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Official Transcript

Hearing on "The Shadow Banking System"

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COMMISSIONERS

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Reported by: JANE W. BEACH

PAGES 1 - 369

Session 1: Investment Banks and the Shadow Banking System:

PAUL FRIEDMAN, Former Chief Operating Officer of Fixed Income, Bear Stearns

SAMUEL MOLINARO, JR., Former Chief Financial Officer and Chief Operating Officer, Bear Stearns

WARREN SPECTOR, former President and Co-Chief Operating Officer, Bear Stearns

Session 2: Investment Banks and the Shadow Banking System:

JAMES E. CAYNE, Former Chairman and Chief Executive Officer, Bear Stearns

ALAN D. SCHWARTZ, Former Chief Executive Officer, Bear Stearns

Session 3: SEC Regulation of Investment Banks:

CHARLES CHRISTOPHER COX, Former Chairman U.S. Securities and Exchange Commission

WILLIAM H. DONALDSON, Former Chairman, U.S. Securities and Exchange Commission

H. DAVID KOTZ, Inspector General U.S. Securities and Exchange Commission

ERIK R. SIRRI, Former Director, Division of Trading & Markets, U.S. Securities and Exchange Commission.

P R O C E E D I N G S

(9:02 a.m.)

CHAIRMAN ANGELIDES: I would like to call the meeting of the Financial Crisis Inquiry Commission to order. Welcome. We have a quorum present today. I want to welcome everyone to our hearing today and tomorrow on the Shadow Banking System.

I am honored to welcome each and every one of you here today. I want to again thank Vice Chairman Thomas and all my fellow Commissioners for all their hard work as we strive to fulfill our mission on behalf of the American people.

I particularly want to thank Commissioners Born and Holtz-Eakin for serving as the lead Commissioners on this hearing.

Today we begin two days of public hearings. They will focus on what has been called "shadow banking" and how it affected the financial and economic crisis that continues to grip our Nation.

It is largely forgotten now, but for much of American history we had a banking system that was unstable and prone to panics. In the 19th Century, runs on banks came every few years, plunging our young Nation into frequent financial crises.

In the first half of the 20th Century we brought stability to the banking system. After the panic of 1907, we created the Federal Reserve. After the great crash of 1929, we instituted reforms like Deposit Insurance, and more federal oversight.

For decades we had a sound banking system that provided capital for businesses and consumers alike. It was one of the foundations of our prosperity.

Over the past few decades, though, a parallel or "shadow banking" system has arisen that has become a linchpin of our economy. However, it is largely unregulated and, as we saw in the financial crisis, much more unstable than anyone had thought.

This world of shadow banking is some $8 trillion in size and almost as large as the traditional banking sector. It includes investment banks, off-balance-sheet entities, money market funds, and hedge funds, as well as some affiliates of traditional banks.

During this crisis, we have seen the shadow banking system upended, first by a liquidity crisis in 2007 as mortgages went bad at an accelerating rate, and building to a crescendo in the fall of 2008 when there was a 19th Century style panic, a run on the short-term, often overnight loans that fund so much business financing in America and around the world.

The market froze. Interest rates soared on the short-term loans. Our financial system was on the verge of collapse. How could this have happened? Consider Bear Stearns, which we will examine today in its own right and as a participant in the shadow banking system.

Like many other institutions, Bear took extraordinary risks, invested heavily in mortgages and mortgage securities, was thin on available capital, and dependent on the good graces of its creditors for overnight loans.

By one measure, its ratio of assets to tangible equity was 38 to 1, a precarious position to say the least. When their funding dried up, the company stood on the verge of collapse and finally had to be purchased by JPMorgan Chase & Company with more than $29 billion in government assistance.

We will also be examining the Securities and Exchange Commission which had oversight over much of the shadow banking world under a 2004 program that ended in 2008 when the five financial giants under its purview either failed, were acquired, or turned into bank holding companies.

We will have questions of Treasury Secretary Geithner who used to head the Federal Reserve Bank of New York, which was charged with serving as the Federal Reserve's eyes and ears on Wall Street.

We will also have former Treasury Secretary Paulson here, and we will ask him how and why the shadow banking system grew and came to pose a risk to our financial system and our economy.

While considerable attention by journalists and historians has, with good reason, focused on the rescue of various financial institutions and our financial system, we want to explore why these kinds of risks developed in the first place; what could have been done and what should have been done to prevent them.

To use a metaphor, yes, there is a general interest in how the fire was brought under control, but our job is to find out why the fire started; what warning signs were ignored; what building codes, if you will, could have prevented the fire in the first place; where were the firefighters; who was playing with matches.

On behalf of the American people, we have been charged with getting the answers to these questions, and we will.

If you go to our website at fcic.gov, you will find more information on the shadow banking system where our research staff has prepared an excellent preliminary report. I would urge everyone to go look at that report to get an overview of the shadow banking system as it developed.

So thank you all for being here today, and now I would like to turn the microphone over to Vice Chairman Thomas.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman. That was a good, broad explanation of where we are today.

This hearing obviously is only a small part of the Commission work, and the broader themes that we have to look at are shifting constantly. This world of finance, which has changed so dramatically, is an area that frankly most Americans are not aware of, and if they are they are not aware of it in any level of detail that we are beginning to investigate.

So when I try to explain what we are doing to some of my friends, I fall back on some of the analogies that allow us to communicate. And one of them that I am very familiar with is the automobile.

Up until the 1950s, it was pretty easy to be a shade tree mechanic. You basically looked at the automobile, and if it wouldn't run you looked at whether or not you got spark; you looked at whether or not the fuel/air mixture was okay; and if it was, then you went through a series of checks that were not all that difficult, not withstanding the confusing nature of an automobile to a lot of people.

When I was in grade school, we went to a bank. I took some money with me to put it in my savings account. I got a passbook, and over the years I began to realize that was where you went to get a loan if they thought you could pay it back.

And what happened to the automobile in the '60s, '70s, '80s, and into the 21st Century, in part happened to the financial structure. That is, cars got very complicated. It was still the old spark and fuel, who got what, when, and how, and so the banking system was the same, but we began to use computers to measure more precisely.

It became much more of a unique relationship. Into the '80s and the '90s we began to merge electricity with the old-fashioned internal combustion engine in an even more complicated way.

So you couldn't work on automobiles anymore. You had to take them to a dealer who had very expensive diagnostic machinery to figure out what was wrong. It was like going to almost a medical facility with your automobile.

What we are beginning to find out is that the financial markets got just as complicated, because people wanted specific products for specific purposes. And the old established structure was not, either because of regulations, or historical patterns, convenient or appropriate.

It is hard for a lot of people that I talk to all the time to understand something called "the shadow banking system," coined by someone who I think we're going to hear from. What is it? And what does it mean?

It is almost a market like an ecosystem that when you look at it it is still greater than the sum of its parts. And I think we are still trying to understand it. To me one of the best ways, frankly, is to do what we are doing today, Mr. Chairman, in holding a hearing.

What we are going to have before us today are a series of panels which are going to help us understand this thing called shadow banking. And I want to underscore, at the beginning of this hearing, these people are here at our request to help us understand this phenomenon. They are in front us of voluntarily and, frankly, are going to be invaluable in our attempt to find out what happened. Because although it's always easy to think that a match starts a conflagration, sometimes it isn't that simple.

We have before us first Bear Stearns, an investment bank which, in addition to it being a prime broker, was involved in securities' underwriting, mortgage origination, securitization, and derivative dealing.

We are going to have GE Capital, a finance company, which is a major lender in commercial and consumer markets. It would be the 7th largest bank in the United States, based on total assets, old-fashioned bank.

State Street Global Advisors, the investment management division of State Street. State Street Global Advisors manages traditional cash, money market funds, and other investment programs.

And PIMCO, an investment company, which specializes in fixed-income mutual fund management.

This is not an exhaustive examination of the so-called shadow banking world, but a beginning of an understanding of a very complex but fundamentally important arena in today's highly complex, post-industrial financial assistance to the real world.

And so, Mr. Chairman, I am looking forward to this testimony. What we are trying to do is understand, which is our fundamental obligation, to explain to the American people what happened, and I am looking forward to the hearing.

Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Vice Chairman.

And now I am going to ask the witnesses on our first panel, if you would please, to rise to be sworn in, which is something we do with all our witnesses. I will read you the oath.

Do you solemnly swear or affirm under penalty of perjury that the testimony you are about to provide the

Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MR. FRIEDMAN: I do.

MR. MOLINARO: I do.

MR. SPECTOR: I do.

(Witnesses are sworn.)

CHAIRMAN ANGELIDES: Thank you. All right, you are sworn.

Now each of the panels, you have provided us written testimony. We are going to ask each of you to make an opening statement of no greater than five minutes--and this is our first time in the Senate chamber and I believe the yellow light, which is in front of you, will--there should be lights that will come on--will come on with one minute to go, and then red when the five minutes is up. So I would like to ask you to take no more than five minutes, and we will start with you, Mr. Molinaro.

And, Mr. Molinaro, why don't you please begin.

VICE CHAIRMAN THOMAS: Mr. Molinaro, would you get the mike closer to you, and is it on? Now try it.

WITNESS MOLINARO: Okay. Would you like me to start again?

CHAIRMAN ANGELIDES: Yes.

VICE CHAIRMAN THOMAS: Sure.

CHAIRMAN ANGELIDES: You have your 17 seconds back. Let's start all over again.

VICE CHAIRMAN THOMAS: I thought we were going to negotiate that?

(Laughter.)

WITNESS MOLINARO: 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 here today.

You have asked me to address several wide-ranging topics. I will attempt to address those by providing an overview of Bear Stearns, the evolution of our funding policies in 2006 and 2007, and the events leading up to our sale to JPMorgan.

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.

Bear Stearns was approximately one-third owned by employees of all ranks. All employees were encouraged to think and act like owners and safeguard shareholders’ money like it was their own, because it was.

Thanks to our culture, Bear Stearns became one of the world's leading financial institutions with 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. While I was the 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.

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. 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 and September 2007 reports.

In light of all of this, I was shocked by the dramatic events of the week of March 10th, 2008. During the first quarter of 2008, the company was engaged in a successful leadership transition process. During the first week of March 2008, we were finalizing our quarterly earnings report and expected to report a profit for the quarter.

However on Monday morning, unsubstantiated and inaccurate rumors were circulating in the market that Bear Stearns was facing a liquidity crisis. Unfortunately, the rumors persisted and by Thursday evening had escalated into a panic.

In this panic, prime brokerage clients withdrew available cash and securities. Derivatives 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.

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 a 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 JPMorgan. Although our negotiations with JPMorgan began as an opportunity to find a commercial solution to our liquidity issue, we 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 made matters worse by appearing to confirm the rumors that the company was insolvent. Moreover, we suffered downgrades by the rating agencies late on Friday, and on Friday evening were informed that the JPMorgan facility would mature on Monday morning.

Accordingly, on Sunday, March 16th, with few remaining options, Bear Stearns announced an agreement for JPMorgan to purchase the company.

Our experience the week of March 10th was surprising and unprecedented. Bear Stearns's reliance on secured funding markets which had proven durable over many other financial cycles and market shocks did not hold up.

While our capital ratios and liquidity pool remained high by historical standards, fears, rumors, and innuendo resulted in irrational behavior that caused a quintessential run on the bank at Bear Stearns. Our liquidity and capital planning models failed in the face of these overwhelming market forces.

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, and I am happy to answer your questions.

CHAIRMAN ANGELIDES: Thank you, very much.

Mr. Friedman?

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

Thank you for the opportunity to appear here today. My name is Paul Friedman. From 1981 to June 2008 I was an employee of Bear Stearns. During my 27 years at the Firm, I worked in a variety of positions in the Fixed-Income Division.

Among my responsibilities at Bear Stearns, I oversaw the Fixed-Income Repo Desk, and had a number of other operational responsibilities within Fixed-Income. In 1991, I became a Senior Managing Director, which was the title I held when Bear Stearns was sold to JPMorgan Chase in March 2008.

