared statement of Mr. Fuld follows:]

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Chairman WAXMAN. Without objection, the Chair and the ranking member will control 10 minutes which they can use or reserve and use at a subsequent time. Hearing no objection, that will be the order.

The Chair will recognize himself.

Mr. Fuld, the committee--our committee requested all the documents relating to your salary, bonuses and stock sales; and the committee staff put together a chart, which I hope will come up on the screen. This chart will show your compensation for the last 8 years. It shows your base salary, your cash bonuses and your stock sales.

In 2000, you received over $52 million. In 2001, that increased to $98 million. It dipped for a few years. And then, in $2005, you took home $89 million. In 2006, you made a huge stock sale; and you received over $100 million in that year alone. Are these figures basically accurate?

Mr. FULD. Sir, if those are the documents that we provided to you, I would assume they are.

Chairman WAXMAN. Okay. The bottom line is that, since 2000, you have taken home more than $480 million. That is almost half a billion dollars, And that is difficult to comprehend for a lot of people. Your company is now bankrupt, our economy is in a state of crisis, but you get to keep $480 million. I have a very basic question for you. Is this fair?

Mr. FULD. Mr. Chairman, your first question was about this slide: Are those numbers accurate? They are accurate the way you have put them up on that slide, but--I believe your number of cash and salary bonuses are accurate. The option exercises--the way you have them portrayed here I believe represent the full option without the strike price. And the only reason I exercised those options is because they came due at maturity. If I had not exercised those, I would have lost it. There was that stock sale--

Chairman WAXMAN. Well, I will leave the record open for you to give me any changes in that list.

Mr. FULD. What I would say to you--

Chairman WAXMAN. But, basically, didn't you take home around 4 to $500 million as the head of Lehman Brothers for the last--since 2000 to now?

Mr. FULD. The majority of my stocks, sir, came--excuse me--the majority of my compensation came in stock. The vast majority of the stock that I got I still owned at the point of our filing.

Chairman WAXMAN. The stock is in addition to the numbers that I have indicated. Because those were your salary and your bonuses. Now, you had bonuses; and, in addition to that, you had some stock sales. You have lost some money of the stock that you have received as compensation, which you received as compensation on top of these other figures. So you have been able to pocket close to half a billion dollars. And my question to you is, a lot of people ask, is that fair for the CEO of a company that is now bankrupt to have made that kind of money? It is just unimaginable to so many people.

Mr. FULD. I would say to you that the 500 number is not accurate. I would say to you that, although it is still a large number, I think for the years that you're talking about here, I believe my cash compensation was close to $60 million, which you have indicated here. And I believe the amount that I took out of the company over and above that was, I believe, a little bit less than $250 million. Still a large number, though.

Chairman WAXMAN. Still a large amount of money. You have a 14 million ocean front home in Florida. You have a summer vacation home in Sun Valley, Idaho. Yet you and your wife have an art collection filled with million dollar paintings. Your former President, Joe Gregory, used to travel to work in his own private helicopter.

I guess people wonder if you made all this money by taking risks with other people's money, you could have done other things. You had high leverage, 30 to 1 and higher. You didn't pay out billions of dollars in dividends. And you didn't have to pay out these millions of dollars in dividends and bonuses. You could have saved some of these funds for lean times, but you didn't.

Do you think it is fair and do you have any recommendations on fundamental reforms that would bring a new approach to executive compensation? Because it seems that the system worked for you, but it didn't seem to work for the rest of the country and the taxpayers who now have to pay up to $700 billion to bail out our economy.

We can't continue to have a system where Wall Street executives privatize all the gains and then socialize the losses. Accountability needs to be a two-way street. Do you disagree with that? And do you have any recommendations of what we ought to be doing in this area?

Mr. FULD. Mr. Chairman, we had a compensation committee that spent a tremendous amount of time making sure that the interests of the executives and the employees were aligned with shareholders. My employees owned close to 30 percent of our company; and that was because we wanted them to think, act and behave like shareholders. When the company did well, we did well. When the company did not do well, sir, we did not do well.

Chairman WAXMAN. Well, Mr. Fuld, there seems to be a breakdown. Because you did very well when the company was doing well and you did very well when the company wasn't doing well. And now your shareholders who owned your company have nothing. They have been wiped out.

I'm going to reserve the balance of my time, and we are going to go on to other members. Mr. Shays.

Mr. SHAYS. If you'd yield me 2 minutes.

Mr. Fuld, I'd like to ask you first, who appoints the compensation committee?

Mr. FULD. The compensation committee is now appointed by the corporate governance committee of the board.

Mr. SHAYS. But did you have a major role in appointing the compensation committee?

Mr. FULD. I believe I had more of a role in the early or mid-'90s. Clearly less of a role these last number of years.

Mr. SHAYS. And then, finally, of the 10 million shares that you had in the company--that is what you have right now, 10 million shares?

Mr. FULD. No. I don't have the exact amount. I think it is closer to 8 million shares, and that does not include the options that expired that are worthless. Well, actually, they haven't expired--that are still there with a longer term vesting but with a much higher strike price than, obviously, where the stock is today.

Mr. SHAYS. Thank you.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Shays.

I want to recognize Mrs. Maloney for 5 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman.

We are in a financial crisis, and we lost four major investment banks in a week, and taxpayers have been called upon to assume a potential $1.7 billion in taxpayer liability to backstop our financial institutions. During this hearing today, we have seen a long list of examples of deregulation and we have heard about the net capital rule, which was eliminated so that Lehman and other investment banks could ramp up their leverage to very dangerous high levels, putting their institutions at risk. And for almost 30 years this rule kept investment banks from taking on debt more than 12 times the value of the banks' investments. Firms were required to stop trading if their debt exceeded that ratio. As a result, most investment banks did not take on excessive debt.

Yet this report in the New York Times--and I'd like permission to have it referenced or put in the record--

Chairman WAXMAN. Without objection.

[The information follows:]

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

Mrs. MALONEY. --last Friday, called the Agency's '04 Rule Let Banks Pile Up New Debt. And many people feel that this was a major cause of the crisis, and they reference a meeting in April of 2004.

And I'd like to ask you, were you at that meeting? Did you lobby for this change? Why did Lehman want to increase its leverage? And, in hindsight, do you think the SEC rule--that changing this SEC rule was appropriate for protecting safety and soundness, the stability of our markets and taxpayers' money?

Mr. FULD. Congresswoman, I was not at that meeting, I believe, in 2004. And I do not recall if any other of my people were there. I had a chance to--while I was sitting in the waiting room, I saw, I would assume, almost all of the first panel. The information about leverage I think has been grossly misunderstood.

RPTS JOHNSON

DCMN SECKMAN

[12:59 p.m.]

Mr. FULD. There are two numbers. One is gross leverage, and one is net leverage. Gross leverage includes--excuse me if I get technical. If I get too technical, please stop me. Close to half of our balance sheet, if not more, was what we called the matched book. The matched book was predominantly government securities and agencies that we took on our balance sheet to finance for our clients. We were one of the top U.S. Treasury Government traders and financiers, meaning financing the U.S. Government debt. And we supplied a tremendous amount of liquidity to institutional investors that owned U.S. Government debt and agencies. At times, that was as high as 300 to probably more, $300 billion. I heard some of the earlier remarks about if you lost 3 or 4 percent of that. For the matched book, you do not--those are government securities. So the real number, the effective number is net leverage.

Mrs. MALONEY. So did you lobby for this capital rule change, and do you think it contributed to the financial instability and loss of safety and soundness in financial institutions such as your own that allowed this increased leverage?

Mr. FULD. I myself did not lobby for the increased leverage.

Mrs. MALONEY. Did Lehman Brothers lobby for it?

Mr. FULD. I am not aware of that.

Mrs. MALONEY. I would like to ask you, now that we have the opportunity of looking back, and we want to look forward on what needs to be done, if you had to give government advice on how we could strengthen the safety and soundness of our institutions and the accountability and transparency that all of us want, what would you recommend to change the system?

Mr. FULD. In my written testimony, I spoke about the need for additional regulation and new regulation; because when the original regulations were written, it was a very different environment. I believe there were 10 million shares a day traded, and today there are close to 5 billion shares traded. The electronic connectivity today, not only within this country but country to country; investors today, given that electronic connectivity, have the right to move their money to the highest returning asset, and money moves very quickly and freely. So it is not just about regulation within the U.S. I believe it is also about more of a matrix regulation that is more global in nature.

I would focus also on capital requirements, capital requirements meaning more capital for less liquid assets, and a more robust understanding of mark to market, which I believe is one of the pillars of the new plan. Mark to market during periods of stress create one set of numbers and obviously, in a functioning noncredit crisis environment, produce another set of numbers.

Chairman WAXMAN. Thank you.

Your prepared statement, which has these recommendations, are in the record. And we want to move on to other questioners. Did you want to add one last point?

Mr. FULD. Yes, please. And the other is, something I strongly believe in, is the creation of what I call a master netting system, where all capital market counterparties download each night all their transactions to one local spot, first in the U.S. and then eventually hopefully make that be global. That is about all transactions and trades. It is about positions. It is about capital. It is about leverage. And it would give whatever regulator is then in control of that master netting system a complete view of the financial landscape, the available capital to each and every asset class, flexibility within those asset classes and vulnerability within those asset classes and vulnerability of one institution versus the next. What I am proposing is clearly expensive, costly, but by comparison to the unprecedented regulation this Congress has just passed, it is a fraction and, I believe, money well spent.

