Statement

of

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before the

Committee on Financial Services

U.S. House of Representatives

April 20, 2010

Chairman Frank, Ranking Member Bachus, and Members of the Committee: Thank you for the opportunity to submit views on the bankruptcy of Lehman Brothers and the lessons learned from the perspective of federal regulators that can help inform the Committee in your important ongoing work to reform the regulation of financial services.

The federal government faced novel challenges during the height of the financial crisis, and regulators took extraordinary actions to meet them. In particular, the Securities and Exchange Commission, with statutory responsibility for the regulation of broker-dealers, worked closely with the Federal Reserve and other banking regulators whose mission is not investor protection but the safety and soundness of the banking system. While the Federal Reserve and the Department of the Treasury played direct roles in negotiating not only loans but equity investments and strategic transactions to rescue both regulated and unregulated institutions, including commercial and investment banks, GSEs, insurers, and even automotive companies, the SEC maintained its role as an arm's length regulator and law enforcement agency. Maintaining this independent but complementary role has ultimately proved important to the vindication of important national interests, as the SEC has been able to bring subsequent enforcement actions arising out of several of these transactions. The Examiner's report of evidence that Lehman filed misleading financial reports and failed to disclose material accounting information to the SEC, the Fed, and the public may provide the basis for SEC law enforcement action in that case, as well.

The lessons learned from the collaboration of federal regulators both before and after the Lehman Brothers bankruptcy can be of particular importance in identifying regulatory gaps and statutory shortcomings that should be addressed in legislation to modernize the existing regulatory framework.

Lehman Brothers was one of several financial institutions that experienced significant stress or collapsed during 2008, including Bear Stearns, Wachovia, Washington Mutual, AIG, Citigroup, Fannie Mae and Freddie Mac. Its Chapter 11 bankruptcy filing on September 15, 2008, was the largest in U.S. history. Lehman was also unique in that, unlike Bear Stearns, Fannie Mae, Freddie Mac, AIG, Citigroup, and hundreds of other financial institutions that would receive taxpayer support through the TARP program and other specially designed facilities, it did not receive such support.

After the near-collapse and emergency sale of Bear Stearns to JPMorgan Chase in March 2008, the condition of Lehman Brothers became the number one focus for the SEC Division of Trading and Markets. It was viewed as the next most vulnerable of the investment banks. Because Lehman's management also knew that its survival was at stake, the SEC, Federal Reserve, and Treasury focused on providing regulatory and other support for the firm's efforts to raise capital, secure a strategic partner or acquiror, restructure itself, lengthen the maturities of its funding, and shed its troubled assets.

The rapid collapse of Bear Stearns had challenged the fundamental assumptions behind the Basel standards, an internationally recognized method for computing regulatory capital at the holding company level, and the other metrics that had been built into the SEC's Consolidated Supervised Entities program. This voluntary regulatory regime for large investment bank holding companies with SEC-regulated broker-dealer subsidiaries had been put in place by rule in the year prior to my joining the Commission, and represented the best thinking of the agency's professional staff. In addition to relying upon the internationally-accepted Basel standards for computing bank capital, it also adopted the Federal Reserve's standard of what constitutes a "well-capitalized" bank, and required the CSE firms to maintain capital in excess of this 10% ratio. Indeed, the CSE program went beyond the Fed's requirements in several respects, including adding a liquidity requirement, and requiring firms to compute their Basel capital 12 times a year, instead of the four times a year that the Fed requires for commercial banks.

During the unprecedented stress of the financial crisis, however, these borrowed approaches from commercial bank regulation had unfortunate results similar to those that were eventually experienced throughout the commercial bank sector in 2008. The creators of the Consolidated Supervised Entity program in 2004 had designed it to operate on the well-established bank holding company model used by regulators not only in the United States but around the globe. But the market-wide failure to appreciate and measure the risk of mortgage-related assets, including structured credit products, demonstrated that neither the Basel I nor Basel II standards as then in force were adequate. Each had serious need of improvement.