I understand that the Commission has asked me to address Bear Stearns' funding strategies, and in particular its use of commercial paper and the repo markets to finance its business between 2005 and 2008.

Bear Stearns generally financed its business by borrowing funds on a secured and unsecured basis, and through the use of equity capital. During 2006, Bear

Stearns decided to reduce the amount of short-term unsecured funding, primarily commercial paper, that it borrowed.

The Firm made this decision primarily based on its belief, which I shared, that commercial paper tends to be confidence sensitive and can become unavailable at times of market stress. On the other hand, secured borrowing based on high-quality collateral is generally less credit sensitive and therefore more stable.

Bear Stearns implemented this strategy in late 2006 and 2007, and succeeded in substantially reducing the amount of unsecured short-term financing and replacing that with secured funding, principally repos.

In early 2007 as part of the Firm's transition away from unsecured borrowing, Bear Stearns also substantially increased the average term of its secured funding, and generally limited the use of short-term secured funding to financing Treasuries and agency securities. By increasing the amount of long-term secured funding, the Firm believed that it could better withstand a liquidity event.

From August 2007 to the beginning of 2008, however, the fixed-income repo markets started experiencing instability in which fixed-income repo lenders began shortening the duration of their loans and asking borrowers to post higher quality collateral to support those loans.

During the week of March 10th, Bear Stearns suffered from a run on the bank that resulted from a loss of confidence in the Firm by certain of its customers, its lenders, and its counterparties. In part, this loss of confidence was prompted by unsubstantiated market rumors about the Firm's liquidity.

Nevertheless, one of the consequences of this loss of confidence was that some repo lenders declined to renew loans even when the loans were supported by high-quality collateral such as agency securities.

Although this loss of confidence in Bear Stearns was unwarranted, given the Firm's strong capital position and substantial liquidity, it resulted in a rapid flight of capital from the Firm that could not be survived.

In retrospect, I don't believe that there was anything that Bear Stearns could have done differently with respect to its funding model that could have prevented this run on the bank.

In the immediate aftermath of the Firm's collapse, I prematurely and incorrectly believed that certain steps such as raising equity could have been taken in late 2007 and early 2008 and that might have allowed the Firm to survive this liquidity crisis.

However, after witnessing the unprecedented and overwhelming market forces in the fall of 2008, including the bankruptcy of Lehman Brothers, the fire sales of Merrill

Lynch, Washington Mutual, and Wachovia, and the severe distress faced by much larger financial institutions such as Citigroup, Goldman Sachs, and Morgan Stanley, it became clear to me, as it is today, that those beliefs were incorrect.

Bear Stearns was the smallest of the major investment banks, and I don't believe that obtaining more long-term secured financing, or making any other changes in Bear Stearns's funding strategies would have enabled the Firm to overcome these unprecedented market forces, or to withstand the liquidity crisis that the Firm experienced in March of 2008.

Thank you for the opportunity to testify before you today. I would be pleased to answer the Commission's questions.

CHAIRMAN ANGELIDES: Thank you, Mr. Friedman. Mr. Spector?

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

My name is Warren Spector. I was the Co-Chief Operating Officer and President of Bear Stearns from 2001 through August of 2007. I thank the Commission for the invitation to appear, and I hope that my testimony will assist the Commission in its efforts to better understand the causes of the financial crisis.

The Commission has asked me to address several topics related to Bear Stearns. By providing an overview of my roles and responsibilities during my 24 years at the Firm, I hope I can shed light on each of these topics.

When I joined Bear Stearns in 1983, I worked in the mortgage area of the Government Bond Department. At that time, some of the very first mortgage securitization deals were created. Bear Stearns strove to differentiate itself by conducting extensive research and providing our clients with the information and tools necessary to understand the growing mortgage market.

As this market grew, Bear Stearns's Mortgage Department grew along with it and consequently became a larger share of the overall Firm. As a result of the Mortgage Department's success, I was given broader responsibility within Bear Stearns and became responsible for Fixed Income.

In this capacity, I oversaw the growth of all areas within Fixed Income, including government, corporate, and high-yield debt, derivative trading, commodities, and foreign exchange, as well as the continued growth of the mortgage area.

In 2001 I became Co-Chief Operating Officer and President of the Firm and began to focus increasingly on Firm-wide strategic objectives. Among my areas of responsibility was Bear Stearns's asset management business. As BSAM developed, launching new hedge funds occurred as part of the normal course of business with input from the parent company's hedge fund committee.

The two hedge funds that collapsed in the summer of 2007 were created in 2003 and 2006. They were designed and marketed as leveraged funds invested primarily in highly rated asset-backed securities.

Although the funds reported consistently positive returns through 2006, when the investment climate changed by the Spring of 2007 the market value of the underlying securities began to decline. As a result, the high-grade funds began to experience investor redemptions and later margin calls from the repo counterparties.

The Executive Committee of Bear Stearns was informed of and became involved in addressing the problem, including holding near daily discussions about the funds and about how best to avoid their collapse.

However, the funds' assets experienced an unprecedented decline in value and ultimately our efforts to save the funds were unsuccessful.

You have also asked me to address risk management practices. Risk at Bear Stearns was managed through a system of checks and balances. Each business unit was responsible for managing its risk, and the head of each division was then responsible for managing the aggregate risk within its units.

The Executive Committee approved explicit limits for all areas of the firm at the trading book level, and also by unit and by department, which were monitored by department heads. These limits were reviewed and monitored by the risk management group, which was an independent unit that reported to the Executive Committee and met regularly with the Board's risk committee.

This group, headed by Bear Stearns's Chief Risk Officer, served as an independent check on the business unit's own risk management function. It distributed daily P&L statements that highlighted any significant gains and losses.

It also provided daily written reports to senior management commenting on changes in exposure, unusual trade, and any concentrated positions.

The risk committee held weekly meetings and the risk management group made monthly presentations to the Executive Committee. At the weekly meetings, trading managers reported on their positions and their risk, and the risk management teams were present to verify the accuracy of these reports and to express their views.

In this way, the risk committee served as a constant check on the business units. There was an active dialogue among senior management about the Firm's overall risk appetite, which we reviewed during both weekly and monthly meetings.

In my opinion, Bear Stearns's risk management practices were robust and effective. During my tenure on the Executive Committee, I found the risk management team to be highly trained and very experienced.

Overall, I thought Bear Stearns was well managed and I was deeply saddened and disappointed when the Firm collapsed.

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

CHAIRMAN ANGELIDES: Thank you, Mr. Spector.

We will now commence the questioning, and I will start the questioning and then we will go to Mr. Thomas, and then our two lead Commissioners on this hearing.

I really want to start by picking up on your testimony in which I think all of you, both in your written and oral testimony have said in a sense that you believe the demise of your institution was beyond your control--which, I might add, is not unlike other testimony we have heard, that this financial crisis may have been an immaculate calamity. But I really want to pose this notion, or question about whether or not the business model was essentially flawed, or whether in fact the management, the risk management, was inadequate and flawed with respect to this institution and some others.

Mr. Molinaro, I would like to start with you. So if you look at Bear Stearns, the assets of the institution grew from about $185 billion in 2002 to $395 billion in 2007. That is a compounded annual growth rate of 16.4 percent, a total growth of 114 percent--extraordinary growth.

In 2007, year end, the leverage ratio was 38 to 1 when measured in terms of tangible assets versus tangible common equity. But in fact, the real leverage ratio, at least tangible assets to tangible common equity, on a monthly average was 42 to 1. And I will talk to you a little bit about that in terms of balance sheet management.

And there was a significant concentration in mortgage-backed securities. In fact, just about a month before the collapse of the institution, the institution had about $12.5 billion in no-documentation loans and what are called "scratch-and-dent loans," loans that had deficiencies in them, which was more than the Firm's total capital--or equity.

I guess I would just ask you, as a starter, why would you think that that business model of extraordinary leverage where asset value drops of 2 to 3 percent would wipe out all equity, why would you think that that would be sustainable in any kind of market disruption?

WITNESS MOLINARO: Well, Chairman, the--the business model that Bear Stearns had operated under was not something that newly evolved in 2006 and 2007. So the amount of leverage that you're referring to is something that I think has existed in the investment banking business model for many, many, many years.

I think one of the things that we have to look at when you're looking at gross leverage levels, which are in my view not terribly telling with investment banks--because when you look at the gross leverage of an investment bank, particularly Bear Stearns, a substantial portion of those assets are secured receivables, secured by customers, equity securities, bonds, mortgages, government bonds, et cetera. So I think that if you look at that, you would probably find that somewhere in the vicinity of $200- to $250 billion of assets were secured receivables where the customer bore the first risk of loss and had margin up securing the loan.

So I think that when you look at all--the investment banking model, which clearly did not stand up well in the face of this market dislocation, some of the issues that had to be dealt with were the size of the inventory positions that we held. Clearly, as you've alluded to--I'm not familiar with the numbers that you just described concerning our mortgage securities inventory--but we did hold substantial inventories of mortgage securities in our role as a dealer in the mortgage-backed securities market.

The leverage that existed and the way that we financed ourselves, we clearly relied on the secured financing markets to be able to finance our operations on a day-to-day basis. And in the face of a significant market stress, and in the face of a significant dislocation--a dislocation that I think was far beyond what any--what most institutions, I can't say any--but with most institutions, risk management modeling had even--couldn't even envision a decline of the magnitude that we were seeing. The model couldn't stand up to it.

CHAIRMAN ANGELIDES: But let me push this even further, because it wasn't just the leverage on the asset side. I mean, you were dependent, as I understand it, on $50 to $60 billion of repurchase agreements, repo rolling over almost every night, correct? Does that seem like a reasonable amount?

WITNESS MOLINARO: I believe that's the number in the first quarter--

CHAIRMAN ANGELIDES: And in 2007 when you first, I think all institutions unveiled their Level 3 assets, which are illiquid assets, you know, for which there's no discernible market pricing, I mean at that point your illiquid assets are 269 percent of our tangible common equity.

I mean, just kind of in lay person's term, the way you guys were set up is, it's like a small business that had $50,000 in cash, it's borrowing $2 million, and $300,000 is coming due every night. It just seems to me that it's ultimately not sustainable.

Is it a model you ever questioned? Or is it just we had always done it that way? It seems to me that any time there was any significant disruption, this would come a cropper. And it had previously in terms of highly leveraged institutions.

WITNESS MOLINARO: Well I think that when we think about the way that we finance the balance sheet and the numbers that you're alluding to, we spent a great deal of time focused on how to finance the balance sheet, and how to set it up in a way that it would be able to sustain a severe market shock in liquidity.

So when we talk about the overnight repos that were--that you allude to, the use of overnight repo was predominantly focused in the markets that were the most liquid markets.

So, yes, we had money that was rolling over every night, but we're dealing with government securities, agency securities, AAA-rated securities, the most liquid securities in the marketplace were what we were moving overnight financing for.

CHAIRMAN ANGELIDES: But at the end of the day, I mean it was kind of the ultimate hand-to-mouth, and you were very dependent on the good graces of your creditors. In the end?

WITNESS MOLINARO: Well you're dependent upon the liquidity of the market. That's what--what we really relied upon was the liquidity of the market. And in the event we were to lose--at least the theory would be, at least in the event we were to lose overnight financing capability, which candidly I don't think we could even envision that happening, that we wouldn't be able to finance Treasuries, and agency securities in the marketplace, we would liquidate the securities.

The Level 3 assets that you allude to, the less liquid assets were not funded in the overnight repo markets. And they were not funded generally in the repo markets. They were funded with long-term debt and equity to make sure that we had an adequate timetable in order to liquidate those assets in a reasonable way.

CHAIRMAN ANGELIDES: All right. Let me talk to you about quote/unquote "balance sheet management."