Chairman WAXMAN. Thank you.

Mr. Mica for 5 minutes.

Mr. MICA. Thank you, Mr. Chairman.

And looking at, first, your comment on Lehman Brothers primarily dealing in some, for most of its history--

Mr. FULD. Sir, I apologize, I cannot hear you.

Mr. MICA. Can you hear me now?

Mr. FULD. Yes.

Mr. MICA. Again, when you opened your statement, you said that Lehman Brothers, and it was around for what, 150 years, dealt in some pretty hard assets and some secure investments. You have been around a while. What turned the corner for you to get into some of the more speculative ventures like subprime and some of the other, again, riskier investments?

Mr. FULD. As I said in my verbal testimony, our participation in the mortgage-related businesses was clearly a natural for us given our dominance in fixed income. That was something that went back a number of years. And even as I listened, as I say, to the panel before me, they correctly pointed out that this was a goal of the government, to provide funding and mortgages to a number of people that typically would not or could not have received a mortgage.

Mr. MICA. And one of your big--well, one of the big packagers or the competitors so to speak was Fannie Mae, which was deep into this. And you were dealing in some of the paper I think for secondary markets and other securitized mortgage paper to basically package it and make money off it. Is that right?

Mr. FULD. Yes, sir.

Mr. MICA. What was Lehman Brothers' exposure to the debt of Fannie Mae and Freddie Mac, and what role did their collapse play in precipitating some of your financial troubles? If it didn't matter--

Mr. FULD. Our exposure to both Fannie Mae and Freddie Mac was both de minimis, sir.

Mr. MICA. Okay. But their collapse, did that help precipitate any problems with your firm?

Mr. FULD. It certainly set the stage for an environment, as I talked about loss of confidence and credit crisis mentality, that permeated our market; clearly set the stage for investors losing confidence, counterparties asking for additional collateral, and clearly an environment that lost liquidity, which is the life blood of a capital market system.

Mr. MICA. I noticed some questions were asked about your political participation. I pulled Lehman Brothers' contributions to Federal candidates for the last 10 years. Fortunately, I didn't find my name there. Not like some of the other Members of Congress. I added some of this up, it is about $300,000 that you gave to influence Members of

Congress. I also got your personal, which wasn't much, you probably bet a little bit too much on Hillary, too. But this is pretty much the extent of your financial contributions? To Members of Congress, to lobby.

Mr. FULD. I believe that that was a result of Lehman's PAC--

Mr. MICA. Right.

Mr. FULD. --which was not corporate moneys.

Mr. MICA. Right. I am just telling you. But wait until you hear this one. And if you haven't discovered your role, you are the villain today. So you have got to act like the villain here.

But guess what Fannie Mae did in the same period of time? $175 million in lobbying contracts over 10 years. Does that surprise you? You were outlobbied. It sounds like rather than just some greed on Wall Street, we had a little greed in Washington. What would you say to that?

Mr. FULD. I think that is more a matter for your committee, sir.

Mr. MICA. I hope we get to it.

Thank you.

Chairman WAXMAN. The gentleman's time has expired.

We now go to Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. Fuld, I really appreciate that you began your testimony by taking full responsibility for the company's downfall, which occurred on your watch.

But there are some concerns that I want to get to. As you know, the American taxpayer, many of them our constituents, we just passed legislation giving $700 billion to rescue Wall Street. One complaint I have heard over and over again from my constituents was that there seems to be a complete lack of accountability. They see Wall Street executives like you walking away with millions of dollars.

And it is very interesting when you were talking about the chart that Mr. Waxman showed you on the board, you said that it was inaccurate. But I am going to discount it for you, and instead of $448 million over 8 years, let's say $350. How about that? $350? Is that okay? Can we discount it a little bit? You said it was not accurate. What would you say is accurate?

Mr. FULD. I would say that is closer, sir.

Mr. CUMMINGS. Okay. I want to ask you about one of the e-mails obtained by the committee. On June 9th, 2008, a former top Lehman executive--can you hear me okay?

Mr. FULD. Yes, sir.

Mr. CUMMINGS. Benoit D'Angelin sent an e-mail to Hugh McGee, who was the global head of investment banking at Lehman. The e-mail says that many bankers have been calling in the last few days, and the mood has become truly awful.

It warns that, and I quote, all the hard work we have put in could unravel very quickly, end of quote.

And it offers the following advice. It says, some senior managers have to be much less arrogant and internally admit that major mistakes have been made. We can't continue to say we are great, and the market doesn't understand, end of quote.

Mr. McGee forwarded this e-mail to you on the same day and explained that it was representative of many others. When you read the e-mail, and this is interesting, what was your reaction? I am just curious.

Mr. FULD. I am sorry, sir, what was the date of that? I am sorry.

Mr. CUMMINGS. That would be June 9th, 2008. You remember that e-mail?

Mr. FULD. I do not--

Mr. CUMMINGS. Let me try to refresh your recollection a little bit. Let me tell you what you did, since you don't remember the e-mail. Here is what happened. You didn't take any personal responsibility. Instead, 3 days later, Mr. Fuld, on June 12th, you fired Erin Callan, your chief financial officer, and Joseph Gregory, your chief operating officer, but you stayed on and admitted no mistakes. You were CEO. Why didn't you take responsibility?

Like today, you said you took full responsibility, why didn't you take responsibility for Lehman's mistakes? Why did you continue to say, quote, we are great, and the market doesn't understand?

In your testimony today, right here, right now, you continue to deflect personal responsibility. You cite what you call a litany of reasons for Lehman's bankruptcy.

Mr. Fuld, I want to ask you about your personal responsibility, since you have taken it. Do you agree that Lehman took on excessive leverage under your leadership? Please answer yes or no.

Mr. FULD. It is not that easy. I will say to you, our leverage at times was higher, but as we entered this more difficult market over this last year, we continued to bring our leverage down so that even at the point, Congressman, on September 10th, when we announced our third quarter results, we had grossly reduced our balance sheet by close to $200 billion, specifically around residential mortgages and commercial real estate and leverage loans.

Mr. CUMMINGS. Mr. Fuld, I have only got about less than a minute. I have got to get this question in. I assume your answer is no. I am just giving you the benefit of the doubt.

Mr. FULD. At the end of the day, we worked hard; our leverage was way down. One of the best leverage ratios on the street. And our tier one capital was one of the highest.

Mr. CUMMINGS. So you feel comfortable with what you did. Is that right? That is not one of the things that you said your--

Mr. FULD. Yes, sir.

Mr. CUMMINGS. Okay, fine. Do you regret spending $10 billion in Lehman's cash reserves on bonuses, stock dividends, and stock buybacks as your firm faced a liquidity crisis? Do you regret that now?

Mr. FULD. I heard some of that while I was in the other room. I think that is a misunderstanding which I would like to clear up.

Mr. CUMMINGS. Well, let me go back to--you go ahead, I am sorry.

Mr. FULD. Because it is important that this committee understands exactly what that was. When I talked about my employees owning close to 30 percent, what is typical of Wall Street is you take a percentage of your revenues and you pay your people. We asked our employees to take a big percentage of their compensation in stock. And so what that $10 billion was--we had close to $19 billion of revenues--what most of that $10 billion was, was compensation to our employees that they received in stock with a 5-year forward vest. So they didn't get that stock until 5 years, which aligned our interests, "our" being employees, with the interests of shareholders. To avoid dilution, because we took that $10 billion, gave it to the employees in stock, we had to take the $10 billion that they didn't get and go back into the open marketplace and buy back that stock so that we did not dilute our shareholders. And we did it each and every year. From where you sit, it looks like we just spent an extra $10 billion. That is not, sir, what we did.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Chairman WAXMAN. It sounds like, though, and I yield myself time here, that you were trying to not to dilute the payment to those employees while you were in a liquidity crisis. Wouldn't it have made more sense to use that money to pay off the debts that were heavily on your shoulders at that point and you knew that you were in a difficult situation?

Mr. FULD. At that time, at the end of the year, last year, I didn't believe that we had that problem.

Chairman WAXMAN. You didn't believe you had a liquidity problem.

Mr. FULD. And we did not have a liquidity problem at the end of last year. We had just completed a record year, none of which, by the way, came from mortgages. And we paid our people fairly and what we thought was competitive with the rest of the Street.

Chairman WAXMAN. Okay. I accept your answer that you didn't think you had a liquidity problem, so you were trying to make sure that your employees were fully compensated.

Mr. FULD. Yes, sir.

Chairman WAXMAN. Okay. Thanks.

Mr. Turner.

Mr. TURNER. Thank you, Mr. Chairman.

Mr. Fuld, in looking at your written testimony, you say ultimately what happened to Lehman Brothers was caused by a lack of confidence.

I have a different view, and I have a couple questions for you about what it really comes down to is we are hearing that the subprime crisis, the predatory lending crisis, the mortgage foreclosure crisis. You said you listened to the first panel and their testimony. I am going to summarize it for you briefly.

Mr. FULD. I heard most of it, but yes, sir.