The fact that these standards did not provide adequate warning of the near-collapse of Bear Stearns, and indeed the fact that the Basel I standards used by the Federal Reserve and other U.S. banking regulators did not prevent the exceptionally costly failures and taxpayer-funded rescues of many other large commercial banks and financial institutions, is now obvious. But even in March 2008, after the Bear experience, it had become clear that the regulatory metrics used by the SEC, the Federal Reserve, and other commercial or investment bank regulators in the U.S. and throughout the world had not used risk scenarios based on a total meltdown of the U.S. mortgage market.

That is why, in March 2008, I formally requested that the Basel Committee address the inadequacy of the Basel capital and liquidity standards in light of this experience. The SEC immediately commenced to help lead this revision of international standards through our work with the Basel Committee on Banking Supervision, the Senior Supervisors Group, the Financial Stability Forum, and the International Organization of Securities Commissions. As of April 2010, however, that work has yet to be completed. In my view, it remains a matter of the utmost urgency, in particular for commercial bank holding companies, whose ranks now include not only such large and systemically important entities as Citigroup and Bank of America, but also the nation's largest investment banks.

The determination in early 2008 that existing supervisory metrics did not provide an adequate early warning mechanism led the SEC and the Federal Reserve to work closely together on the development of more stringent and varied measures for Lehman and the other large investment banks, including stress tests based on scenarios of much shorter duration and that were much more severe, such as denial of access to secured as well as unsecured funding. Those more stringent scenarios assumed no access to the Fed's discount window or other liquidity facilities, although in fact such facilities were then available to the major investment banks. The SEC also worked closely with the Federal Reserve in directing this additional stress testing. Not only Lehman but all of the investment banks were urged to maintain capital and liquidity at levels far above what would be required under the standards in the SEC rules. The SEC and the Federal Reserve also directed Lehman and other investment banking firms to strengthen their balance sheets, in part by shedding or marking down illiquid assets.

As part of this scrutinizing of Lehman's secured funding activities, the SEC and the Fed encouraged the establishment of additional term funding arrangements and a reduced dependence on "open" transactions, which must be renewed as often as daily. This process also focused on the so-called matched book, a significant locus of secured funding activities within Lehman and other investment banks, to guard against potential mismatches between the "asset side," where positions were financed for customers, and the "liability side," where positions were financed by other financial institutions and investors. The SEC staff obtained expanded funding and liquidity information for Lehman on a continual basis, and monitored the amount of excess secured funding capacity for less-liquid positions. The additional stress scenarios that were developed with the Federal Reserve were layered on top of the existing scenarios as a basis for sizing more stringent liquidity pool requirements. Also, the SEC discussed with Lehman's senior management their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets. Since Lehman's management had by this time been made fully aware of their need for more capital, greater liquidity, and reduced leverage, the focus of both the SEC and Fed staff was on Lehman's working toward these objectives more deliberately and urgently. These strong messages were presented jointly by the SEC and the Fed to Lehman's management.

Beyond highlighting the inadequacy of the pre-Bear Stearns CSE program capital and liquidity requirements, the early experience during the credit crisis also highlighted the importance of closer collaboration between the SEC and the Federal Reserve to close the regulatory gap that existed for investment bank holding companies. That is because there was then (and is now) no provision in the law giving the SEC, the Fed, or any federal agency the authority to regulate investment bank holding companies -- whether by requiring them to compute capital measures, or to maintain liquidity on a consolidated basis, or to submit to limits regarding leverage. This is attributable to the failure of the Gramm-Leach-Bliley Act to give regulatory authority over investment bank holding companies to any agency of government.

Notwithstanding the lack of statutory authorization, the SEC had taken the lead in creating its voluntary program, stretching rather dramatically its authority over the broker-dealer subsidiaries of investment bank holding companies that the SEC then did regulate, to cover the entire global conglomerate. Congress also gave the SEC authority to regulate the investment companies and investment adviser subsidiaries within the investment bank holding company structure. But this still left a gaping hole in regulatory coverage. Lehman Brothers, for example, consisted of over 200 significant subsidiaries;

the SEC was not the statutory regulator for 193 of them. Among the vast portions of unregulated terrain were some of Lehman's riskiest areas -- including over-the-counter derivatives businesses, trust companies, mortgage companies, and offshore banks, broker-dealers, and reinsurance companies. Lehman was effectively outside of the regulatory jurisdiction of any individual federal department or agency. This was a fundamental flaw in the statutory scheme that had to be addressed -- but in the meantime, it was up to the SEC, the Fed, the Treasury and other regulators to improvise solutions.