If you look at your 10K for 2007, you show assets of $395.4 billion. But there is a disclosure that says that is in fact about 12.2 percent lower than the monthly average assets, which was $450.3 billion.

So what it appears you did is you did pull your assets down at the reporting period. When we interviewed the former company treasurer, Mr. Upton, he said that this was, quote/unquote, "window dressing." He said it was done to, quote, "make sure that creditors and rating agencies were happy." Close quote.

In your 10K you talk about reduction in asset balances is predominantly in highly liquid short-term instruments that are financed on a secured basis.

I just have a very basic question: Why are you, for reporting purposes, pulling down your assets for reporting purposes? Why not fully disclose throughout the year what your real assets were? I mean, it looks like your real leverage, again tangible assets to tangible common equity, is 42 to 1.

I guess my real question is: Doesn't this really speak to the fact that even you thought internally that you were overleveraged?

WITNESS MOLINARO: No--

CHAIRMAN ANGELIDES: I mean, isn't this a little--I know you disclosed it, but why wouldn't you see this essentially as kind of gaming it to deliberately pull down your assets at the end of the year?

WITNESS MOLINARO: Well we didn't think that we were overleveraged by any stretch. And the method, you alluded to some statistics at the beginning of your questioning around the growth of the Firm's balance sheet. And I think if you look at the growth of the Firm's balance sheet over the time frame, it was in line with the growth of the Firm's equity.

So we did attempt to maintain an absolute level of balance sheet leverage. It was one of many statistics that creditors looked at. In my years of being the Chief Financial Officer of Bear Stearns, I spoke to many creditor groups, and many investor groups. I would say that gross leverage was not a statistic that was generally looked at.

CHAIRMAN ANGELIDES: So why did you pull down your leverage?

WITNESS MOLINARO: So we--

CHAIRMAN ANGELIDES: Why did you yank it down for the reporting period?

WITNESS MOLINARO: So we established targets every, every year that we wanted to keep the balance sheet at. We forced the business units at every reporting date to bring the balance sheet down. That did--

CHAIRMAN ANGELIDES: Why?

WITNESS MOLINARO: --a couple of things.

It one, ensured that we weren't ballooning the balance sheet with assets that we didn't ultimately think that we could be able to sell. And it made the business units have to live with the discipline of getting rid of--getting rid of the--getting rid of securities, or getting rid of positions to make sure that we knew that we had the balance sheet liquidity that we, that we expected to have.

So we didn't try to hide any of this. It was all disclosed in our public filings. I think it's evidence of the fact that the balance sheet was very liquid. The types of assets that typically would go away towards the end of quarters were the most liquid securities--matchbook repo activity, low-margin. Low-margin trading activities would be taken off.

CHAIRMAN ANGELIDES: All right, let me--Mr. Friedman, let me ask you a set of questions.

You said today that you have a different view than after the Firm collapsed. But back then, back in the day, you said: We did this to ourselves. We put ourselves in a position where this could happen. It's our fault for allowing it to get this far and for not taking any steps to do anything about it. It's a classic case of mismanagement at the top. There's no question about it.

You know, I was looking as we reviewed the information for our investigation, it appears that there were a lot of warning signs along the way, and I want to probe this to the extent to which moves could have been made with respect to this institution and others to build higher levies, or to batten down the hatches for a possible storm that would come.

I reviewed as part of this, as I know other Commissioners did, a series of Monthly Monitor Reports for the SEC. And I would actually like to enter into the record a series of reports dated February 1st, 2006; April 6th, 2006; June 7th, 2006; August 2nd, 2006; October 6th, 2006; November 7th, 2006; January 4th, 2007; March 1st, 2007; March 30th, 2007.

And in these Monthly Monitoring Reports--and I know, Mr. Molinaro, you dealt a lot with the SEC, but these really go to the nature of the activities, Mr. Friedman--in February 2006, the SEC notes in conversations with Bear that there's a sharp increase in aged inventory and mortgage and asset-backed area which grew $900 million to $3.6 billion.

In April 6, 2006--this is fairly early on--growing problems with put-backs on subprime originators. By August 2nd, the risk manager highlighted the lower turnover this month as well as significant increases in aged inventory, which means you're having to hold mortgages you are buying in inventory rather than moving them off in securitizations.

October 6th, markets are very benign, almost uncomfortably so. Some risk managers commented these very benign market conditions feel a little like the fall of 1998 prior to the implosion of long-term capital management.

January 4th, 2007, subprime mortgage arrangers are struggling. In addition, many pools of subprime loans are performing poorly.

March 1st of 2007, mortgage business incurred significant losses. January markdown approximately $300 million of inventory by $58 million.

March 30th, subprime mortgage market turmoil continued to cause credit risk. This is all a year before the collapse.

I really want to ask you, Mr. Friedman, do you not believe the Firm could have repositioned itself, raised additional equity, shed some of its troubled mortgage assets at a point early enough prior to the collapse of Bear Stearns's asset management hedge funds to get itself at least in a position where it might have survived ultimately to the point at which it might have had a chance of surviving this environment?

I mean, it seems like there were a lot of warning signs. A lot of red and yellow lights going off.

WITNESS FRIEDMAN: I'd like to address--I'll answer your question, certainly, and I'd like to address first, if I could, the statement you read. I have a feeling I'll have other statements of mine read back at me today.

CHAIRMAN ANGELIDES: Very eloquent.

WITNESS FRIEDMAN: Thank you. I would hope the Commissioners would be understanding of the time at which that interview took place.

The Firm at which I had worked for 27 years had imploded very abruptly, putting me and a great number of my friends out of work; putting thousands of people at Bear Stearns out of work; destroying billions of dollars of wealth both of employees, of shareholders, investors. I was angry.

I was interviewed over a period when I was looking to find someone to blame. I lashed out. I blamed all sorts of people that were taken, some out of context, some in context, because I was certainly angry at that time. Included are--I'm sure you have read quotes where I blame people I've never met.

I apologize for it in so many ways, and I have--it has bothered me for two years. So--

CHAIRMAN ANGELIDES: But let's talk about the SEC reports. You know, all those warning signs.

WITNESS FRIEDMAN: I actually have never seen those SEC reports, but I understand the context in which you're asking the question.

I don't know of anyone that I've run across--and I was not involved with risk management, and I was not involved with trading management at Bear Stearns--but I don't know of anyone I've run across who, either within the Firm or outside of the Firm, who in 2006-2007 had any sense that the markets would become as disrupted as they had.

The funding model that Mr. Molinaro talked about, which was a matching of less liquid collateral and longer term financing, was designed to give us a six-month to nine-month head start on either needing to replace financing, or needing to--being able to sell assets.

Starting in 2007 we found that you could--you had a lot of difficulty doing both. It was not a Bear Stearns situation. The markets were not amenable to making wholesale changes to the holdings of firms like ours.

Maybe someone saw it in 2006; I don't know who those people were.

CHAIRMAN ANGELIDES: Well I will return to that, but let's do this. I'm going to yield the balance--right now I'm going to stop. I will reserve the balance of my time and I'm going to ask the Vice Chairman to proceed.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

Mr. Friedman, are you using the argument about that quote that you're human? Is that your fallback?

WITNESS FRIEDMAN: I hadn't intended it that way, but I am human.

VICE CHAIRMAN THOMAS: That's one of the things that I'm most curious about. We're not just relying on the panels in this whole area of shadow banking, I do want to say, because we are currently in the process of carrying out a survey of almost 500 companies across the financial industry in order to better understand the exposure of individual firms to other players in the shadow banking system.

We are trying to gather data on, among other things, funding sources, derivative exposure, leverage ratios from commercial banks, broker dealers, money market funds, pension mutual funds, hedge funds, insurance companies.

When most people think of the financial world, Wall Street is an easy statement that most people think sums it up. And when you think about Wall Street, you perhaps most often think about it as a bunch of sharks in the water kind of a belief that everyone's out to get everyone, and they're all out for themselves.

I don't know how in the construction of your model that you--Mr. Molinaro, you used the term "fears, rumors, innuendo" that was going on. Mr. Friedman, you even used "unsubstantiated rumors." And to me that's an undertone of kind of unfairness at a time of need.

I am really impressed at how dependent you folks were, and others in the shadow banking, in the use of the financial instruments that you had. You were so dependent on others for your daily bread. And you can talk about securitized assets.

Mr. Molinaro, you talked about JPMorgan as though they were supposed to do something and they didn't because you could show them what you looked like and they would react in a certain way, and they didn't.

So I'm really ambivalent in terms of whether you were in competition with others in a way that people would gain by your failure, and that you just wound up being exposed at an inopportune time so that they could swallow you.

Or, based upon our history of commercial banks, especially in the '30s with the runs on banks, and yeah, there were fears, rumors, innuendo, unsubstantiated rumors, even from some folks as unsophisticated as customers trying to get their money out of the bank, which creates an illiquid situation. They had to have a holiday to close the banks to calm things down.

But what I get from some of your testimony is that once we set up the structures to dispel the rumors, especially if you could tell people that your money was insured and that we'll take care of it in the older, simpler spark and fuel days of banking, did you honestly believe that you were immune from fears and rumors, unsubstantiated though they may be, from more sophisticated players in the market about whether or not they could believe or understand or accept what you thought were secure assets? Or they were supposed to behave in a certain way?

Was there an unwritten code? I don't know whether it's sharks in the water, or it's a bee hive in terms of a need to have a mutual understanding or support. How could you folks, as sophisticated as you were, with the models that everyone felt comfortable with, believe that you were the victim, I guess--and tell me if I'm wrong in reading your testimony--that you were the victim of unsubstantiated rumors, fears, and innuendo that your colleagues did you in?

I mean, how do you dispel the belief that you actually thought this sort of thing could never happen, since it's happened in other instances with other individuals with some kind of a mob mentality about fears, unsubstantiated or not?

WITNESS MOLINARO: We certainly did not think that we were immune to this. And as I alluded to a little earlier, we spent a tremendous amount of time thinking about our capital adequacy, thinking about our funding model, how we financed the balance sheet--as you've correctly pointed out, there was a great deal of leverage.

We did use the repo markets extensively. We did use short-term unsecured debt, long-term unsecured debt, and equity capital to finance ourselves.

Our goal in financing our balance sheet always was that we could run the business without having to replace any maturing unsecured indebtedness for a 12-month period without being forced to liquidate assets.

Certainly an underlying theme of that structure was that the secured financing markets for liquid collateral--for liquid collateral--would be there.

It might be in a period of market stress that lenders would ask for more margin, and we had provisions built into our liquidity model to try to capture that. And one of the reasons we maintained a liquidity pool at our parent company of almost $18 billion was for these kinds of expected outflows, that lenders in a period of stress might ask for more collateral and that we needed to be prepared to provide them with more collateral.

And the way that we tried to measure those amounts that we thought we might need--and of course we are crystal-balling a little bit here--but the way that we tried to measure those amounts is we would look back historically over all of our careers, which go back 20-plus years, and say in periods of market stress how much did the haircut level on agency securities increase, AAA-mortgage-backed securities, how much did the haircuts increase by? Would we be able to finance corporate bonds in those markets?

So our funding strategy was completely based upon an assessment of each of the individual assets, how liquid they were, and how they would be financed in a period of market stress. It's the reason--

VICE CHAIRMAN THOMAS: But weren't you still dependent on others saying 'yes'--

WITNESS MOLINARO: As I said--

VICE CHAIRMAN THOMAS: --in terms of cooperating and playing the game as you perceived it laid out? You had no anticipation of someone saying 'no', even if they saw an opportunity to benefit themselves, by virtue of putting you in jeopardy?

WITNESS MOLINARO: I have to say, I never envisioned that issue and we did not envision a scenario in which we would not be able to finance the most liquid assets on the balance sheet.

VICE CHAIRMAN THOMAS: Okay, I don't like to put various institutions on the spot, but in your testimony on page 3 I'm trying to read between the lines on your negotiations with JPMorgan.