Mr. TURNER. They said there was a period of easy credit; that housing prices were escalating and then declined; that there was securitization of mortgages; that houses became like ATMs where people withdrew their equity; and excessive CEO compensation.

That is not necessarily our experience in Ohio.

Mr. FULD. I am sorry, that is not what?

Mr. TURNER. That is not necessarily our experience in Ohio. In 2001, my community held a series of hearings on then subprime lending, predatory lending at the behest of City Commissioner Dean Lovelace. And we found that, in many instances, what we were seeing in the escalation of foreclosures was a result of inflated property values at the time of loan origination. In fact, we then turned to the Miami Valley Fair Housing Center in our community, an agency that was helping people who were in the foreclosure crisis, and Jim McCarthy from there reports that over 90 percent of the people that they were dealing with were actually refinances and that many of them had issues of the original value of the property at the time of refinancing where the property values were inflated.

Now, clearly, we are in a period now of decline or slow growth in some areas which is compounding the problem, but I think people are getting off too easy when we say that declining property values are the problem. And I want to tell you what my concern here is. I believe that if you issue a loan at origination where the loan value exceeds the property value and that you then issue securities based upon that loan and you don't disclose that gap that existed at loan origination, that you are in fact, I believe, stealing.

I believe that we are in a series of situations where people aren't disclosing that at loan origination, in fact, there was already a gap between value and loan amount, and that the declining house values really just emphasize it and compound it.

So I have two questions for you. The first is, do you believe that if mortgage-backed securities are issued and they do not disclose at origination that the original loan amount exceeds the property value, that it is stealing? And secondly, would you please describe Lehman Brothers' role in both issuing subprime loans and mortgage-backed securities?

Mr. FULD. I do not believe that any of the original mortgage securitizers knowingly at the point of origination would have taken a mortgage whose value was in excess of the value of the home. I find that very difficult to either understand or believe.

Mr. TURNER. And if it occurred?

Mr. FULD. If it did occur, I would say it was lack of understanding of what the real value was. But I don't think--I can't talk for the world in general, clearly, but highly unlikely that anybody would do that purposely.

Mr. TURNER. Then could you go to the role of your company in actually issuing original loans and then mortgage-backed securities?

Mr. FULD. We actually owned a number of what we called origination platforms. But those were more wholesale, where we went around to individual groups or companies of brokers that did in fact originate loans. When we bought them, we changed management, we changed underwriting standards to make them much more restrictive, to improve the quality of the loans that we did in fact originate so that those loans that we did then put into securitized form would be solid investments for investors.

Mr. TURNER. So then would it be your testimony that none of those original loans that were issued by your company exceeded the property value at origination?

Mr. FULD. Congressman, in all fairness, I did not review each and every loan. I must tell you the truth on that, I did not. And it would be a misstatement for me to say that--

Mr. TURNER. I thought I had heard you say that no one would do that. And I tell you the experience in Ohio is that is exactly what was being done.

Mr. FULD. I would say no one would do it knowingly.

Mr. TURNER. Since you were at the top of the organization, I really wanted to get your perspective of how something like that could be happening. As I go through neighborhoods in Ohio and see abandoned house after abandoned house, where so many times the American dream of having a home have been stolen from people in refinancing where they did not understand the transaction they were in, and where the value at origination was inflated, making them captive to the house, ultimately leading to foreclosure.

Mr. FULD. Let me clarify that if I can. I said nobody would knowingly do that.

Mr. TURNER. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Turner.

Mr. Kucinich.

Mr. KUCINICH. Thank you. I want to associate myself with the remarks and questions of my colleague from Ohio.

Mr. Fuld, I have here a copy of a memo from April 12th, 2008, that you sent to--it is an e-mail that you sent to Thomas Russo. It says you just finished the Paulson dinner. This is a memo--did you have dinner with Mr. Paulson back in April?

Mr. FULD. I very easily could have, sir.

Mr. KUCINICH. This memo references it.

Mr. FULD. I don't believe it was just the two of us.

Mr. KUCINICH. But did you meet with him?

Mr. FULD. You are asking me specifically on that date?

Mr. KUCINICH. Did you talk to Mr. Paulson on a regular basis?

Mr. FULD. We had a number of conversations, sir.

Mr. KUCINICH. Okay. Now, would you tell me, this memo says, that you sent to your colleagues, that we have a huge brand with Treasury. Speaking of Treasury, loved our capital raise. Do you feel at any time in this process that Mr. Paulson misled you?

Mr. FULD. I am sorry, sir, in response to this--

Mr. KUCINICH. Do you feel at any time in these conversations--we have your telephone logs--that you were misled by the Treasury Secretary?

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

Mr. KUCINICH. And do you feel then--you know, on September 10th, you had a conference call with your investors. During the conference call, your investors were told no new capital would be needed; that Lehman's real estate investment property--investments were properly valued. Five days later, you filed for bankruptcy. Did you mislead your investors? And I remind you, sir, you are under oath.

Mr. FULD. No, sir. We did not mislead our investors. And to the best of my ability at the time, given the information that I had, we made disclosures that we fully believed were accurate. And I should--and I should--

Mr. KUCINICH. I want to go back to something here. You know, you have a memo here where you say that Secretary Paulson wanted to implement minimum capital standards, leverage standards, and liquidity standards. These seem to be some of the things that got your company in so much trouble. Now, did he ever tell you in all the conversations you had with him that he decided not to implement any of the proposals he discussed with you last April? And does any part of you feel that you were double crossed by the Secretary and he was playing you off against let's say Goldman Sachs?

Mr. FULD. I would sincerely hope that was not the case.

Mr. KUCINICH. And what about these things that he said to you about minimum capital standards, leverage standards, liquidity standards? Did he ever tell you he decided not to implement any of these things? You talked to him on a regular basis. What can you tell this subcommittee to enlighten us about where Secretary Paulson was? And you, as the head of Lehman Brothers, did you rely on anything that he told you that could have put Lehman Brothers down?

Mr. FULD. We instituted ourselves our own plan for reducing leverage, our own plan for increasing liquidity. And I will note that, on September 10th, when we pre-announced our earnings, we had $41 billion of excess liquidity.

Mr. KUCINICH. Let me ask you this, when did you know that J.P. Morgan was going to make a $5 billion collateral call? When did you first know about that?

Mr. FULD. I know that they had had conversations with our Treasury people.

Mr. KUCINICH. When?

Mr. FULD. I am not sure of the date. But it was--

Mr. KUCINICH. Mr. Chairman, if I may--thank you, sir, you are not sure.

Mr. Chairman, this is a central question here, because with J.P. Morgan making a $5 billion collateral call, and on September 10th, they were telling investors they didn't have any more need for capital, that the real estate investments were properly valued, this puts us in a position where one of two things is possible. Either they were lying to their investors or they were misled by Secretary Paulson as to what could be done to help you, because after that $5 billion collateral call, that is what led directly to Lehman Brothers going down. Isn't that correct? Didn't you go down right after you understood that they were not going to remove that collateral call?

Mr. FULD. When you say collateral call, that is not the same thing as a margin call.

Mr. KUCINICH. I am talking about a collateral call.

Mr. FULD. No, I know. But the collateral call was not to meet a deficit in collateral that they were holding to offset risk. The collateral call, I believe, was because, as our clearing bank, they just asked for additional collateral to continue to clear for us.

Mr. KUCINICH. Thank you.

Thank you, Mr. Chairman.

Thank you, Mr. Fuld.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Tierney.

Mr. FULD. Excuse me, I should clarify also, sir, I didn't mean to cut you off there. This is probably a subject for litigation, and it is probably appropriate that I leave it to that. I believe the creditors and J.P. Morgan are having a conversation.

Mr. KUCINICH. Indeed. Indeed.

Chairman WAXMAN. Mr. Tierney.

Mr. TIERNEY. Mr. Fuld, thank you for joining us here this afternoon.

Just before Lehman went into bankruptcy, you were in conversations with the Korean Development Bank, which I believe is a South Korean lender. What amount of money were you looking for them to contribute to Lehman?

Mr. FULD. Congressman, our conversations with KDB, as one of five banks in a consortium, stretched over a number of months.

Mr. TIERNEY. Can you tell me the amount that you were looking for from the consortium?

Mr. FULD. It wasn't so much that we were looking from them. Their original proposal was they wanted to buy in the open market close to 50 percent of our stock. It was not about giving us new capital. They wanted to buy close to 50 percent.

Mr. TIERNEY. And was that type of arrangement something that you were looking for at that time?

Mr. FULD. I would have welcomed that transaction, yes, sir.

Mr. TIERNEY. Okay. Now, at about that time, in looking for that kind of transaction, you knew, because you had known for some time that you were already in a precarious situation. And I say that because there were reports that as far back as Christmas of 2006 that you were telling people that you had a cautious outlook for the year ahead. The next month in January, when you were in Davos at the World Economic Forum, you were reportedly telling people that you were really worried about the risks inherent in the property valuations and excess leverage and the rise in oil and commodity prices. Would that be fair to say you were of that mind around January of 2007?

Mr. FULD. I was clearly focused on oil, yes, sir.