To ensure close coordination between the Fed and the SEC, Chairman Bernanke and I negotiated a detailed Memorandum of Understanding aimed at better information flows between regulators, including the communication of market surveillance information, position reporting, and current economic data, so that both agencies could get a more comprehensive picture of capital flows, liquidity, and risk not only at individual firms but throughout the system. The MOU did not open up entirely new territory, but formalized and strengthened the ongoing cooperation between the SEC and the Fed. One reason the MOU was needed was that the Fed was reluctant to share supervisory information with the SEC, out of concern that banks would not be forthcoming with information if they thought it would be referred to the SEC for enforcement.

Both before and after the execution of the MOU, the SEC and the Fed worked closely together in addressing many aspects of the crisis. Chairman Bernanke and I endeavored to set that tone through the MOU and through our own regular consultations. And while staff level cooperation was not always perfect, each agency shared its expertise and the effort was improved because of it. SEC and Fed staff worked together inside Lehman and saw the same information. SEC staff were of course more expert in the securities industry, and Fed staff were more expert in banking supervision, and safety and soundness regulation. Because of the Fed's need for this complementary expertise, both the New York Fed and the Federal Reserve Board in Washington sought to hire SEC staff as they took on responsibility for investment bank oversight; at one point, in order to tamp down these recruitment efforts, the SEC negotiated a "no-poaching" agreement with the New York Fed. That agreement was subsequently abandoned at the request of the New York Fed, and the Fed did hire key SEC personnel. Such cross-pollination, while temporarily disruptive to the agency whose employees are recruited away, will undoubtedly improve regulatory quality and SEC-Fed cooperation in the long run.

Lehman's failure to raise sufficient capital and improve its liquidity pool during this period was not the result of government insistence and direction that it do so, but rather its inability to follow those joint SEC-Fed directives to meet established financial objectives in the face of rapidly deteriorating market conditions. In June 2008, Lehman did raise approximately $6 billion in capital. And throughout the summer, it took steps to improve its liquidity. But the deepening subprime crisis -- including the July 11, 2008 FDIC receivership of Indymac Bank, the fourth-largest bank failure in United States history, and the September 7, 2008 announcement by the Treasury and the Federal Housing Finance Agency of the federal government's conservatorship for Fannie Mae and Freddie Mac -- only worsened the conditions in which Lehman was operating.

The SEC joined the Federal Reserve and the Treasury over the weekend of September 12-14, 2008, in a final collaborative effort to save Lehman Brothers. Treasury Secretary Paulson, New York Fed President Geithner, and I met with the chief executives of financial institutions at the New York Fed headquarters. The board's decision to file for Chapter 11 bankruptcy that weekend, while setting in train a series of negative reactions and market impacts, immediately clarified the responsibilities of the SEC and other departments and agencies of government, restoring each to its accustomed role. With regulatory improvisation at that point brought to an end, the SEC immediately set to work assisting with and overseeing the sale of the significant assets of Lehman Brothers, Inc., prioritizing the protection of Lehman's brokerage customers and ensuring that the hundreds of thousands of Lehman's customer accounts had access to their cash and securities.

As this Committee infers lessons from the regulators' experiences surrounding the bankruptcy of Lehman Brothers, it is important to focus on the dramatic departure from the statutory norms that the events of 2008 represented. Prior to the Federal Reserve's unprecedented decision to provide funding for the acquisition of Bear Stearns, neither the Fed, the SEC, nor any agency had as its mission the protection of the viability or profitability of a particular investment bank holding company. Indeed, it has been a fact of life in Wall Street's history that investment banks can and will fail. Wall Street is littered with the names of distinguished institutions — E.F. Hutton, Drexel Burnham Lambert, Kidder Peabody, Salomon Brothers, Bankers Trust, to name just a few — which placed big bets and lost, and as a result ended up either in bankruptcy or being sold to save themselves. Not only is it not a traditional mission of the SEC to regulate the safety and soundness of diversified financial conglomerates whose activities range far beyond the securities realm, but Congress has given this mission to no agency of government. In the future, the roles and the powers of regulators must be clearly defined, their responsibility to intervene to save specific institutions or to let them fail must be clearly delineated, and regulatory gaps such as those that existed for investment bank holding companies must be closed. Neither the SEC nor the Federal Reserve learned that Lehman used Repo 105 transactions to artificially reduce its apparent leverage, as described in the Examiner's report.