Did they say 'no' when you thought they would have and should have said 'yes'?

WITNESS MOLINARO: I wasn't trying to allude to that. During 2007 and during--and really during 2007 when the liquidity crisis was first coming —up on the markets, as Mr. Friedman alluded to in his statement, the financing markets were getting quite difficult.

This was not, this was not news to anybody during this period of time. Many of the structures that had provided liquidity to the markets were undergoing stress. Money funds were undergoing stress. The SIV market was undergoing stress. So the short-term liquidity markets were definitely in a period of stress during that period.

We spoke with many banks during that period of time about larger liquidity lines, lines that we may not have traditionally had in place but we wanted to try to be belts-and-suspenders and have larger liquidity lines.

We talked to many of the large money center banks. We talked to many foreign banks. We actually negotiated--

VICE CHAIRMAN THOMAS: But not withstanding all of that--

WITNESS MOLINARO: Not withstanding all of that. So we negotiated many lines predominantly with the foreign banks.

Why the U.S. money center banks were not more willing to participate and provide lines during that period of time, I can't tell you. You'd have to ask their--I presume that they had their own issues to deal with.

When we went to JPMorgan on that evening, we knew that we had an extraordinary situation. We went to JPMorgan because we thought they were the bank that had the most financial capacity to potentially provide us with a loan of this type in this kind of a crisis.

VICE CHAIRMAN THOMAS: And you worked with them. They were your clearing bank.

WITNESS MOLINARO: They were our clearing bank.

VICE CHAIRMAN THOMAS: And you had a familiarity, and they had a familiarity with you--

WITNESS MOLINARO: Yes.

VICE CHAIRMAN THOMAS: --which would create a relationship that wouldn't be necessarily absolutely pure business?

WITNESS MOLINARO: Well I think more they had a relationship with the kinds of collateral that they had. They knew what--

VICE CHAIRMAN THOMAS: A comfort level.

WITNESS MOLINARO: They had a comfort level with what we were doing.

VICE CHAIRMAN THOMAS: And?

WITNESS MOLINARO: We went to them that evening--

VICE CHAIRMAN THOMAS: They were uncomfortable?

WITNESS MOLINARO: They--they expressed to me that the, that the potential amount of financing that we needed was going to be in an amount that was in excess of what they could do on their own, and that they were going to talk to the Fed.

VICE CHAIRMAN THOMAS: Mr. Friedman, you used the term "unsubstantiated rumors." Normally when you qualify rumors that way it has a kind of a, not just a negative but a motivated negative aspect to the rumors. Did you think people were out to get Bear Stearns?

WITNESS FRIEDMAN: I don't think so. I didn't intend it that way. Certainly there were a lot of rumors of that at the time. I think we all read it in the press.

VICE CHAIRMAN THOMAS: But why did you say "unsubstantiated?"

WITNESS FRIEDMAN: Because they weren't correct. People had--

VICE CHAIRMAN THOMAS: But if they held out, they would be.

WITNESS FRIEDMAN: If they turned out to be true, they would be substantiated, yes, sir.

VICE CHAIRMAN THOMAS: So they were substantiated because they failed to act the way your model anticipated they should have acted, based upon all of the arguments that have been made.

WITNESS FRIEDMAN: The rumors themselves were not true until the telling of the rumors created the truth.

So the markets were by themselves skittish. There were--there had been a story in I believe it was Barron’s over the weekend that talked about the possibility of Fannie Mae going bankrupt, and there was a lot of speculation that that would cause Bear Stearns to be bankrupt.

There was an error made by one of the rating agencies--or actually by the press. One of the rating agencies had downgraded a securitization that Bear Stearns had done years before, and it was picked up by the press as Bear Stearns has been downgraded.

So there were rumors circulating that things were happening to Bear Stearns--

VICE CHAIRMAN THOMAS: Well ultimately in a commercial bank your safe, your ultimate safe is, hey, your money is insured; don't worry about it. You had no fallback to your fallback. There was no fundamental undergirding structure.

So to me it seems like it was based on trust of others more than a model that could rely on what you had. And this is where it gets very difficult for some of us in understanding the so-called shadow banking area, or the banks that developed because it was more convenient to utilize them in certain ways in the society; that very sophisticated people who knew the history of runs on commercial banks created a model which was based upon trust and the ability to survive fears, rumors, or innuendo, even unsubstantiated rumors, but obviously that wasn't the case.

WITNESS FRIEDMAN: I would put it this way. Mr. Molinaro said a moment ago that there is certainly a question in hindsight of whether the investment banking model as a whole is survivable without a lender of last resort. I agree with that.

VICE CHAIRMAN THOMAS: Oh, I think factually we know that now, don't we?

WITNESS FRIEDMAN: I don't disagree.

You referenced earlier money market funds. Anyone who is essentially a deposit-taking institution, you know, we've talked a lot about repos this morning; we haven't talked about customer credit balances, and all the other money that generally people entrust to an investment bank that you can't really predict outflows in a panic.

So I think, you know, any institution that is a deposit-taking institution in any sense of the word, including money market funds, investment banks, and the like, is at risk of a run on the bank. I don't dispute that.

VICE CHAIRMAN THOMAS: And we set up a system on the old-fashioned commercial banks to try to protect against that, and then we invented all this new money that was utilized in very positive and creative ways by folk, but we had no fallback. That's what I don't understand in terms of a belief that with these very complicated automobiles you can at least go to a dealer and put on a diagnostic machine and figure out what's wrong with it. And I think an awful lot of people, including myself, thought that through the regulations and the structure that we had, and certainly the very wise people who were operating in this area, that we had pretty much a diagnostic structure that would figure out how to make sure that the system ran, and that finally and ultimately that just wasn't the case.

That is what worries me so much about where we are today. And obviously why Congress and others are looking at ways to shoring up the system.

Thank you, Mr. Chairman, I will reserve the balance of my time.

CHAIRMAN ANGELIDES: Thank you, Mr. Vice Chair.

I have a quick question before we go to Ms. Born, just to follow up though on a line of questioning that the Vice Chairman had, and that is about the extent to which rumors helped precipitate the fall of Bear.

There was in the final week, I believe March 11th, a rumor widely circulated--in fact I think there was a report on CNBC when Mr. Schwartz was interviewed--about a certain trade where Goldman had said they wouldn't, they didn't want to take Bear as its counterparty.

And specifically, Hayman Capital was in a derivatives contract with Goldman. They wanted Bear to replace them in that. And we have now reviewed the documents surrounding this matter, and on March 11th, 2008, Hayman Advisors Controller Stuart Smith sent an email to Bear Stearns in which it asked to novate a $5 million CDS trade with Goldman.

A couple of hours later, Marvin Woolard of Goldman Sachs replied that, quote, "Goldman does not consent to this trade."

The next morning, Debby LaMoy sent an email to Faina Epshteyn of Goldman asking why Goldman did not consent to the novation. Ms. Epshteyn responded, quote, "Our trading desk would prefer to stay facing Hayman. We do not want to face Bear."

Ms. LaMoy forwarded the email to Mr. Bass and wrote that, quote, "The desk wants to face Hayman as opposed to Bear Stearns because of counterparty risk."

Now a little over an hour later, however, Mr. Woolard wrote to Ms. LaMoy and Bear Stearns that Goldman would consent to the trade.

Now when asked about this, the president of Goldman initially said that the reason they didn't want to see the replacement was they thought that that would in fact exacerbate the situation and, quote, "We weren't looking to take advantage; we were looking to be helpful."

I guess my question is: How damaging was this rumor to you in that final week? Well, the fact that initially there wasn't a consent, and then there was a rumor that in fact--you know, that went through the marketplace?

WITNESS FRIEDMAN: I wasn't even aware of that story and that rumor until I read it in the press afterwards, so I don't know that that rumor per se had any real impact on anything that happened at Bear Stearns that week.

CHAIRMAN ANGELIDES: All right. Was it the type of kind of news story that you were alluding to, though, about things coursing through the marketplace, because you have a major institution that doesn't want to face you anymore?

WITNESS FRIEDMAN: Those were the sorts of things in particular because the derivatives' assignment process was, and I think still is, fairly manually intensive. I think firms who were seeing a lot of assignments of trades that had previously been at Bear Stearns were, for good reasons, putting the brakes on at the speed at which they were taking on the risk. And I think in good faith a lot of institutions decided to step back and evaluate what risk they were being able to take, and that mere slowdown was taken as a statement of a lack of confidence.

CHAIRMAN ANGELIDES: All right.

VICE CHAIRMAN THOMAS: Mr. Chairman, just very briefly?

CHAIRMAN ANGELIDES: Oh, yes--but can I just say, I would like to at least enter that communication that I cited into the record.

CHAIRMAN ANGELIDES: Mr. Vice Chairman.

VICE CHAIRMAN THOMAS: Just a quick commercial announcement. I do want to let folks know that at www.fic.gov--

CHAIRMAN ANGELIDES: "fcic."

VICE CHAIRMAN THOMAS: What'd I say? "fcic," we have some staff reports that I think are really exceptionally well done for someone who isn't as familiar with the area as we would like to be in explaining the shadow banking and the financial crisis, and other supporting papers. So that you can get from the fcic.gov website some very useful material that consolidates, condenses, and refocuses some of the more complicated discussions and explanations on shadow banking and the financial crisis.

CHAIRMAN ANGELIDES: Right. Thank you.

Ms. Born?

COMMISSIONER BORN: Thank you very much, Chair Angelides.

As the Chair has said, in parallel with our commercial banking system an enormous shadow banking system grew composed of financial institutions with significantly less regulation than commercial banks, including investment banks like Bear Stearns.

By the time of the financial crisis, a great deal of financial activity was taking place outside the regulated banks and in the shadow system. By that time, the five largest investment banks had grown very large, rivaling our largest bank holding companies.

Bear Stearns was the fifth of the five big investment banks in size. Some parts of Bear Stearns and of the other large investment banks had traditionally been regulated by the Federal Government--for example, its securities broker dealer arms, and its investment advisory arms.

However, most of its other operations had no government oversight until the Securities and Exchange Commission adopted the Consolidated Supervised Entity Program in 2004 that allowed the five largest investment banks voluntarily to submit to a program of SEC oversight of the holding company and its subsidiaries that was designed to assess and assure the companies' safety and soundness.

Nonetheless, despite that oversight, Bear Stearns was the first of the large investment banks to experience the equivalent of a bank run in March 2008 that led to its government-assisted acquisition by JPMorgan.

Within six months thereafter, all four of the other large investment banks had experienced similar bank runs and had disappeared as independent investment banks. Lehman Brothers through bankruptcy. Merrill Lynch through acquisition by Bank of America. And Goldman Sachs and Morgan Stanley through conversion to bank holding companies.

We are here today to investigate why the investment banks failed, and the role of that failure in the financial crisis.

Were there problems with the business model? With the management of the institutions? With the supervision by the SEC? Or did they succumb to runs for other reasons? For example, the lack of an ultimate government guarantee or support like the commercial banks had?

I wanted to review with you in some more detail the factors in your operations that may have made it subject to a bank run. And I will direct this question at least to Mr. Molinaro.

We have talked about your reliance on short-term funding. At year-end on November 30th, 2007, Bear Stearns had more than $102 billion in short-term funding through repurchase agreements, or repo; an additional $4 billion in commercial paper; while its assets were less than $400 billion and it had equity of less than $12 billion. Thus, short-term funding supported more than a quarter of your assets.

Why did Bear Stearns rely so heavily on the short-term funding?

WITNESS MOLINARO: The repo balances that you alluded to, I don't know that all of those were short-term, though I'm sure that there was a substantial portion of them that were. And as I said earlier, the method that we used to evaluate how much short-term secured funding we would utilize was completely rooted in our assessment of the liquidity of the underlying asset.

