

Testimony of Samuel Molinaro
Before the Financial Crisis Inquiry Commission
May 5, 2010

Chairman Angelides, Vice-Chairman Thomas, and Members of the Commission, my name is Samuel Molinaro and I am the former Chief Operating Officer and Chief Financial Officer of Bear Stearns. I appreciate the invitation to appear before you today.

The past two years have seen unprecedented events reshape the financial services industry. The freezing of the credit markets resulted in the fall of our company, Bear Stearns, as well as the bankruptcy of Lehman Brothers and the consolidation of many other institutions. However, there is still no complete understanding or consensus about the causes of this crisis. To develop stronger financial institutions and better economic policies, the public needs—and deserves—a deeper understanding of the facts. This Commission was established to examine the causes of the financial and economic crisis in the United States. It is a vital task.

You have asked me to address several wide-ranging topics in my testimony today. I will attempt to address those topics by providing you with an overview of Bear Stearns and how we managed our organization, our funding policies and their evolution during 2006 to 2007 and the events leading up to our sale to JP Morgan Chase & Co.

Like many Bear Stearns employees I enjoyed a long career with the company, working there for twenty-two years. In 1996 I was appointed Chief Financial Officer, and, in 2001, I became an Executive Vice President and joined the Company's Executive Committee. In August 2007, I became Chief Operating Officer as well. I remained with Bear Stearns until after the completion of the Company's sale to JPMorgan in June 2008.

I am proud to have been a part of Bear Stearns. Despite having been a public company since 1985, Bear Stearns clung to its partnership culture, characterized by its high level of employee stock ownership, risk aversion, hands-on management, and entrepreneurial spirit. Indeed, Bear Stearns was approximately 1/3 owned by its employees, of all ranks. All employees were encouraged to think and act like owners and safeguard shareholders' money like their own, because it was. Thanks to our culture, Bear Stearns became one of the world's leading financial institutions, employing 14,000 people in offices in the United States and abroad and operating business lines in: research, sales and trading of institutional equities and fixed income; investment banking; global clearing services; asset management; and private client services.

The life blood of an investment bank is liquidity. Over the course of my tenure as the Company's Chief Financial Officer, we worked to develop a liquidity strategy that would ensure the continuity of our funding during periods of market stress. Historically, we financed our operations through a combination of equity capital, short term and long term unsecured debt, and secured debt. We obtained secured financing through repo facilities, which permitted borrowings secured by a broad range of collateral under repo agreements with a wide variety of counterparties. We also obtained secured financing through securities lending agreements and secured bank loans. Unsecured debt was obtained through the issuance of commercial paper (a short term debt instrument that in some cases can have an overnight maturity), unsecured bank

loans, medium term notes and other long term borrowings. Beginning in 2006, we made a deliberate decision to reduce our use of unsecured short term funding and materially increase our use of secured financing. Specifically:

- we increased the use of secured repo funding, because we believed that secured funding was inherently less credit sensitive and thus more stable due to the collateralized nature of the borrowing;
- we introduced substantially greater amounts of longer-term secured funding into the repo and bank loan portions of our secured funding mix;
- we reduced reliance on short term unsecured funding sources, thereby lessening both exposure to rollover risk and dependence on backstop lines of credit; and
- we expanded the size and scope of the Company's liquidity pool, which consisted of cash and cash equivalents held at, or available to, the parent company for deployment as needed.

The tenor of our repo facilities matched the perceived liquidity of the assets that they were intended to finance. So, for example, short term overnight repos were generally used only for the most liquid securities; longer-term repos were used for less liquid assets; and long term debt and equity financed those assets that could not be rehypothecated in the repo and bank loan markets.

Prior to these changes, the Company's alternative liquidity protocols depended on our ability to pledge unencumbered securities as collateral under the terms of committed and uncommitted loan facilities. However, this approach had the risk that in a major liquidity stress event these backup lines might not be available. Accordingly, the purpose of these changes was to protect Bear Stearns' balance sheet from tightening in the credit markets or other market stresses. In fact, Moody's cited our liquidity management as a strength in its May 2007 and September 2007 reports on Bear Stearns.