Mr. TIERNEY. Then I think we go back to the situation where we know you were in that stage in December of 2007. At the end of that year, there were payments made out, both cash and stock bonuses to your employees. They totaled about $4.9 billion. So is there any thought given at that point in time to say to your employees, this isn't the time to be handing out $4.9 billion in cash. We have got a liquidity issue here. We have been seeing it coming for all year long. And we are going to keep that money in the company liquidity for the benefit of our shareholders, for the benefit of the public with whom we deal, and for the economy.

Mr. FULD. At the end of 2007, I did not believe at the time that we had a liquidity problem. And our most important assets in the firm are clearly our employees. They are the ones that touch the clients every day and do business every day.

Mr. TIERNEY. I understand. I am a little shocked. I mean, a lot of other people thought that you had a very precarious position. At the end of 2007, you thought everything was fine?

Mr. FULD. We had just completed a record year, sir.

Mr. TIERNEY. And if you want to cover that for a second, the record year that you just completed and the reports on that had some, according to one account, had some rather aggressive and bizarre accounting practices on that. They list out four or five things that they thought were strange. You listed a $722 million paper profit on level three equity holdings, stock that doesn't trade publicly; there aren't liquid markets out there. You claimed a 9 percent profit on them. At the same time, Standard and Poor's index on publicly traded stocks fell by 10 percent. That was what made you seemingly have a record year. One of your short sellers, Mr. David Einhorn, said he was told by your chief financial officer that $400 to $600 million came from writing up the value of electric generating plants in India. He thought the value was somewhere around $65 million, not $400 to $600 million. He also said Lehman showed some $600 million of profit because of the decline in the market value of your own debt obligations and sort of assimilated that to the fact that it is permissible accounting surely enough, but it is like the profit that you make when your house is foreclosed for a value that is lower than your mortgage. Lastly, he said another $176 million was on your books by almost doubling, to some $365 million, the value ascribed to certain mortgage servicing rights; in other words, the value you get paid for servicing mortgage holders' collection of payments and doing their paperwork, which are sort of tricky things to value.

So I know that at the end of the year maybe your books looked like they were good, but if those were the reasons for that, then I think it is questionable why $4.9 billion is going out to the employees in bonuses, cash and stock, and why you are spending another $4 billion buying some of that back. And I think one of your investors here today clearly said he was horrified to find out you were doing that. That is why I raise the question.

Thank you, Mr. Chairman.

Chairman WAXMAN. I would just note, Mr. Fuld, that in January of 2008, there was a presentation to your board, on which you serve, by Eric Felder. And he said very few of the top financial insurers have been able to escape damage from the subprime fall out. And a small number of investors, accounting for a large portion of demand liquidity, can disappear quite fast. So I just want that to be on the record.

I would now go to Ms. Watson.

Ms. WATSON. Thank you so much.

And Mr. Fuld, we are so pleased that you are willing to come and sit on the hot seat and admit that you take full responsibility.

We heard from the first panel's view on what caused this financial crisis. And one key factor was deregulation or inadequate regulation of big financial entities like yours, Lehman Brothers. I would like to get your view on this topic, because as a publicly owned broker-dealer investment bank, Lehman was subject to a number of SEC regulations. The company was required to report important financial information to shareholders, and you were required to meet the basic SEC requirements to make sure that you were adequately capitalized. Is that correct?

Mr. FULD. Yes, Congresswoman.

Ms. WATSON. And in your written statement, you explain that the SEC and Fed conducted oversight of your balance sheet. As you stated, they were privy to everything that was happening. Is that correct?

Mr. FULD. Yes, Congresswoman.

Ms. WATSON. But, Mr. Fuld, Lehman Brothers went bankrupt. Your investors and your creditors lost hundreds of billions of dollars. And the failure has had a widespread impact for the rest of the economy. Would you agree that the current regulatory framework and the way they were implemented in your case failed?

Mr. FULD. Are you asking specifically about the SEC?

Ms. WATSON. Yeah. The regulatory framework.

Mr. FULD. Specifically about the SEC?

Ms. WATSON. Yes.

Mr. FULD. Because I had said in my written testimony that I thought the overall regulatory system had to be redone.

Ms. WATSON. You will agree that they failed.

Mr. FULD. But specifically to the SEC, we had extensive dealings with the SEC. They actually had dedicated and knowledgeable people actually in our firm overseeing a number of our daily activities. I went to them, our firm went to them specifically talking about naked short selling. They were constructive and positive. We went to them with an idea of creating something that we call Spinco. Spinco was the--was a new independent entity into which Lehman would place some number of commercial real estate assets, along with a piece of capital, and then spin that, which means give that to our shareholders, which we believed would have created true shareholder value over a longer period of time. This actually was a model that I believe could have been very helpful and instructive.

Ms. WATSON. Yeah, I am watching our timer there. So let me just say that we have learned how Lehman Brothers relied on an unregulated bond rating agency, whose conflict of interest gave him every incentive to rate your company's risky bonds as safe investments. We have heard how housing and banking regulators failed to curb the predatory lending abuses in the subprime market. And we have heard about how the net capital rule was implemented so Lehman and other investment banks could ramp up their leverage to dangerously high levels. And we heard that the SEC is underfunded, understaffed, and led by a chairman who either was unable or unwilling to enforce even the basic laws on the books. Do you think this deregulation and lack of oversight contributed to the melt down on Wall Street?

Mr. FULD. I cannot talk to what--

Ms. WATSON. Do you think it contributed--my time is almost up--to the melt down on Wall Street?

Mr. FULD. I cannot talk to what the SEC did with the other firms.

Ms. WATSON. Do you think it contributed, or are you wholly and solely responsible for the melt down on Wall Street?

Mr. FULD. I actually gave the SEC high marks for trying to be constructive.

Ms. WATSON. No--okay. Here is my bottom line question. If all the things that I just spoke of you think were just fine and worked like they should, the regulations, then it is your total responsibility for the failure of Lehman Brothers in bankruptcy?

Mr. FULD. In retrospect, it is easy to go back--

Ms. WATSON. Yes or no? Yes or no? My time is up.

Mr. FULD. If you are asking me, do I--

Chairman WAXMAN. The gentlelady's time is up, and Mr. Fuld, you will be permitted to answer the question.

Mr. FULD. Thank you, sir. If you are asking me, did the regulatory framework contribute, or the lack of regulatory framework, contribute to where we are today? I would say yes. And that is why I think we need to redo--

Ms. WATSON. Thank you. Thank you. That is the answer I was trying to get to.

Mr. FULD. That is why I think we need to redo the regulatory framework.

Chairman WAXMAN. Thank you, Ms. Watson.

Mr. Higgins?

Mr. HIGGINS. Thank you, Mr. Chairman.

Mr. Fuld, there appears to be inconsistencies between your public statements and the private information you were receiving internally. Let me read you some of these inconsistencies and ask you to respond. In January of this year, Eric Felder, one of your top executives, made a presentation to you and the board of directors. He talked about the company's finances, and observed that, quote, very few of the top financial issuers have been able to escape--

Mr. FULD. I am sorry, I didn't hear that. I am sorry. After Felder, I didn't hear that.

Mr. HIGGINS. Yeah, he talked about the company's finances. He observed that, quote, very few of the top financial issuers have been able to escape damage from the subprime fall out, end of quote. He then warned you explicitly that in the current environment, quote, liquidity can disappear quite fast.

But that is not what you were telling the public. In December of 2007, in a press release, you said, quote, our global franchise and brand have never been stronger.

My question is, why didn't you say publicly what you were being told internally, that you had to be careful because your liquidity could disappear quickly, which was in fact what happened?

Mr. FULD. Mr. Felder's presentation was when, January you said?

Mr. HIGGINS. December of 2007, January 2008. This year.

Mr. FULD. We actually listened very carefully to Mr. Felder. And I believe the record book will show that we reduced our balance sheet. We reduced our leverage. We raised capital. We increased liquidity. So we did listen.

Mr. HIGGINS. Let me show you another internal document. This document is a document that your attorneys produced to the committee. It is from June of 2008, 6 months later. This is a set of talking points describing what happened over the past year and why your company posted record billion dollar losses. This is an internal document that was never made public. And it seems to admit the truth about what was going on. It asks, this is your internal document, why did we allow ourselves to be so exposed? And then it spells out the reasons. Quote, conditions clearly not sustainable. Saw warning signs. Did not move early, fast enough. Not enough discipline in our capital allocation.

But that is not what you told the public that month. Here is what you said during an earnings call with investors on June 16th: Let me discuss our current asset valuation on those remaining positions. I am the one who ultimately signs off and am comfortable with our valuations at the end of the second quarter. Because we have always had rigorous internal process, our capital and liquidity positions have never been stronger.

Mr. Fuld, I don't see how you could say that. Your internal documents said that conditions are clearly not sustainable and that you did not move early or fast enough.

But you told the public Lehman had never been in a stronger position. How do you reconcile your public statements with the company's internal assessments?

Mr. FULD. Was this my document?

Mr. HIGGINS. These are documents that your attorneys provided the committee.

Mr. FULD. I didn't mean that. Is this my document? Is this a presentation that I gave?

Mr. HIGGINS. These are documents internally that went past your desk in the past 6 months.

Mr. FULD. This document does not look familiar to me. And if it was an internal document, it was--I really can't speak to that, because this document is not familiar to me.

Mr. HIGGINS. Well, these documents were made--

Mr. FULD. But if you tell me it is mine, I believe you.