We never--we never deluded ourselves into thinking that people were lending us money because they thought our credit was good, or because they liked us, or any other reason. They were lending us money because they were lending money against government securities, agency securities, and they made an assessment of the volatility of that asset when they set the haircut requirement.

So certainly an underlying foundation to the financing methodology of Bear Stearns, and I think of all of the independent investment banks, was that you would be able to pledge liquid marketable securities to lenders under these types of agreements, and there was virtually no scenario that you could envision where you wouldn't be able to do that, or where you wouldn't be able to liquidate the underlying asset, if there were one or two lenders that got skittish for some reason.

So I think that when we look at this issue, as you're correctly pointing out, it turned out to be a major flaw in the model of the investment banking model.

And without a lender of last resort, without someone that the markets could--that your counterparties could feel comfortable that you could get liquidity from, coupled with, in my opinion, the way that broker dealer bankruptcies work, and as people--my guess is, many market participants hadn't spent a lot of time thinking about that until 2007--it is very clear that in broker dealer bankruptcy there's a liquidation. And that is not a scenario that people that are in money funds lending you overnight repo want to be involved with.

COMMISSIONER BORN: Let me ask you, was all the collateral you were using for your repo at say year-end 2007 agency securities and Treasury securities? Was any of it, for example, highly rated mortgage-backed securities, or CDO tranches?

WITNESS MOLINARO: Definitely highly rated Non-agency mortgage-backed securities were a significant portion of what we were financing. I can't speak to whether or not there were CDO tranches in there. At that juncture I would doubt it. But it's possible that at an earlier time when the markets were different we might have been able to finance the AAA portion, and in that way I don't know the answer to that.

COMMISSIONER BORN: Was that the first--were the mortgage-backed securities the first collateral that was not being accepted as the repo market tightened up?

WITNESS MOLINARO: I think as Mr. Friedman has alluded to, yes, there were lenders who were getting more nervous with taking non-agency mortgage securities because of the fear of the unknown. And in a market that started with a subprime crisis, that at least some people thought was contained to the subprime market, but many people were fearful that it would spread to other sectors of the mortgage market. So we did see early cracks there, but by March I think it was more institutions who were lending to you on overnight repo who are likely to be money funds or people like that, they just did not want to be involved in the name.

If there was a problem, they don't want to be there.

COMMISSIONER BORN: So it was more lack of confidence in Bear Stearns than lack of confidence in the underlying collateral?

WITNESS MOLINARO: Probably a little bit of both.

COMMISSIONER BORN: Was there a time when agency securities became unacceptable, then, in March?

WITNESS MOLINARO: My recollection is at that period of time people were not taking agency securities.

COMMISSIONER BORN: How about Treasury

securities?

WITNESS MOLINARO: I don't recall.

COMMISSIONER BORN: When you made the shift from heavy reliance on commercial paper to repo, going from unsecured credit to secured credit, was that solely because you thought that that was a safer and more secure kind of funding? Or were you also seeing the commercial paper market begin to dry up to some extent at that point?

WITNESS MOLINARO: At that juncture the commercial paper market was quite liquid. What we were focused on at that time is we had to have an alternative method of liquidity in the event that the commercial paper market were to be unavailable.

And at that juncture, our model was: In that case, we would take our liquid securities that were unpledged and pledge them against, against committed and uncommitted bank lines.

As the balance sheet grew, we became very uncomfortable with that because our fear was that in a market crisis of any kind, to go out with tens of billions of dollars of securities at that point, even if they were highly liquid securities, we didn't want to rely on whether banks would lend to us, or whether institutions would lend to us in that environment.

So our view was that we would--we knew that the secured financing markets is where we wanted to be; that we would pledge that collateral out; that was a more expensive way to finance the balance sheet, but we thought that that was a cost worth incurring and we would significantly diminish our use of commercial paper.

COMMISSIONER BORN: Did you also consider during this, any of the time in 2007 early 2008, trying to raise equity?

WITNESS MOLINARO: We had--our equity capital ratios are Tier I Ratio under CSC. It was very high. We did not feel that we had an equity capital problem certainly in the summer of 2007 when the crisis kind of first started to develop.

For many years I would say most, most of our investor constituency thought the company was over-capitalized, not under-capitalized. That was a recurring theme that I would have with investors: Why didn't we buy more stock back? And why didn't we reduce our equity? As opposed to increasing it.

So throughout the course of 2007 we felt that our equity capital levels were actually adequate and did not need to raise additional equity capital for any other potential reason other than confidence. And of course our view of that was that that could be a potential double-edged sword.

Going out and raising capital some might view in that kind of an environment as proof that we have a problem. And since we didn't think we had a problem, we decided that that was not the course that we would take at that juncture.

COMMISSIONER BORN: You did raise some long-term debt during 2007, didn't you?

WITNESS MOLINARO: Yes, we did.

COMMISSIONER BORN: How much was that?

WITNESS MOLINARO: I think from the beginning of 2007 to the end we added about $14 billion to our long-term debt position. And I know--I believe in September we did $2.5 billion financing sometime after our third-quarter earnings.

COMMISSIONER BORN: Did you meet with the SEC officials who were involved with the Consolidated Entity Program?

WITNESS MOLINARO: I did.

COMMISSIONER BORN: Did they ever raise issues about the amount of your short-term funding? Or urge you to seek equity, or more long-term funding?

WITNESS MOLINARO: From the time that the Bear Stearns asset management managed hedge funds ran into difficulty in the summer, we were in very steady dialogue with the SEC concerning our liquidity position and the changes that we were seeing in our liquidity position, concerning activity that was going on in our prime brokerage business--because there was some unrest there in the summer of '07 concerning our capital adequacy levels, and concerning our market and credit risk exposures.

So we were in pretty steady dialogue with the staff of the SEC during that period of time.

COMMISSIONER BORN: Did they make any recommendations of actions that the company should take in terms of strengthening its financial situation?

WITNESS MOLINARO: I don't recall them making recommendations, but I do recall extensive dialogue. And my view of that was that they were comfortable with the actions that we were taking and the way that we were managing the situation.

COMMISSIONER BORN: And am I correct that at all times Bear Stearns--except perhaps at the very end--Bear Stearns was in compliance with the net capital requirements, the liquidity requirements, et cetera? Obviously when your liquidity got down to $2 billion at the end, I suppose you weren't--

WITNESS MOLINARO: Right, but up--

COMMISSIONER BORN: --in compliance.

WITNESS MOLINARO: --until that point, we were. Yes.

COMMISSIONER BORN: Let me ask you about your concentration in mortgage-related assets. You were a very large mortgage securitizer and had securitized $113 billion in mortgage-backed securities, and an additional $23 billion in CDOs during 2006.

And by the end of 2007 you held $46 billion of mortgages and mortgage- and asset-backed securities, which was more than 10 percent of your total assets.

I understand that you had made a decision to increase our exposure to the mortgage market sometime during 2007, even as the mortgage market was beginning to experience difficulties. Is that correct?

WITNESS MOLINARO: I don't recall that.

COMMISSIONER BORN: Mr. Spector, can you respond to that question?

WITNESS SPECTOR: I don't recall that either.

COMMISSIONER BORN: All right. Do you feel that this--oh, I see my time is up.

CHAIRMAN ANGELIDES: Oh, I'm sorry. Three minutes?

COMMISSIONER BORN: Thank you. Was this concentration in the mortgage sector a factor in precipitating the run on the company? And did it result in your holding a lot of illiquid assets in that area?

WITNESS MOLINARO: My opinion is that it did factor into the loss of confidence in the Firm, in a very important business to the organization for many, many years that we had been very successful at. I think investors were concerned about what the business model in the mortgage space would be going forward, and whether that would continue to be viable. And of course they were worried about whatever risk we were running, holding $40 billion of mortgage assets at that time.

COMMISSIONER BORN: Do you think that the failure of the hedge funds in mid-2007 when those two hedge funds had been focused largely on subprime securitization--maybe I should ask Mr. Spector this question--factored into the loss of confidence in general in Bear Stearns and its focus on mortgages?

Mr. Spector?

WITNESS SPECTOR: Well I have two comments.

First, I'll say that the two hedge funds were focused on a wide range of asset-backed securities, and not exclusively subprime securitization or subprime securities.

And secondly, I did not observe any loss of confidence in the firm through August of 2007 when I departed.

COMMISSIONER BORN: Mr. Molinaro, do you have a reaction?

WITNESS MOLINARO: Certainly I think during the summer of '07 it was an issue, because I think that the firm had long been regarded as having outstanding risk management culture and practices.

I think our investors viewed us that way and we’re surprised when we found ourselves, if you will, in the headlines as a firm, not the fact that we were running those funds that Mr. Spector has alluded to.

So I think it had--it certainly didn't help, and it certainly undermined confidence to some degree in the summer. I honestly believe that by the end of that year we had restored some of that confidence, and some of that early issues that we were experiencing in the summer of '07 had passed.

COMMISSIONER BORN: Well do you have a reaction why Bear Stearns was the first of the big investment banks to fall?

WITNESS MOLINARO: Well there's no question the market was very concerned about our concentration in these mortgage assets, with very little visibility, if you will, into ours and every other institution's balance sheet to understand how those risks were managed. It was a market that was going through a freefall at that point in time that I think we had managed reasonably well, but I think that for many reasons, including the fact that we were the smallest of the five major investment banks, there was a significant loss of confidence.

COMMISSIONER BORN: Thank you.

WITNESS MOLINARO: You're welcome.

CHAIRMAN ANGELIDES: Thank you, Ms. Born.

But just for the record, I do want to observe--following up on Ms. Born's question in terms of continuing to move forward in an aggressive way in the mortgage environment--I do want to point out that, for example, on March 27th, 2007, Bear Stearns bought approximately $400 million in the Goldman Timberwolf CDO that, by the way, was marked down very substantially a month later.

And on March 29th--and I'd like to enter this for the record--there is a thing called a "Fixed Income Overview" in which Bear Stearns, for Investor Day, March 29, 2007, talks very extensively about kind of its bullishness and its continued and planned activities in the mortgage area, including in February of 2007 the acquisition of a new subprime originator called Encore Credit Corporation.

And you say in here that: Encore Acquisition, February 2007, doubled our wholesale origination capacity and diversified our product mix.

So it is very clear from this presentation that it's full-steam ahead in the spring of '07, Mr. Spector, and you were heading this division. I've got to believe you were aware that you were still moving in a full-steam-ahead way.

WITNESS SPECTOR: Well first of all, I was in 2007, at that point president of the corporation. I was responsible for all fixed-income and all equity sales and trading, the prime brokerage and clearance operations, as well as oversight of asset management.

CHAIRMAN ANGELIDES: So were you not aware of the acquisition of the subprime lender?

WITNESS SPECTOR: So I was--so I just wanted to be clear that I didn't know all the individual activities within the asset management--

CHAIRMAN ANGELIDES: Well I understand that. But you did know that--you did know that you had acquired this subprime lender; correct?

WITNESS SPECTOR: I actually don't recall the acquisition of the subprime lender. The Firm and the Mortgage Department was in the business of originating mortgage product, actually originating mortgage loans through a variety of different entities.

We also had a mortgage conduit that purchased loans from small originators and aggregated them for securitizations.

CHAIRMAN ANGELIDES: Well, yes, I guess, but you were still--yes, you were still number one in this business, weren't you? I mean, this was not unknown to you?

WITNESS SPECTOR: Number one in which business, sir?

CHAIRMAN ANGELIDES: In the securitization business in mortgages. Certainly, for example, for Adjustable Rate Mortgages I think you were number one.

WITNESS SPECTOR: The--I want to answer your question as fully as I can. I think that's a difficult question to answer because there are a lot of different measures that Wall Street firms use to determine league tables.

It is quite common to have five, or six, or seven different firms claiming that they're all number one, for one reason or another.

CHAIRMAN ANGELIDES: Well let's--

WITNESS SPECTOR: Bear Stearns was certainly, unquestionably, a major player in the mortgage securities market.