Much speculation has focused on whether the government's extraordinary financial interventions, beginning with the relatively smaller Bear Stearns and ultimately extending to such enormous firms as Citigroup, Bank of America, and AIG, were on balance ameliorative or disruptive. And in the case of Lehman Brothers, the question has often been asked whether there was a legally available option to save the firm. The discrepancy between the rescue of the smaller Bear Stearns, avowedly on systemic grounds, and the abandonment of Lehman Brothers to bankruptcy is usually raised in this connection. In attempting to answer such questions, it is important to bear in mind that the impact from a regulatory action or inaction can have unintended consequences.

Many analysts have wondered why, following the collapse of Bear Stearns and the alarms that set off for every investment bank, Lehman's management did not agree to sell the firm at a lower price, or take other actions to save Lehman earlier during 2008. One possible reason is that Lehman -- inspired by the fact that the much smaller Bear Stearns had been rescued on the grounds of its systemic significance -- was expecting that the federal government would financially participate in any such transaction. As late as the weekend of September 12-14, 2008, when Treasury Secretary Paulson, New York Fed President Geithner, and I met with the chief executives of financial institutions concerning Lehman, the attendees at that meeting themselves appeared uncertain, at least initially, whether the announcement that there would be no federal help for Lehman was ironclad or negotiable.

Likewise, the U.K. government's unwillingness to support a Barclays-Lehman deal may have been influenced by the lack of such U.S. government participation. These expectations may well have been created by the earlier public announcement that Bear Stearns was too systemically important and interconnected to be allowed to fail. Not unreasonably, this could be taken to establish the proposition that larger investment banks would also be deemed too systemically important and interconnected to fail. Individuals and firms may have behaved differently if they had not been expecting the government to intervene.

For legislators, the lesson is that clarity and consistency in policy making are often as important as the rules themselves. Individuals and firms can best order their affairs if they know what rules will apply. The lack of such clarity may have contributed to the demise of Lehman in September 2008.

A final lesson from the Lehman experience is that statutory reform is necessary to close the regulatory gap that the SEC and the Fed attempted to fill through an ongoing, ad hoc collaboration. In this connection, current SEC Chairman Mary Schapiro has endorsed an Oversight Council that would be responsible for identifying risk across the system. Among her reasons for favoring this approach are that multiple sets of eyes would ensure that different perspectives are brought to bear on systemic risk analysis, that the inclusion of multiple agencies will reduce conflicts of interest, and that tapping the expertise of several regulators will ensure a higher level of sophistication in evaluating risks posed by different kinds of institutions. These are all sound reasons for favoring such an approach. But as the Lehman experience has shown, the mere existence of a collaborative forum will not necessarily produce a high level of information sharing, without more. Clear lines of authority and responsibility, drawn in statute, will be important, as will clear mandates for deeper inter-regulatory collaboration and timely access to information.

Throughout the worst of the financial crisis to the present day, the professional staff of the SEC has steadfastly worked for the protection of investors. At the same time, the agency has consistently used its regulatory powers in support of other agencies and regulators, including the Federal Reserve and the Treasury, whose missions have led them to act in extraordinary ways that have (one hopes temporarily) blurred the distinction between what is government and what is private. I am pleased that the legislative proposals you are now considering will serve to strengthen the SEC in its fundamental mission of investor protection. If we take care to heed the lessons learned in the recent financial crisis, I am confident that the financial regulatory system of the future will provide a bulwark for investor confidence and a more transparent and flexible set of authorities for the federal government to help restore and sustain American prosperity.

Thank you for the opportunity to discuss the experience of the SEC in the Lehman crisis, and the lessons it holds for fundamental regulatory reform in the future.