Bear Stearns was one of the initial participants in the SEC's Consolidated Supervised Entities program. By virtue of Bear Stearns' participation, the SEC had broad access to information about Bear Stearns' finances. Indeed, from the summer of 2007 on, Bear Stearns provided the SEC with continuous updates on the status of the Company's liquidity position, risk profile and capital levels. As of March 2008, our liquidity and regulatory capital levels were strong. As the SEC has stated:

- As of the morning of March 11, Bear Stearns had a pool of high quality, highly liquid assets of over \$18 billion.
- Throughout the week of March 10, Bear Stearns had a capital ratio well in excess of the 10% level used by the Federal Reserve Board in its "well-capitalized" standard.
- In addition, the Bear Stearns' registered broker-dealers were comfortably in compliance with the SEC's net capital requirements.

In light of all this, I was shocked by the dramatic events of the week of March 10, 2008. During the first quarter of 2008, the Company was engaged in a successful leadership transition process. In addition, during the first week of March 2008, we were finalizing our quarterly earnings and expected to report a profit in the first quarter. However, on Monday morning, unsubstantiated and inaccurate rumors were circulating in the market to the effect that

Bear Stearns was facing a liquidity crisis. Unfortunately, the rumors persisted through Thursday, with our credit spread widening dramatically and share price declining. By Thursday evening, these rumors, which were magnified by press reports, had escalated into a panic. In this panic, an increasing number of prime brokerage clients began to request that their available cash and securities be moved to other brokers. Moreover, late on Thursday, a significant proportion of our repo counterparties informed us that they would no longer lend to us, even on the basis of secured collateral. As a result of these conditions we experienced a significant cash outflow which reduced our liquidity pool dramatically.

With significant uncertainty as to our ability to obtain financing from our traditional lenders, Bear Stearns was faced with the risk that we could not conduct business on Friday. Although we had significant quantities of highly-rated securities available for loan collateral, we needed to arrange for backup liquidity for our ongoing business operations. Consequently, we approached JP Morgan, our clearing bank and an institution we believed had the capacity to open a secured liquidity line of the size Bear Stearns needed. We were not looking for a bailout. Rather, we asked for a liquidity line secured by highly-rated securities. Although our negotiations with JP Morgan began as an opportunity to find a commercial solution to our liquidity issue, they ultimately resulted in a funding facility backstopped by the Federal Reserve Bank of New York. This facility was announced on Friday. Unfortunately, the announcement, in the context of that week of panic and rumors, made matters worse by appearing to confirm the rumors that the Company was insolvent. Moreover, we suffered downgrades by the ratings agencies late on Friday and on Friday evening were informed that the JP Morgan facility would mature on Monday morning. Accordingly, on Sunday, March 16, 2008, with few remaining options, Bear Stearns announced an agreement for JPMorgan to purchase the Company.

Bear Stearns' experience the week of March 10, 2008 was surprising and unprecedented. While our capital ratios and liquidity pool remained high by historical standards, market rumors, coupled with our rapidly declining share price, served to increase investor concerns. As a result, we experienced a quintessential run on the bank. Prime brokerage counterparties increasingly withdrew assets; derivative counterparties moved aggressively to assign away our trades, causing market disruptions and margin calls; and, finally, repo counterparties ultimately refused to roll over repo facilities, resulting in a material draw-down of our liquidity pool at the end of the week.

Our liquidity and capital planning models failed in the face of these overwhelming market forces. Bear Stearns' reliance on secured funding markets, which had proven durable over many other financial cycles and market shocks, proved to be insufficient in this instance. Market fears surrounding mortgage-backed securities and rumors and innuendo in the end resulted in fear-induced, irrational behavior that caused a run on the bank at Bear Stearns and then at Lehman Brothers and others during the financial crisis. In this environment, without a lender of last resort or the stability of a deposit base, neither we nor the independent investment banking model itself could survive.

Thank you for the opportunity to testify before you today.