CHAIRMAN ANGELIDES: Yes. I just wanted to point out that Ms. Born had asked you about your continued activities in 2007 and you said you didn't recall them, and I was just pointing out a presentation done by Mr. Mayer and Mr. Morano in which it details very specific activities, including continuing and expanding activities in the area.

WITNESS SPECTOR: Yes. Ms. Born asked me if I recalled expanding our activity in 2007. And even with the comments you've made and the presentation you allude to, I don't believe--I don't recall "expanding" our activity. It was a continued focus of the Firm. It was a major activity. It was a major business line of the Firm, and we continued to be very active.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman, and thank you gentlemen for taking the time to be with us today.

Obviously the failure within the shadow banking system are in fact the financial crisis. The decline of Bear Stearns, Lehman, AIG, Fannie Mae, Freddie Mac, the freezing of a variety of markets, commercial paper, auction rate securities, lots of securitized vehicles are what transformed a subprime mortgage and housing crisis into a broad, full-blown financial crisis in the United States.

Our goal today I hope is not so much to dig into the details of your particular Firm's difficulties but to understand better what allowed this set of activities and institutions to be so vulnerable to a subprime mortgage shock of this magnitude.

And so I am going to revisit, as a result, some of the territory we have already covered on the nature of leverage in short-term finance, the risk management practices, and how you dealt with liquidity management, and really want to emphasize that in doing so I'd like to get past answers that take the form of what we have heard from Citigroup, which is that no one could possibly have imagined this.

Well, that's true. But if Citigroup had managed its balance sheet against the risks that ultimately it faced, and every institution had followed that practice, we wouldn't have a financial crisis.

So to simply say, geez, we couldn't imagine that everybody didn't do their job is not actually what we're looking for. And I appreciate you taking the time.

I am crippled in this investigation because I'm trained as an economist. I don't actually understand the real world. So bear with me. I'm going to reveal this in several points.

But I want to start with sort of the internal culture of risk management at Bear Stearns, which actually all three of you have spoken eloquently about, and mentioned that even market participants felt that you had very high standards of risk management practice.

But we have had access to this report by Oliver Wyman that's dated the 5th of February, 2008. It's done by outsiders looking at the Bear Stearns risk management, and comes to conclusions that there was no formal framework for risk appetite; that there was no clear process for approval of trades; there was a lack of coherent limit structure and an under-developed process for strategic risk assessment; a lack of mandate for the risk management group within Bear Stearns, and a lack of institutional structure for risk management.

It reads to my eye as a fairly sweeping critique of the very culture that all three of you have praised. And so I would ask each of you, in turn, starting with Mr. Molinaro, to tell me what is wrong with that report; or what you agree with; or how I am supposed to reconcile the report and your testimony.

WITNESS MOLINARO: Well that report was commissioned and initiated--their engagement with the Firm was, was commissioned in late 2007. We were going through changes in the management structure of the organization.

Mr. Spector had left the company's employ in August of 2007. He had been one of the senior-most members of management, overseeing the market risk of the Firm. So we were going through some reorganization internally with new managers--Alan Schwartz ultimately becoming the chief executive--and making changes in some of the procedures that we were utilizing.

The reason that Oliver Wyman was brought in was not to tell us what we were doing well. Oliver Wyman was brought in to tell us what we could do better, and to tell us how to, in the changes that we were envisioning, how to hardwire that process into the organization.

Whenever I have historically talked about risk management with investors through the years, and there's obviously been a great deal of discussion with investors through the years on our risk management practices, risk management started at the top of the Firm. Risk management starts with the organization's appetite for taking risk.

We viewed ourselves as being very careful with the way that we took on market risk, and being highly disciplined with the way that we took on market risk.

COMMISSIONER HOLTZ-EAKIN: Could I interrupt you, with apologies?

WITNESS MOLINARO: Yes.

COMMISSIONER HOLTZ-EAKIN: My understanding--and correct me if I'm wrong--is that, unlike some of your counterparts in the investment banking business you didn't have a firm-wide value at risk limit, and you didn't actually set as a firm an overall appetite for risk? Is that wrong?

WITNESS MOLINARO: We were not--I don't recall, candidly, if we had an override, a firm-wide value-at-risk limit. We were not big believers in VAR. I mean, VAR is a simple measure of risk we felt was inadequate; that there were many other elements of the market risk of the position that VAR did not capture.

We did use scenario analysis to attempt to look at the amount of risk in each of the different businesses that we had.

So to answer your question, I don't really know whether we had a firm-wide VAR limit. We may have later on. I don't think we had one early in 2007.

COMMISSIONER HOLTZ-EAKIN: Well what was the alternative? I mean, how did you set firm-wide risk limits?

WITNESS MOLINARO: Each, each business unit had specific levels of risk that we provided limits for, and I think we did have a stress loss limit that we tried to utilize, that risk management attempted to monitor when they ran stress scenarios across the organization.

COMMISSIONER HOLTZ-EAKIN: Mr. Friedman?

WITNESS FRIEDMAN: I'm afraid I can't be much help on this topic. I wasn't involved with risk. And until the Commission staff showed me that report last week, I didn't even know it existed.

COMMISSIONER HOLTZ-EAKIN: Mr. Spector?

WITNESS SPECTOR: Well that report was commissioned after my departure, possibly somewhat as a result of my departure, and so I am not familiar with it. I have not seen it.

Through my career at Bear Stearns until August I felt the Firm had a robust and effective risk management culture. I thought our chief risk officer was somebody very talented, knowledgeable, senior. We had made a point over the years of beefing up risk management.

We had moved people out of trading positions into risk management. We had substantially, I would even say dramatically increased the compensation of people in risk management over the years so that senior members of risk management were making as much as many of the other senior people in the firm.

We had several senior managing directors in our risk management department. We took it very seriously. It was discussed every single week at a meeting that I attended, and that Alan Greenberg attended, along with all the heads of all the trading areas and the senior people in the risk management group.

They wrote commentary, as I said in my opening statement, but this was very important. We got generally several pages of commentary daily sent to every senior manager of the firm, certainly every member of the Executive Committee and quite a few others, commenting on any concerns that had come up, and that risk management thought needed to be brought to our attention.

So I thought that the overall process was serious, was robust, and worked well. We did report--my recollection is we did report firm-wide VAR. Our firm-wide

VAR was a very low number relative to, frankly, any of the other risk measurements that we used. And so it was something that we tracked, but it was frankly less important than the other measures because they seemed to be more realistic.

Things such as stress tests where, instead of doing some--running through some statistical model that would say, well, 98 percent of the time you are not going to lose more than a few million dollars in this position, seemed less valuable to use and less valuable to me certainly than having the head of the risk management group, or the head of a unit within risk management, say to me, well, if we suffer a decline in this particular area like we did in '98 or '01 or something like that, that unit will lose $150 million, was much more valuable to me than being told that the risk--that the VAR had moved from $3.7 to $3.9 million.

So we did have both, but we focused more on the other elements because we found them frankly more practical, more useful, more easily understood, and more easily managed, too.

COMMISSIONER HOLTZ-EAKIN: Mr. Molinaro, you mentioned that you did scenario analyses. This is a firm that's heavily exposed, without getting into a debate over the numbers, to housing and mortgage markets. What kind of scenarios did you use to guide this very heavy exposure?

And since obviously you got caught on a downside that you didn't anticipate, how do you explain a firm who is so heavily in one area being inadequately prepared on the risks there?

WITNESS MOLINARO: So historically the way that we had looked at scenario analysis is we would frequently talk about worst observable event. We wanted to run these models at the worst observable event, whatever that event was, wherever the crisis was in the market, attempting to at least run real-world scenarios that we could say we had seen.

I think one of the fundamental flaws in the industry's risk management practices, because this is certainly an industry problem, is it is difficult to think about scenarios that have never been observed before. Where do you draw the parameters of that? Where do the boundaries of that discussion go?

So when we ran those scenario analysis based upon worst observable market events, we were certainly attempting to manage our risk profile to mitigate for those types of events, as well as other events that the people running the business, or the risk managers might have reasonably foreseen.

COMMISSIONER HOLTZ-EAKIN: Did you ever run scenarios where housing prices fell?

WITNESS MOLINARO: Not to the degree that housing prices ultimately did fall.

COMMISSIONER HOLTZ-EAKIN: But so--I guess I just find it amazing that you can take the upside. We're in the midst of an unprecedented upside, and not contemplate a larger than historically experienced downside.

WITNESS MOLINARO: I'm not an expert in the housing market, though we had many people in the firm who were. We had many people in the organization, research analysts and others that were viewed as experts in the industry, and I have to say there was--I can't recall any dialogue during my tenure where there was a concern about a nationwide decline in housing prices.

There may have been views about regional issues. There may have been views around issues in the subprime market specifically, but the events that ultimately took place, and the depths of the decline we did not model those and we did not foresee those.

COMMISSIONER HOLTZ-EAKIN: Let me turn to a couple of other things you mentioned that I guess I'm trying to understand.

You said that you had built a financing model that was durable--and I probably have the quote wrong; you mentioned it earlier--over previous financial cycles and shocks. What would those be?

WITNESS MOLINARO: Well, there's been several. There has been several. We could start, at least in my experience, the '87 stock market crash was a pretty significant shock. And we certainly studied the way the financing markets responded in 1987 to that shock, and the way that we were able to finance, and the way that others were able to finance.

We could look at other crisis of confidence that took place over the period from 1987 on to see how the financing markets responded. In 1998 in the crisis in '98, and in other similar stress scenarios, how did the secured financing markets respond to those issues?

Our view was that if we had a crisis of confidence, a market stress or a crisis of some kind, whether it was generic--specific to us, or generic to the market, that access to commercial paper would likely not be there. But we thought that the secured financing markets for highly liquid collateral would be there.

COMMISSIONER HOLTZ-EAKIN: And so both you and I guess Mr. Friedman were in on this decision in 2006 to switch the nature of your short-term financing. What prompted that decision? What did you see coming that wanted you to shift it?

WITNESS MOLINARO: Well as I said, this was an area of ongoing focus. This was not something that we did every now and then. This was something that we were consistently focused on, which is trying to manage the balance sheet liquidity to the greatest extent we can.

And in 2006, after a prolonged robust period in the markets where all of our businesses were growing, our balance sheet was growing, our prior funding model where we had used more unsecured short-term funding, relied upon an alternative liquidity strategy where we would take the unencumbered securities in the event of a crisis and pledge them against committed and uncommitted bank loans.

And what was happening was, as our business was growing it was becoming more difficult to be able to negotiate bank loans that you weren't going to draw on in that kind of size that we thought we needed.

So we made the conclusion that we were going to get away from that strategy because we felt that under a market-stress environment it would fail, and we moved to pledging out the collateral in advance and securing the secured financing in advance of the situation so that we wouldn't have to then be shifting to it in a period of stress.

COMMISSIONER HOLTZ-EAKIN: I just want to make sure I understand this, because there have been some pieces of this that have been confusing to me. You didn't think in a crisis people would accept the collateral that you had for bank loans?

WITNESS MOLINARO: We didn't think in a crisis somebody that wasn't already lending us money would necessarily want to step up and fund in that environment.

COMMISSIONER HOLTZ-EAKIN: Regardless of the quality of the collateral?

WITNESS MOLINARO: Well, since most of our--the highest quality collateral was already out on repo, we didn't want to be in a situation where we would have to pledge equity securities, corporate bonds, and other corporate securities in a stress environment and attempt to borrow money at that time.

So our feeling was that the lenders would be more comfortable with the collateral in their hands, having the relationship--of course they're making more money doing it that way, and our view was that that was a much more sustainable model; and, candidly, we were not unique here. Many other institutions in the industry, particularly the independent investments banks, adopted similar models during this period of time.

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield Commissioner Holtz-Eakin five additional minutes.