Mr. HIGGINS. And ultimately, you are responsible. And this inconsistency with public statements made conveying a strong position and internal documents showing a direct contrast to that assertion, I think, is very troubling with respect to the issue of trust and confidence. According to your lawyers--

Mr. FULD. I am looking very carefully at this--

Mr. HIGGINS. --this is a document that you either wrote or you reviewed.

Mr. FULD. I am looking at this very carefully, sir. It does not look like my document. Nor does it look like a speech that I gave. Nor does it look like anything that I reviewed.

Mr. HIGGINS. These are your documents.

Mr. FULD. Excuse me, sir?

Mr. HIGGINS. These are your documents.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Shays, you wish to yield 2 minutes to Mr. Mica.

Mr. MICA. Let me get down to some of the heart of this. I guess a lot of the collapse occurred on the 9th and 10th of September. You were trying to find $5 billion to back up your transactions. I recommend to everybody the Wall Street Journal today. They did an excellent job, better than the committee, of going through some of the public and private statements. I wouldn't necessarily pay for it. Maybe you could get it online. It is two bucks.

But it does outline what you were going through. One is J.P. Morgan asked you for the $5 billion. Lehman executives claimed that they had a restructuring plan. And then you had discussions that night. You wanted to go into a conference call. Your counsel said not to go into a conference call. Maybe you could tell us about that.

On the 10th, however, you told investors, we are on the right track to put these last two quarters behind us. Now, people want to know if you defrauded investors--I mean, I am going to be blunt here--by coming out and saying that as opposed to what happened on the 9th, and you knew or were told you weren't going to get the money.

Mr. FULD. As I said before, I am not--I am not really sure when that conversation--

Mr. MICA. Yeah, but you had to know at some point you weren't going to get the $5 billion. I mean the Korea--the attempt to get the money from Korea was--

Mr. FULD. I am sorry, I thought you were talking about J.P. Morgan. I apologize.

Mr. MICA. Okay. But you were trying to get the money--well, J.P. Morgan wanted the money, and you were trying to find the $3 billion to $5 billion, right, to keep the ship afloat.

Mr. FULD. Two very different things. Very different things.

Mr. MICA. Well, this is on the 9th.

Mr. FULD. Well, J.P. Morgan, as I said before, in answering one of the other questions--

Mr. MICA. On the 9th of September, you needed $5 billion to keep the ship afloat. You were told, and your counsel told--also advised you not to go ahead with the conference call to disclose this internally. But you came out on the 10th and said, we are on the right track to put these last two quarters behind us. That is what you said.

Again, I am just reporting--

Mr. FULD. Correct. In our September 10th analysts call, I firmly believed that we put the last two quarters behind us. We had done a tremendous amount--I don't want to go through the whole thing all over again--but lowered our leverage, raised capital; you heard it all before. I am not going to go through it again.

Mr. MICA. Were you told the night before you weren't going to get--be able to cook the deal?

Mr. FULD. I don't know what that refers to.

Mr. MICA. Getting the money to keep the Lehman ship afloat.

Mr. FULD. What we said on September 10th was that we had adequate capital. We talked about a plan that involved spinning off those commercial real estate assets and that we were going to have to put capital into that. On the call, people talked about, how are you going to fill that? We talked about the sale, potential sale of IMD, either all or some, which would have created $3 billion of tangible equity. I think if you go back and look at the third quarter announcement, you will see that. Possibly more if we had sold it for a higher price. We had plans at the time to go to some of our preferred holders and convert some of those preferreds to equity. Because we had to prerelease because of the rumors about our company, we didn't obviously have a chance to complete some of those plans. We didn't know how much capital we were going to need to equitize Spinco. We didn't know how much of the commercial real estate assets would be sold. But that was all 3 months out. On that Wednesday, we had $41 billion. We had plenty of capital to operate. All conversations about additional capital were about what we were going to do when we took capital and put it into the new Spinco. That was all 3 months out. And that was obvious to shareholders. That is what we were talking about. And there were a number of questions from analysts at that time about that. So there was disclosure about where we were and, I believe, understanding. And there certainly was no attempt to mislead anyone.

Mr. MICA. Again, again, before the committee, under oath, the night before September 10th, when you made that statement, did you in fact know that you weren't going to get the estimated $3 billion to $5 billion to keep the ship afloat?

Mr. FULD. Congressman, again, I say I am sorry, those are two very different numbers. One is additional collateral for our clearing bank. I know you are looking for an answer here. That is not capital. That is collateral. Two very different things. We believed we were going to raise, quote, that $5 billion, by either selling all or part of Investment Management or the sheer fact that we were going to spin those assets off, then we didn't need that much capital. The $5 billion was additional collateral that J.P. Morgan was asking for.

Chairman WAXMAN. The gentleman's time has expired.

The Chair now recognizes Ms. McCollum.

Mr. FULD. Did I answer that, though, for you, sir?

Ms. MCCOLLUM. Mr. Chair, a point of personal privilege.

Chairman WAXMAN. Yes.

Ms. MCCOLLUM. How I would go about yielding to the gentleman from Tennessee so he could make a flight?

Chairman WAXMAN. I didn't hear you.

Ms. MCCOLLUM. How I would go about allowing time for the gentleman from Tennessee to go ahead of me so he could catch a plane?

Chairman WAXMAN. Then why don't I just recognize him now?

Mr. COOPER. I thank the Chair.

Mr. Fuld, in your testimony, on page eight, you say what happened to Lehman Brothers could have happened to any firm on Wall Street and almost did happen to others. But it didn't happen to the others. There is a difference. And you cite many factors in your testimony about how it could have been different, you know, if regulators had behaved differently or different things had happened. What could you have done differently personally that might have changed the fate of Lehman Brothers?

Mr. FULD. With the benefit of hindsight, sir, going back a couple of years, I would have made some changes to how we looked at and thought about our mortgage origination businesses, our commercial real estate business, and probably our leveraged loan business. Those were three of the areas that over the second and third quarter created some losses. And I believe in my verbal testimony I said, given the opportunity to look back, I would have done things differently. Should I have closed those businesses down then, I think people would have looked at me and said, that's irrational to have done that. But knowing what I know today, that clearly could have been a smart move. But given the information that I had, that is not the decision I made.

Mr. COOPER. Well, that was a decision you could have made 2 or 3 years ago. Given your book of business in 2007 and 2008, were there decisions you could have made to have changed the destiny of Lehman Brothers just in the immediate past?

Mr. FULD. We did make aggressive decisions to close some of the mortgage origination businesses. We had substantial hedges on our residential mortgage positions. In retrospect, I think we were slower on commercial real estate. I, like a number of other people, thought the mortgage crisis was contained to residential mortgages. There were a number of people, many experts included, that also thought that. And I was wrong. Looking back now at that information, I thought it was contained. We thought it was contained. And experts thought it was contained.

Mr. COOPER. You mentioned being, quote, slow on commercial real estate. Does that mean correctly valuing the portfolio of commercial real estate properties?

Mr. FULD. No, sir, it does not mean anything about valuation. It means about how quickly we thought about disposing those assets. And I think the record book will show that we went from $50 billion of those assets to $30 billion, keeping the remaining--I shouldn't say keeping, but ending up with $30 billion that would go into--either 30 or less, depending upon how much of the remaining 30 we sold in the fourth quarter, the remaining piece going to Spinco to be spun to our shareholders, which we firmly believed had real value.

Mr. COOPER. You had a committee, the finance and risk management committee, which I believe was chaired by the once legendary Henry Kaufman, a previous panel said that this committee only met twice a year in 2007 and 2006. Were they giving you advice on these long-term strategic directions?

Mr. FULD. Let me just clarify one thing, if I may. I believe they did meet twice in 2007, but they met four times this year so far. Well, it is over now, so it is four times this year.

Mr. COOPER. Were they giving you advice on changing strategic direction for the firm?

Mr. FULD. We talked about assets, and not just at the risk and finance committees, we talked about it at the board. We talked about how we were bringing down our exposures on residential and on commercial and on leveraged loans at almost each and every board meeting. Whether it was the risk committee or finance committee, we talked about it. It was clearly a subject on everybody's mind. Keep in mind that this was a board that did have a lot of financial experience. This was a strong, independent board. I was the only Lehman person on the board. These people--some of these people ran banks, IBM, other companies, Celanese. These were experienced people. And they had never any reservations about giving me advice and having a view about the markets.

Chairman WAXMAN. Thank you, Mr. Cooper. Your time has expired.

Ms. McCollum?

Ms. MCCOLLUM. Thank you, Mr. Chairman. And I thank the committee for allowing Mr. Cooper to move forward.