COMMISSIONER HOLTZ-EAKIN: Another question I've just been confused by. Why in the moment, even if you had

Treasuries as your collateral, were people unwilling to do repo with you? And why didn't the haircuts just adjust to continue to give you access?

WITNESS MOLINARO: That's a question that we were asking ourselves in that period of time. We were surprised by the way that this was happening. And I think in hindsight, looking back on it, I think many of the institutions that were involved in the overnight repo market with us were getting a lot of pressure inside of their firms about why are we taking--why are we in this position with Bear Stearns if there is a problem?

Even if there's a remote chance that there's a problem, let's get out. And if the crisis passes, we'll come back. And if there's a problem, we're not going to be there.

And I think that I alluded to the fact earlier that when you look at the way that investment banks, when they get in trouble what happens, the prospect for an overnight lender to get embroiled in a bankruptcy situation where the firm liquidates I think was just something most people didn't want to deal with.

COMMISSIONER HOLTZ-EAKIN: Help me with that. They have the collateral, and they own it

WITNESS MOLINARO: Yes.

COMMISSIONER HOLTZ-EAKIN: Why should they care?

WITNESS MOLINARO: Because you're going to have a mass liquidation. Everybody is going to be liquidating at the same time.

COMMISSIONER HOLTZ-EAKIN: Last question. You described your funding strategy as matching the illiquid assets with the long-term funding?

WITNESS MOLINARO: Yes.

COMMISSIONER HOLTZ-EAKIN: And you discussed I guess in your public comments the concept of cash capital.

WITNESS MOLINARO: Yes.

COMMISSIONER HOLTZ-EAKIN: How did you judge the liquidity of particular assets? I mean, this sort of saying you're matching to the illiquid and liquid to make sure you can get the classifications right.

At the end of 2007 you had $227 billion in Level II assets, and $28 billion in Level III assets, and if my numbers are right you had about $12 billion in equity, and $59 billion in long-term debt. Doesn't this raise a significant risk of being able to finance your assets as liquidity changes? And did the risk management structure surface these kinds of concerns?

WITNESS MOLINARO: Well two points. Two answers to that question.

Let's start with Level II and Level III assets. Level II assets are things like U.S.--you know, corporate bonds. So these are not securities that are hard to--they don't trade on an exchange, but they're Level II assets. They're not difficult to ascertain the value of. So I think that that's not really where the issue was.

The assessments that we made about the liquidity of the underlying assets was based upon the collective view of people inside the organization who dealt in these markets on a day in and day out basis. They were the experts in our firm who understood the liquidity of these instruments and the volatility of the assets.

COMMISSIONER HOLTZ-EAKIN: Okay. Mr. Spector, I want to turn to the collapse of the hedge funds.

Why weren't you aware of the underlying problems in those funds and able to take action against their collapse?

WITNESS SPECTOR: Well let me see. First of all, we did become aware of the problems in the funds. And as soon as we became aware of problems in the funds, we began to take action.

We received monthly reports--

COMMISSIONER HOLTZ-EAKIN: And what was that action?

WITNESS SPECTOR: So--let me get to that--we received monthly reports on how each of the funds was doing. When the--when the first bad news came out of price declines in the mortgage market, particularly drops in various indices such as the ABX Index, one of the questions I asked, and that was asked around the firm was, how are the two high-grade funds doing?

We got the report that in fact one of the two funds was profitable, and the other fund was slightly unprofitable. So that the quality of their assets, the type of positions they had, whatever offsetting hedges they had in the book, were successful. So that certainly did not set off any alarms.

Eventually, by some time in I think May but I'm not sure of the date, but certainly in the Spring, it became clear to us that these funds were in fact suffering losses, markdowns, that investors were looking to redeem. And ultimately, as I've said before, repo counterparties began to take--began to call for margin.

The firm took a series of activities--a series of steps to try and remedy the situation. One of the first things we did was we asked senior members of the firm to try and be helpful in advising asset management.

So we asked Mr. Friedman to help on any issues with repo counterparties, and repo agreements. We asked the head of our mortgage department to help look at mortgage positions and see if he could be helpful. We talked to the portfolio management team and to the CEO of Bear Stearns

Asset Management about actively reducing the leverage of the book.

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

WITNESS SPECTOR: The--what we discovered when we talked to the people within Asset Management and asked them to reduce their positions is that they were able to reduce some of the positions quite quickly, which was what our expectation was; they simply put out a bid list, which is a street vernacular for a list of securities they wanted to sell, and sold them. So that seemed like a good first step and leverage was reduced.

So we said: Excellent. Continue doing that. They came back to us, after a short period of time, and said: Well, we've put out another bid list, but we don't have any bids yet. And we said, well, you know, you sold the first securities in a day or two, go ahead and sell more securities.

And they said, well, we're having a problem. And we said, well what problem are you having? And they said, well, we can't actually get anybody in the Street to give us a price, which was a phenomenon that was very surprising.

The more we investigated that, the more it became clear that the securities that they held were in structured deals that were quite complex. And instead of the Street being capable of pricing and therefore making bids on them in a matter of minutes or hours, or maybe a day or two, they needed an extended period of time.

And because the market was in some disarray at that point--certainly prices were falling--they were not able to get prices. They simply couldn't sell their positions. And that's when it became clear that the problem was much more significant than any of us had believed.

At that point, we shifted into meeting at the Executive Committee level almost every single day. We secunded the head of the Mortgage Department to Asset Management. We moved people over from the repo area, from the treasurer's office, the legal department; we moved a whole team of people in. And ultimately, even with all of those people, it was too late.

The repo counterparties kept demanding margin. The prices that they put on the securities didn't go down by small increments, but went down by enormous increments. You would have something that had been marked by a dealer at, you know, 98 or 99, all of a sudden marked at 80, or 70, or lower. And there was a scramble by all the creditors to get as much collateral as they possibly could as quickly as they possibly could, and the funds collapsed.

COMMISSIONER HOLTZ-EAKIN: I thank you, Mr. Chairman. For some bookkeeping, I would like to enter the

Oliver Wyman report into the record.

CHAIRMAN ANGELIDES: So be it.

(The Oliver Wyman report follows:)

CHAIRMAN ANGELIDES: Senator Graham.

COMMISSIONER GRAHAM: --Mr. Chairman--

CHAIRMAN ANGELIDES: Microphone on, sir?

COMMISSIONER GRAHAM: Mr. Spector, you said that Bear Stearns had given a lot of attention to the mortgages that made up its securitized portfolios. Could you elaborate on what you did to try to assure that these portfolios had quality underpinning?

WITNESS SPECTOR: I'm not sure that--I'm not sure that I testified to exactly that, but let me see if I can answer your question.

Bear Stearns was in the business of securitizing a wide variety of different mortgage loans. We securitized loans from very high-quality borrowers with high credit, or FICO scores, generally ones that would be too large to fit into the Fannie Mae and Freddie Mac Programs.

We securitized what were known as Alt A mortgages, which would be one step down the credit curve, all the way down to various types of subprime loans.

The most important aspect of doing that, or certainly one of the important aspects of doing that, was making sure that there was full disclosure on exactly what was the nature of the underlying loans.

The market had an appetite for purchasing different loans with different yields. So the more credit exposure, or the riskier the underlying collateral, the higher the yield would be demanded by the investor. Also, the subordination levels required by the rating agencies would be higher. So there were quite substantial differences between the different securitizations.

And our job as an underwriter of these structured transactions--not an underwriter of the underlying loans but of the transactions--was first and foremost to make sure that the loans that went in were fully disclosed, all the statistics were made available to the investors; and secondly, that the loans that went in in fact matched the description that investors were receiving.

And we had an extensive due diligence team that provided those checks to make sure that that information was correct.

COMMISSIONER GRAHAM: What were some of the principal items of disclosure to your investors?

WITNESS SPECTOR: Senator, I'm going to do my best to answer that question, but I want to make it clear to you that the last time I worked full time in the mortgage department of Bear Stearns was in 1992. So I have a general understanding that the--of what was disclosed, and I don't think I can give you a comprehensive list.

COMMISSIONER GRAHAM: Would you assume that your disclosure list was more or less the standard for the industry? Or was it more or less expansive?

WITNESS SPECTOR: I would assume that there was an industry standard, sir.

COMMISSIONER GRAHAM: Do you know now, several years later, did your securitized mortgages of the same original estimate of their worthiness, did they stand up better, worse, or about the same as similar portfolios being issued by your competitors?

WITNESS SPECTOR: I have absolutely no idea.

COMMISSIONER GRAHAM: Mr. Friedman, you said that at one point I think in 2007 you had advocated that the firm should secure more equity. What was the reason for that advocacy, and how was it received?

WITNESS FRIEDMAN: The reason at the time that I believed it was that it was a step, as we were hearing it from some of our customers and some of our investors, some of our lenders. I don't know that I thought we needed it, per se; but because people thought we did, it seemed a logical approach.

It was received seriously. I wasn't involved in the conversations at the Executive Committee so I don't know how they discussed it, or what the conversations were. I was personally in a couple of meetings with potential equity investors, so I know there were conversations that included reaching out to investors. I don't know enough about the whys and the whereas of how seriously it was taken, or why we didn't do it.

COMMISSIONER GRAHAM: Mr. Spector, do you know? Were you aware that there was within the firm some advocacy for increased equity? And if so, what was the argument pro and con as to whether to pursue that?

WITNESS SPECTOR: There were no discussions prior to my departure in August of 2007.

COMMISSIONER GRAHAM: I note that Bear Stearns, I think similar to your peer group, has based much of its compensation on return on equity. Was any consideration of whether to expand the amount of equity and therefore dilute the positions of current equity holders a reflection of that method by which compensation was going to be calculated?

WITNESS FRIEDMAN: I'm sorry, are you directing that question at me, sir?

COMMISSIONER GRAHAM: I'll direct it to whoever can comment on that.

WITNESS MOLINARO: Absolutely not a factor. I would point out to you that we spent a great deal of time trying to design a compensation method and philosophy in the organization, not only for the senior-most people but for all Bear Stearns employees, that balanced our focus on of course making money and profits for our shareholders, with the longer term well being of the organization.

So all of our, not only all of our senior management but all of our senior managing directors and many of our employees in the organization held significant amounts of stock as part of the design of these plans.

In fact, all of our senior people held five years worth of deferrals of stock at any given point in time. So there was no--if we thought that the best interest of the firm would have been to have raised equity, we would have done so. It was not a factor how the compensation plan was designed.

COMMISSIONER GRAHAM: What percentage of the compensation, let's say first for the highest level executives and then for everyone else, was a function of annual returns?

WITNESS MOLINARO: So the general design of the compensation plans for not only the executive officers of the company but for the most highly paid people in the organization was that half of their total compensation would come in the form of stock that would be subject to a three-year vesting period, and had to be held for five years.

COMMISSIONER GRAHAM: And the--

WITNESS MOLINARO: People that were also senior managing directors, I think even below that to the managing director level and up, so many of our officers in the company, they had increasing amounts dependent upon their compensation levels starting at 25 percent.

COMMISSIONER GRAHAM: Increasing amounts of stock?

WITNESS MOLINARO: So it started at 25 percent of their total comp came in the form of stock. And then escalated up to 50.

COMMISSIONER GRAHAM: All right. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you, Senator.

Just one clarification for the record, though. If you look at the 2006 proxy, apropos of your question, Senator, what it says is, quote, "The Compensation Committee determined that the formula used to calculate the Executive Committee pool" which is the top guys, "would be based on the company's adjusted after-tax return on common equity." Closed quote, period.

Mr. Wallison?

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

As you know, our role here is to find the causes of the financial crisis. And at least at this point, it is not entirely clear to me whether Bear Stearns, and I'll say investment banks in general, or the shadow banking system in general, is a cause of the financial crisis or a victim of the financial crisis.

I would like to make a few comments about some of the things that have been said here, and what my views are about how we should look at this question.