My constituents in Minnesota understand that you don't have to do something illegal to do something wrong. Imperfect Federal regulation isn't a license for unethical behavior, especially when it puts taxpayers at risk. In our current regulatory framework, there is a gray space between legal activity and illegal activity. And in that space, financial firms can make a choice to either obey the letter of the law but not to honor the spirit of the law. 12 years ago, and you have been with the firm for 42 years according to your testimony, Lehman Brothers Holding, Inc., sent a vice president to California to check out First Alliance Mortgage. Lehman was thinking about tapping into First Alliance Mortgage's lucrative business of making subprime loans. The vice president, Eric Hibbert, wrote in a memo describing First Alliance as a financial sweat shop, specializing in high pressure sales for people who are in a weak state. First Alliance, he said, the employees, and I quote, leave their ethics at the door. The big Wall Street investment bank, that was Lehman Brothers, decided First Alliance wasn't breaking any laws, and Lehman went on to be, to lend the mortgage company--they needed about $500 million worth of sells and more than $700 million worth of bonds. In other words, Lehman Brothers is an example of how Wall Street's money and experience could have been used to prevent us being in this subprime mortgage crisis. History: We should learn from it. You, in your statement, and I quote from it, on page five, you said, we did everything we could to protect the firm. So I go back to this memo that Mr. Bishop had up and ask you if you agree with the spirit of the memo. Why did we allow ourselves to be so exposed? Did you ask those questions? Did you reflect that conditions were clearly not sustainable? Did you see warning signs? Did you move fast enough?

And I ask that because of two things that have come to my attention, that the Federal Bureau of Investigation has launched preliminary inquiries as to whether or not Lehman or its executives committed fraud by misrepresenting the firm's condition to investors. So, sir, I want to ask you some questions. On September 10th, 5 days before your bankruptcy filing, you and your chief financial officer, Ian Lowitt, held a conference call for investors. According to the Wall Street Journal, you were advised by your bankers not to hold this call because there were too many open questions. It is my understanding that at the time you did make the call, and that you were frantically trying to raise capital either through new investors or selling off assets.

RPTS CASWELL

DCMN BURRELL

[2:05 p.m.]

Ms. MCCOLLUM. [Continuing.] So when you and Mr. Lowitt spoke to your investors and said that you did not need more capital, and that Mr. Lowitt said to investors when asked whether Lehman would need to raise $4 billion, quote, I am paraphrasing, we don't feel that we need to raise that extra amount. Our capital position at the moment is strong.

So, sir, is this accurate? Were you told not to hold the call? Were you trying to raise capital during the week before you filed bankruptcy? Is it an accurate statement that your capital position was strong on September 10?

Mr. FULD. It is correct that our capital position on September 10 was strong.

Ms. MCCOLLUM. Did anyone tell you, advise you against holding the conference call I referred to? That should be a yes or no, sir.

Mr. FULD. Well, you are asking me did anyone.

Ms. MCCOLLUM. So that's a pretty big call that was made--

Mr. FULD. Yes.

Ms. MCCOLLUM. --5 days before filing bankruptcy, and your chief financial officer was present on the call.

I ask you, did any of your outside bankers or other advisers warn you against making, holding this call?

Mr. FULD. I had so many conversations, I would never say to you that no one--

Ms. MCCOLLUM. Well, sir, maybe you remember. Were you trying to raise capital during the week before you went bankrupt ?

Mr. FULD. The week before, 2 weeks before, 3 weeks before.

Ms. MCCOLLUM. Sir, I asked you a week before. I was just asking you for the week before this.

Mr. FULD. I am saying yes to all.

Ms. MCCOLLUM. You are saying yes to all. When you were raising that capital, no one in your firm--

Mr. FULD. Yes. No, no, let me finish. I would like to finish because there's a different piece to that. What we were looking to do was to raise capital after we completed--

Ms. MCCOLLUM. You were raising capital.

Mr. FULD. Excuse me, please.

-- after we completed the spinoff, which would probably have been January. After we had completed the spinoff of the commercial real estate assets.

On September 10, we had a strong capital position. We were trying to anticipate how much capital we were going to put into Spinco, how much capital we were going to use. We were trying to anticipate how much we would sell the investment management division for.

So there were a number of moving pieces. But on September 10, given the business that we had, we had sufficient and strong capital and liquidity.

Mr. TIERNEY. [Presiding] Thank you, Mr. Fuld. Thank you, Ms. McCollum.

Mr. Van Hollen, you are recognized for 5 minutes.

Mr. VAN HOLLEN. Thank you, Mr. Chairman.

Mr. Fuld, you said earlier in your testimony that at Lehman Brothers when things were going well then people would do well. When things weren't going so well, then people would have cutbacks.

I have to say that I think people looking in have concluded, based on the compensation structure, that when things went well people did really well. When things didn't go well, they still did very well.

I would like to call your attention to a memo that was written on September 11, 2008, just 4 days before Lehman Brothers declared bankruptcy. And I hope someone can provide you with a copy of the memo.

It's a proposal from the compensation committee, you are cc'd on the memo. It talks about compensation for two employees of Lehman Brothers. One was Andy Morton, I assume you recognize that name.

Mr. FULD. I do, sir.

Mr. VAN HOLLEN. He was the previous global head of fixed income. It said, the document here says he was involuntarily terminated. The memo here proposes to give him an additional $2 million cash payment.

The other official mentioned in the memo is Benoit Savoret. I assume you know him as well, is that right?

Mr. FULD. I do indeed, sir.

Mr. VAN HOLLEN. He used to be Lehman's chief operating officer of Europe and the Middle East until he was terminated. He was also, according to this memo, involuntarily terminated. Yet this memo proposes to give him a $16 million cash payment, again, just days before Lehman Brothers declared bankruptcy.

These are two individuals who were involuntarily terminated. I think the normal sort of parlance is fired. Yet they are being given, combined, about $20 million in additional compensation, despite the obvious poor performance at this point, which nobody can deny.

I ask you, is that appropriate? I mean, we are here having this conversation with you and the American people. Is that appropriate that 4 days before Lehman Brothers declares bankruptcy, that two individuals who have certainly been part of the decisionmaking that led to the decline would be given $20 million in additional compensation?

Mr. FULD. There were two pieces to that, clearly, Andy

Morton and Benoit Savoret. Andy Morton was given, I think it's $2 million.

Mr. VAN HOLLEN. Yes.

Mr. FULD. We felt that that was--or, more importantly, the compensation committee felt that that was appropriate for his years of service.

The $16 million, $16.2 million, was not a severance payment. The $16.2 million was a contractual obligation that the firm had made to Mr. Savoret, I forget when it was, but it was earlier in the year.

That contract said that at any time if terminated he was due the items of the contract. So that's what that was. That was not a severance payment, sir.

Mr. VAN HOLLEN. Regardless of his performance, he would be due that amount of money is what you are saying, under the contract?

Mr. FULD. Unless he was fired for--

Mr. VAN HOLLEN. Let me ask you this. You would agree, would you not, that people can make decisions that in the short term maximizes profits and bonuses but are bad decisions for the long term? I mean, there are decisions that can maximize short-term profits, but people would also agree that they might not be the best long-term interests in the company; isn't that right?

Mr. FULD. If you are referring to this gentleman?

Mr. VAN HOLLEN. No, I am just referring as a general proposition. You would agree that there are times when you can maximize short-term profits, but if you looked at over the longer term, people would agree it's not a good, long-term decision. You would agree that there are some decisions that fall into that category?

Mr. FULD. Certainly not by design, but in retrospect, clearly.

Mr. VAN HOLLEN. Let me ask you about clawbacks. I am not talking about anything with respect to Lehman Brothers, but just as a proposition. Wouldn't you agree that it's appropriate that if somebody makes a decision that raises short-term profits and, therefore, bonuses, but then it's later shown that those same decisions resulted in harm to the company, that on behalf of the shareholders and certainly in cases where the public is now involved, that the shareholders or the public should be able to go back in and get a clawback and take those bonuses or additional payments back that are proven, with the benefit of hindsight, to have been bad decisions for a company and the shareholders?

Mr. FULD. That was actually one of the things I spoke about when I said interesting way to go forward is a long-dated compensation system. In our case, that's exactly what we had. We had a long-dated compensation system.

Look, I am not proud of the fact that I lost that much money. But it does show that the system, our compensation system, did work.

I left 10 million shares plus a whole number of options. I say, I am not proud of that. But when the firm did not do well, I was probably the single largest individual shareholder. I don't expect you to feel sorry for me. I don't mean that. That's not my point. My point, though, is that the system worked.

Mr. VAN HOLLEN. Mr. Chairman, if I could, you are now referring to shares that you owned which, obviously, when the company went bankrupt, went down. I am also referring to bonus payments that may have been made in previous years to executives, including yourself, when, now that the company has gone bankrupt, wouldn't it make sense to have provisions to protect shareholders, not just to--clearly, when the shares go down, the value of the company goes down, the share values do.

But wouldn't it make sense to have clawback provisions with respect to bonus payments, cash payments? The shareholders could recover those monies that were bonuses for what clearly proved to be bad decisions?

Mr. TIERNEY. If you could answer that briefly, Mr. Fuld. Then we will move on.

Mr. FULD. I am sorry, sir.

Mr. TIERNEY. If you want to answer that briefly, you may, but we have to move on.

Mr. FULD. Our compensation system was specifically set up, even for me. In 19--I am sorry, in 2007, 85 percent of my compensation was in stock. I lost that. All stock that I got for the last 5 years, I lost that.

Actually, compensation that I received back from 1997, '8 and '9, I went to the compensation committee and said I believe we should extend the vesting on this. I could have gotten it 7 years ago. I went to the compensation committee and said this should be extended to a 10-year vest. I lost all of that.

I would like also for this committee to know that before the end of our second quarter, I went to my board, and I said, I think we are going to have a tough quarter. We were talking about how we were going to pay the troops, as I called it. I said I want you to take me out of it. I believe, given this performance, my recommendation to you, is that I do not get a bonus.

I would like this committee also to know, I got no severance, I got no golden parachute. I had no contract. I never asked for a contract. I never sold my shares. That's why I had 10 million, because I believed in this company.

I believed that this company--and that's why I said, I am glad I got these last two quarters behind us. I believe we are on the right track. I could have sold that stock. I did not, because I firmly believed that we were going to return back to profitability and get back on the road.

Mr. TIERNEY. Thank you, Mr. Fuld. Thank you, Mr. Van Hollen.

Mr. Sarbanes, you are recognized for 5 minutes.

Mr. SARBANES. Thank you, Mr. Chairman.

I believe that you believed in this company, but I also believe that your belief in the company at a certain stage began to cloud your judgment.

Let me ask you this first off. When you say to the public, our capital and liquidity positions have never been stronger, that is intended to convey the overall strength of the firm and the company, is it not? In other words, you can't assert that a company is not strong if you are asserting that its capital and liquidity positions are strong?

Mr. FULD. Our capital position was strong, our liquidity position was strong. We had completed a whole number of things that we did to protect the firm.

Mr. SARBANES. So the firm was strong, is what you were intending to communicate with a statement like that?

Mr. FULD. We had--I will go through it again with you if you would like, sir. We reduced our leverage.

Mr. SARBANES. Was the firm strong, was the firm strong? Was that the intended communication in saying our capital and liquidity positions have never been stronger? It was to convey that the firm was strong, right?

Mr. FULD. My--

Mr. SARBANES. I am going to assume that is what it was intended to convey. I think that the problem that we have had here is that statements of this kind, at the time they were made, were simply implausible. So it then raises a question of whether your perspective on the health of the firm was clouded or whether there was something else going on. I am going to leave that aside, because I want to move to a different question.

You talked about how Lehman got into the originating business, and, I gathered, did business with a number of other originators, First Alliance was one, for example, for some period of time, before you then actually took an equity stake in those businesses; is that correct?

Mr. FULD. We took an equity stake in BNC Mortgage and also Aurora. A group in Europe called Elk, yes, sir, we did.

Mr. SARBANES. But those were firms or companies that you have been doing business with for some period of time before you then took the next step of taking an equity position? I mean, you did some business with them, so you knew how they operated?

Mr. FULD. We did some business with them.

Mr. SARBANES. You then said earlier that at the time you bought them you changed management, changed underwriting standards and took other actions designed to pull back on the very risky nature of the way they were conducting business, which I respect, although there's some evidence that the practice has continued nonetheless. I guess that's an admission by Lehman that the standards that were being used up to that point, in other words, by those companies, when you were doing business with them but had not yet bought into them, were not adequate standards.

Now, your, one of your vice presidents, this was mentioned briefly, went to California to kick the tires on First Alliance and came back with a memo saying these sorts of things. First Alliance is a financial sweat shop specializing in high pressure sales for people who are in a weak state.

Let me just mention, my primary concern with all of this, and Lehman is an example, it's not the only example, it's an example, is that what was happening was the thirst for more originated loans upon which you could build an empire of derivatives and slice and dice up the chain to make more money, the thirst for those got pushed down the chain and encouraged people to look the other way in terms of standard conventional underwriting standards, and so forth, which then created a culture and atmosphere in which predatory lending could flourish. I think that's what ended up happening to the detriment of millions of homeowners across this country.

So sweat shop was one description. You said First Alliance was the "used car salesman" of blemished credit lending. They made loans where the borrower had no real capacity for repayment. At First Alliance it is a requirement to leave your ethics at the door, and in spite of this Lehman went ahead, invested in the company, and there's other evidence--I may run out of time, because I want you to respond to this--there's other evidence that these sorts of practices and ethics continued even after First Alliance was purchased, or you took some kind of ownership stake in First Alliance.

How could you consort with this kind of an operation, given how lax those standards were?

Mr. FULD. I am not sure if we took an equity stake in First Alliance, but that doesn't answer your question at all. We actually spent some time with First Alliance. I believe that was in the mid-1990s, and I think in the late 1990s we extended financing to them. We worked with them to change underwriting standards.

In the case of the ones that we bought after BNC and Aurora, we acted more as a conduit. That means we went to them and bought their production, and their production of mortgages. In that, we began to understand their business practice, our name became associated with them. We realized the best way to handle that was to buy them. If our name was going to be associated with them, buy them, change the management and change the underwriting standards, and that is what we did, and that is why we did it.

Mr. SARBANES. Thank you. Mr. Chairman, there's some evidence that it didn't change, but I will accept that answer.

Chairman WAXMAN. [Presiding] The gentleman's time has expired.

Mr. Welch, before you start your questions, I want to, just for housekeeping purposes, ask unanimous consent that all the documents that have been referred to in this hearing be made part of the record. We will certainly leave the record open for questions for members and responses.

Without objection, that will be the order.

Mr. Welch.

[The information follows:]

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

Mr. WELCH. Thank you. Thank you, Mr. Chairman.

Thank you, Mr. Fuld, for being here today. This is a tragedy unfolding all across America, and we are only beginning to feel the pain.

I know you sit here as the chief executive of a company that has a proud history of 158 years, did some tremendous things, and I have known some employees at your company and they are terrific, and 28,000 employees now don't work at Lehman Brothers. You had accounts, $700 billion, I guess. I am not going to beat you up about your salary here, but I want to ask you a couple of questions.

Number one, it seems that Wall Street and Lehman, along with others, turned what was a basic, simple transaction that was a step in reaching the American dream, and that is a family buying a house and being able to do that by borrowing money on a mortgage. It was a straight-out transaction oftentimes between a neighbor who was a community banker and a just wide-eyed young couple oftentimes being able to afford the first house.

That got to be turned into a commodity. It got put on steroids with these subprime mortgages. It then got securitized. As long as the real estate values in this country were going up, fueled by low-cost credit, it was a house of cards that would stand until the first whiff of a downturn.

In retrospect, do you believe that this process of securitization, of easy credit, of convincing people who couldn't afford a mortgage, particularly when the rates were retriggered, was a house of cards that was bound to fail in retrospect?

Mr. FULD. Seeing it as I see it now--

Mr. WELCH. Is that a yes?

Mr. FULD. I am not sure I would say it was a house of cards. It was--none of us ever expected housing prices to decline with the depth of violence that it did.

Mr. WELCH. So, I mean, what I understand the problem you had is that you didn't get out fast enough and delever fast enough, and the market went faster than you were able to make the adjustments.

Mr. FULD. You know, actually, Congressman, that was not the case. Residential mortgages were not our problem at the end. We had--

Mr. WELCH. Let me ask you a couple of questions. Thank you. I don't mean to interrupt, but I only have 5 minutes.

I want to ask you a little bit about AIG. I mean, there was a whole series of bailouts. Then Mr. Paulson made the decision that when it came to Lehman there was going to be no governmental assistance. So, in fact, Lehman Brothers was treated differently than some other financial industry giants that were in similar circumstances. Obviously, the Treasury

Secretary made a decision for reasons that he can explain.

But let me ask you this, my understanding is that you did have pretty regular contact, telephone contact with Mr. Paulson and probably some individual meetings. I also understand from reports in the New York Times that Goldman Sachs in fact was a major trading partner of AIG, about $20 billion on the other side of contracts.

Did you have any concerns that there may be some arbitrary reasons why Lehman Brothers, facing similar predicaments as AIG, was allowed to fail, whereas AIG was the beneficiary of an $85 billion bailout sponsored by the Treasury Department?

Mr. FULD. Well, I clearly would have loved to have been part of the group that got that.

Mr. WELCH. Well, do you have any views on that or thoughts on that, why you were allowed to fail, you, Lehman Brothers, were allowed to fail and AIG was bailed out?

Mr. FULD. That was a decision that was made that Sunday afternoon.

Mr. WELCH. I know that.

Mr. FULD. And I was not there.

Mr. WELCH. You have got to be wondering. You are the head of this company. You want to keep it going. I understand from you everybody knew you were dedicated to the survival of Lehman.

Mr. FULD. Until the day they put me in the ground.

Mr. WELCH. Exactly.

Mr. FULD. I will wonder.

Mr. WELCH. You got an e-mail, as I understand it, from someone in your office, Mr. Humphrey, I think, about the Jarrett Waite situation, telling you that Mr. Waite had stopped by and commented in just a few weeks on the buy side it's very clear that GS, Goldman Sachs, is driving the bus with the hedge fund cabal and greatly influencing downside momentum, Lehman and others; thought it was worth passing on.

What was the meaning of that, as you understood it? This was from a business associate ally of yours; correct? By the way, I don't blame you for asking the question. That's what we are asking.

Mr. FULD. What Mr. Waite was talking about was that, obviously, Goldman Sachs was involved with the hedge fund community.

Mr. WELCH. Well, that's the short selling, right?

Mr. FULD. Greatly influencing the downside momentum of Lehman and others.

Mr. WELCH. And that refers to short selling?

Mr. FULD. I have no proof of that at all.

Mr. WELCH. I will just ask you your opinion. Do you think that there was any justified reason why Lehman was treated one way; namely, allowed to fail, and AIG, just as another example, was given $85 billion in taxpayer assistance to bail it out?

Mr. FULD. I do not know why we were the only one.

Mr. WELCH. Is there any rational business decision why there would be a distinction made between the predicament that Lehman faced and the predicament that AIG faced?

Mr. FULD. I, actually, I must tell you, Sunday night or, more importantly, that weekend, we walked into that weekend. I firmly believed we were going to do a transaction. I don't know this for a fact, but I think that Lehman and Merrill Lynch were in the same position on Friday night, and they did a transaction with Bank of America.

We went down the road with Barclays. That transaction, although I believe we were very close, never got consummated.

Mr. WELCH. Well, I thank you. You know, I feel bad, I know you do, for those folks at Lehman and your investors and your shareholders.

Mr. FULD. Let me just speak to that for a second, because, you know, we talk about what happened at Lehman, and we talk about whose fault, and why wasn't I on it, and my employees, my shareholders, creditors, clients have taken a huge amount of pain. Again, not that anybody on this committee cares about this, but I wake up every single night thinking what could I have done differently. And this has been going on, what could I have done differently. In certain conversations, what could I have said, what should I have done.

I have searched myself every single night. I come back to at the time--and that's why I said this in the beginning--at the time I made those decisions, I made those decisions with the information that I had. Having said all of that, I can look right at you and say this is a pain that will stay with me for the rest of my life, regardless of what comes out of this committee, regardless of what comes out of when the record book gets finally written.

That's all.

Chairman WAXMAN. Thank you, Mr. Welch.

Mr. Shays.

Mr. SHAYS. Thank you very much, Mr. Chairman. Mr. Fuld, I know it's been a long day, but we are coming to a close.

I have a variety of questions. Let's see how well we can get through them.

First off, what we are doing is we are trying to see what happened. We are trying to see who is responsible, and to determine who is responsible, and that includes Congress, ultimately it must, and what being responsible means.

So I am going to end my question, and I will tell you now, by having you tell me the significance of the fact that you take full responsibility. That's going to be my last question.

But I need to know what that means, and I don't want it now, because I want to ask a few other questions.

Then we are going to look at what do we do to change the system. We are the oversight committee. I am also on the Financial Services Committee that will come up with solutions.

Now, we had Enron and WorldCom and every part of the system broke down. The directors didn't direct, the managers didn't manage. The employees didn't speak out. One spoke out privately, didn't speak out publicly.

The law firm was duplicitous and part of the problem. The accounting firm was part of the problem. You had the rating agencies, everybody, every part of the system failed. So we passed Sarbanes-Oxley.

Amazingly, Fannie and Freddie were not under that, because they are not under the '33 and '34 act; therefore, they weren't under Sarbanes-Oxley. So two huge organizations were never under the very system we put in place with Sarbanes-Oxley, much less all the other laws that were required. But that's just a footnote.

What I want you to speak to is the highly leveraged. It strikes me that Wall Street was incredibly blase about risk, including yourself, that 30 to 1, you didn't leave yourself enough to deal with the potential run on a bank, and that when you gave these bonuses you just made it less likely that you would have the kind of reserves you needed, which strikes me, obviously in hindsight, as reckless. But people were saying, as we were going through the system, we have too much leveraging.

I kind of responded, well, you know, the hedge fund folks will tell me, you know what? It's the really wealthy people, and they can absorb the risk. They know what the risk is. They know it's huge leveraging. But what we know now is Wall Street can bring down Main Street. Frankly, I am going to tell you, it's a little scary, because we don't even know all the folks that have been impacted by Lehman Brothers going down. I mean, we know stockholders, shareholders, clearly, employees, but all the different folks who had resources held by your company.

So what I want you to do is speak about risk. Why did we get into this position of having such high leverage, and was it just too easy to make money that way, and so we just said the risk be dammed?

Mr. FULD. We certainly did not say risk be damned. I believe Lehman Brothers had a robust risk process. As far as the leverage, and I spoke about it earlier, there's a very big difference between the 30 times and where we were when we finished in the third quarter at 10-1/2. A big piece of what that 30 was, again, was the match book, which was governments and agencies. So that should not be considered as an additional piece of risky leverage.

Again, I will say that on September 10 we finished with the best or one of the best leverage ratios on the street and one of the best tier 1 capital ratios on the street. And, even to your question, that's how I viewed the company, and that's why I viewed it as strong, Mr. Congressman.

Those were the metrics. Those were the metrics that the regulators used. Those were the metrics that all of us in the industry used, and ours were one of the best.

Mr. SHAYS. Let me ask you about the rating agencies. What kind of relationship do you have with the rating agencies? You end up having to pay them to determine your value. Describe to me, do you have any financial relationship with the rating agencies?

Mr. SHAYS. Yes, sir, we do.

Mr. SHAYS. Okay. Tell me that relationship.

Mr. FULD. On securitizations, for example, we go to them with the components of a potential securitized deal, the mortgages, valuation, loan to value, geography.

Mr. SHAYS. Right, and you pay them for that?

Mr. FULD. They charge us a fee for a rating.

Mr. SHAYS. How can we feel comfortable that the very people who are paying them are the very people they are evaluating?

Mr. FULD. That was one of the things on my list of things that should be included in, hopefully, tomorrow's reform.

Mr. SHAYS. Let me just quickly go to executive compensation. I mean, this is the largest irritant, frankly, to the general public. When I got my MBA at NYU, I read a book, the 5,000 people that run America are the 1,000--I forgot what it was, but it was the people who run a company are on the board of three other companies or two other companies. So they help decide the compensation of someone else, and someone else helps decide the compensation of them.

Do you really feel comfortable that the compensation committee can objectively evaluate what you and others should get when in fact you have some real say in who they are and--well, I don't need to say more.

Mr. FULD. There was nothing shy about my or the firm's, more importantly, the firm's or the board's compensation committee. They had access to outside experts, and they used it. They had access to other firms' competitive data. They were independent, and I find no--I was not on that board or on that group.

Mr. SHAYS. Let me just end by saying to those of us on the outside, it seems a little screwed up, and it doesn't seem to us subjective, and that's my closing comment.

I appreciate you being here today. Thank you.

Chairman WAXMAN. Thank you, Mr. Shays.

Mr. Sarbanes wanted additional time, and the Chair still has additional time. So I yield you 2 minutes.

Mr. SARBANES. Really, this is just to add something to the record, Mr. Chairman, getting back to the First Alliance issue, because you talked about how once you took an equity stake and the evidence is that you did do that, that you put new management, that the practices ceased and so forth.

But the record is that even after you put hundreds of millions of dollars in there Mr. Hibbert, the same vice president who warned you about these practices before, indicated that First Alliance was still violating the Truth-in-Lending Act.

In 2000, First Alliance went bankrupt. In 2002, the Federal Trade Commission charged First Alliance with systematically cheating elderly homeowners. The next year, more than 7,500 homeowners sued Lehman and First Alliance for these same tactics. Where most lenders were charging fees of 1 or 2 points for a loan, your company was charging 25 points.

The jury delivered a $50 million verdict against First Alliance and specifically found that Lehman Brothers "substantially assisted First Alliance in perpetrating the fraud."

In light of that, it's just difficult to conclude that

Lehman didn't know what was going on in terms of this subprime activity. I just wanted to add that to the record, Mr. Chairman. Thank you.

Chairman WAXMAN. The gentleman's statement is part of the record.

Mr. Fuld, we have completed the questioning by the members, but I want to thank you for being here. I know this wasn't easy for you to be here, and I accept the fact that you are still haunted every night, as you said, by the wondering whether you could have done something different, whether this could have had a different ending.

But I must say that statement you made that the system works because you lost the value of some of your shares really doesn't sound right to me. Because the system that you lived under gave you a very, very generous reward when your company was highly leveraged and everything was going up, and that's the American way. But when the leverage meant that you were taking huge losses, when the values were not holding up, you still got substantial compensation.

I just would say that most Americans don't understand, even if--we thought you made $500 million, you said you only made around $350 million. That just seems to me an incredible amount of money.

We have held hearings on executive compensation, and we found some conflicts of interest with these compensation committees. We are going to hold a hearing on the ratings, the groups that do the ratings for these bonds, because we think that that ought to be explored more fully. But if you walked away with even $350 million and your shareholders got nothing, and the taxpayers have a system now where we put up $700 billion, and the American people are looking to see, are they going to come out of this?

This is another day with a deep loss on Wall Street. We are just completely battered by the failure of our economic system as has shown up on the Dow and the ability to get credit. So something is just not right to say that the system worked as it should. That system didn't seem to be the system that makes sense. I still think that we have got to look for ways to change it.

Mr. Shays, do you want to make any closing comments?

Mr. SHAYS. Just to say that I look forward to the next four hearings, and I do hope that we do get right in the thick of Fannie Mae and Freddie Mac.

Thank you.

Chairman WAXMAN. What I didn't hear from you, Mr. Fuld, you took responsibility for the decisions you made. In retrospect, you think you should have done some things different, but you don't seem to acknowledge that you did anything wrong. That, I think, is also troubling to me.

Thank you very much for being here.

That concludes our hearing for today, and we stand adjourned.

[Whereupon, at 2:45 p.m., the committee was adjourned.]