Now it is true that the shadow banking system is unregulated, but its results were not substantially different from the results in the regulated banking system. We shouldn't forget that, although Bear Stearns had problems, terrible problems also existed and resulted in the demise of Wachovia, WaMu, Indy Mac, and of course we've done quite a bit of investigation of Citi.

So all of them actually had very serious problems, just as investment banks had, and other perhaps members of the shadow banking system. And that suggests to me that there was some fundamental underlying cause that affected both of you, the regulated system and of course banks are very heavily regulated, as well as the unregulated system. And that is an important thing I think for all of us to keep in mind.

Now our information is that--and some of your testimony confirms--that Bear Stearns was solvent when it was "rescued" with some government assistance by JPMorgan Chase. And also you expected that you would have a profitable quarter in the quarter in which you were rescued.

So although you'd had a loss in the previous quarter, at the end of the previous year, in this first quarter of the new year you were going to be profitable.

Can you confirm that? Is that true?

WITNESS MOLINARO: That is true. Yes.

COMMISSIONER WALLISON: Now in addition to that, you had billions of dollars in U.S. Government Securities, Treasuries. You said that agencies, which are Fannie and Freddie Securities, were getting hard to finance, but you had billions of dollars in Treasury Securities that couldn't be financed.

Are you aware of anyone else in the market that was having that kind of difficulty?

WITNESS MOLINARO: Actually I'm not sure whether Treasuries could not be financed at that point in time, but I do believe that the market environment in that period was growing increasingly difficult for most of the investment banks that needed to access the repo markets on a daily basis. So I don't think it was unique to us from a general sense.

COMMISSIONER WALLISON: But you were able, you were able I gather to--or you think you were able to finance your Treasuries, in any event?

WITNESS MOLINARO: I don't recall. I don't know.

COMMISSIONER WALLISON: Okay. Now Bear Stearns is significant, it seems to me, because it was rescued. It was rescued when it was solvent. It was rescued when it was profitable. And the implication of that is that any other very large financial institution, larger than Bear Stearns, was also going to be rescued. And that's not something we can ignore.

Because when the time came for problems at Lehman Brothers, there's at least the possibility that the moral hazard created by the rescue of Bear Stearns convinced the market that Lehman was certainly going to be rescued also. And when that didn't happen, I think a huge shock occurred which I think some people would identify as the beginning of what we might think would be the financial crisis, when there was a freeze-up in lending all over the world.

So this whole episode, where Bear Stearns is rescued even though it's solvent, and even though it was having a profitable quarter, is an interesting thing for this Commission to be looking at.

Now I would like to turn to the question of what might have caused this problem. Because everyone who has talked about the problems in the market has talked about the mortgage problems--that is, the fact that there was a huge bubble, and the bubble began to deflate in late 2006, and then finally began to come apart, and the mortgage-backed securities market essentially disappeared in early 2007.

So it became almost impossible to market mortgage-backed securities, except on a very distressed basis, getting very distressed prices in the market.

And I would like to ask you first, Mr. Spector, you have some experience in the mortgage market. You said it ended in 1992, but were you aware as a member of the top management of Bear Stearns of the size of the bubble that had developed in the housing market by the middle to late 2006? Was that something that was discussed around the management table?

WITNESS SPECTOR: I'm going to say two things, if I may. First of all, Commissioner, you said that the--you described the mortgage market in early 2007 as being extremely illiquid and things were only able to trade at distressed prices.

I would describe that as only being accurate for a very small percentage of the mortgage market; that the vast majority of the mortgage market functioned, and functioned well.

And as you go through 2007, more parts of it became distressed, and I can't speak of what happened after August, but it was functioning and we were able to trade in the market for virtually everything that we had.

COMMISSIONER WALLISON: Including your subprime mortgages, or your--

WITNESS SPECTOR: Virtually everything that we had.

COMMISSIONER WALLISON: --backed by subprime mortgages?

WITNESS SPECTOR: Yes. Virtually everything that we had.

COMMISSIONER WALLISON: Okay. Are you--were you aware at the time of the number of subprime and Alt A mortgages that were in the market at the time? And what would you estimate that to be?

WITNESS SPECTOR: I couldn't sit here today and estimate how big that market was. I was generally aware of the growth of the subprime and Alt A market, and in general the growth of the overall mortgage market.

COMMISSIONER WALLISON: Well there is information the Commission has received that about half of all mortgages in the market in 2006, 2007, and 2008 were subprime or Alt A. And so they were, I think you'd probably agree, susceptible to failure much more readily than prime mortgages would be.

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the gentleman an additional three minutes.

COMMISSIONER WALLISON: Thank you.

WITNESS SPECTOR: Certainly subprime mortgages are more susceptible to credit problem than Alt A, and Alt A mortgages are more susceptible in general than prime mortgages, though that gets a little complex when you deal with--some mortgages, some Alt A mortgages may be larger than prime mortgages but the underlying borrowers might actually be better credits.

And I would suggest that when the Commission does its investigation, you differentiate between subprime and Alt A, because I think that there may be substantial differences. And I don't know the percentage of the combined Alt A and subprime, subprime would have been much, much, much smaller than--

COMMISSIONER WALLISON: I gather from what you're saying that this was not a subject that was considered in detail by those who were considering the kinds of risks that the firm was facing in 2007? The size of the mortgage market, the size of the subprime and Alt A mortgage market, the delinquency rates that were beginning to occur there; that was not something that you recall being discussed in detail?

WITNESS SPECTOR: I would say in general within the mortgage department, within fixed-income, and occasionally at the Executive Committee level, but certainly within the department, within the business unit, all of these things were being discussed on a constant basis.

And I think it's important to recognize that, while we describe the billions of dollars of positions that were on the balance sheet of Bear Stearns in the mortgage area, Bear Stearns also had billions of dollars of hedges and short positions.

So I can't tell you exactly at any given point in time what the net exposure was, but the net exposure changed rather substantially from day to day and month to month. But the--but we had a very large active and well regarded mortgage research team.

And despite the fact that they did not predict what happened in the marketplace, they were regarded as expert by most market participants. And there were reams of statistics that were provided to mortgage traders, mortgage managers, the head of the mortgage department, the head of fixed-income, and all the way up to the Executive Committee.

COMMISSIONER WALLISON: My last question. What would you--to what would you attribute the panic that developed in the market by March of 2008 when Bear Stearns faced near collapse, or had to be rescued? What do you attribute that panic to?

WITNESS SPECTOR: Since I left the industry in August of 2007, and put--and from that point forward I stopped paying close attention to the things that I used to pay close attention to when it was my full-time job, I don't have--I don't have an explanation for what happened in March of 2008.

COMMISSIONER WALLISON: Mr. Molinaro, do you?

WITNESS MOLINARO: Well I think I said earlier that--

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the gentleman an additional one minute for the finishing of the questions, and I--well, I'll talk about it in a minute. Go ahead.

WITNESS MOLINARO: I don't think there's any question that the difficulties in the U.S. housing market and the turmoil that resulted in the U.S. mortgage-backed securities market played a large role ultimately in the loss of confidence in Bear Stearns and many other firms in the industry during that period of time.

COMMISSIONER WALLISON: Thank you.

CHAIRMAN ANGELIDES: Mr. Georgiou.

COMMISSIONER GEORGIOU: Thank you, Mr. Chairman, and thank you to the witnesses.

I am going to ask a couple of generic questions and then focus on some more specific ones. You know, we have now heard from a whole parade of witnesses who played significant roles in the public sector and the private sector in connection with this worst financial crisis of all of our lifetimes, which has led to people losing their homes, their livelihoods, and their dignity really. And yet, remarkably enough, almost all of our witnesses seem to cling to what I regard as the somewhat pathetic mythology that this crisis occurred without anyone doing anything wrong in either the private or the public sector, or anything significantly wrong.

And together the three of you served for the better part of 100 years, most of your professional lives, with Bear Stearns, which is an 85-year-old firm that was profitable for each and every year of its life until it was eviscerated basically in the Spring of 2008.

So I would like--now that you have had two years to reflect upon it--I would like each of you to dig deep and try and help us do our job by identifying the contributors to the collapse of Bear Stearns. That is, what did you personally do that you wish you had not done? And what did you not do that you wish you had done that could have avoided the demise of Bear Stearns?

Maybe I will start with Mr. Friedman in this case.

WITNESS FRIEDMAN: I would be willing to guess that there's probably barely a day that has gone by in the last two years that I haven't asked that same question of myself.

At the level of what could the firm have done differently, I am not sure. I don't know--you know, as may be obvious here I am a funding guy in a lot of ways, and so I tend to think in terms of money. I'm not a mortgage trader. I'm not the CFO. I think in terms of money.

I can't imagine envisioning a situation like we had starting in the Summer of '07 and the Fall of '07 where we approached banks to talk about borrowing money and they would turn to us in the middle of the meeting and go, oh, we thought you were here to lend us money.

So I want to feel that I should have envisioned that the underpinnings of the world financial system, of major financial institutions who are in the business of lending money to others, not just to Bear Stearns but to each other and to highly rated financial institutions, would unravel in the way it did.

I would like to think I should have seen that coming. I would like to think we should have seen that coming. I don't know how we could have. I am a believer that that is a significant portion--yes, there's no question, the acceleration of the housing bubble, the growth of the subprime lending, all of these things contributed to it. I am a believer that what exacerbated the problem was a liquidity problem.

COMMISSIONER GEORGIOU: But that liquidity problem meant that you couldn't finance assets that you had on your balance sheet that people regarded as highly financeable, and then they became effectively unable to be lent against.

WITNESS FRIEDMAN: No, sir. I'm suggesting it was a much larger issue. There were days in the money markets in August and September of 2007 having nothing to do with Bear Stearns where major international banks announced that they were not lending that day to anyone. They had no money.

It is hard for someone who wasn't in the trenches living it to appreciate how that resonated through the markets, but it created a sense of--"panic" is too strong a word, but a sense of fear among market participants that rippled into unwillingness to lend, and unwillingness to buy securities for fear of being unable to sell them at a general decline in the securities market, both the purchase and sale markets as well as the lending markets.

COMMISSIONER GEORGIOU: And don't you think that the quality of those securities, that people's doubts about the quality of those securities had a significant impact on their unwillingness to buy?

WITNESS FRIEDMAN: There was no question that, you know, someone has used the reference that I read once to e. coli, that if you're worried that some food is infected you're afraid to buy any food. I understand that. And there's no question that concern about the nature of assets generally was in the market and was affecting people's behavior. I do agree with that.

COMMISSIONER GEORGIOU: And how involved in the securitization process were you personally in your career at Bear?

WITNESS FRIEDMAN: Not at all. It was not what I did for a living.

COMMISSIONER GEORGIOU: Mr. Molinaro?

WITNESS MOLINARO: I was also not involved in that.

COMMISSIONER GEORGIOU: Mr. Spector?

WITNESS SPECTOR: I had been involved in the securitization business in the late '80s and the early '90s, and then from that point forward I was involved as senior management.

COMMISSIONER GEORGIOU: Okay. Well I'm going to skip that line of questioning then.

Let me ask, have any of you looked at this report that the Inspector General did of the Securities and Exchange Commission with regard to the Consolidated Supervised Entities Program? We're going to have from him later today, Mr. Kotz. Are any of you familiar with it at all?

WITNESS FRIEDMAN: I am not.

WITNESS SPECTOR: No, sir.

WITNESS MOLINARO: I have had some excerpts shown to me, but I have not read that whole document.

COMMISSIONER GEORGIOU: I mean, do you think that you were adequately regulated by the Consolidated Supervised Entities Program, which now has been abandoned even by the SEC, and most people regard as a failure? Do you think that government regulation in any way with regard to either your capital or your liquidity or your risk assessment practices, or in any other way, could have assisted Bear Stearns in surviving beyond 2008?

WITNESS MOLINARO: That's a very difficult question to answer. I can only tell you that in my experience in dealing with the SEC throughout the CSE process and even before, they had knowledgeable people. They asked us very probing and appropriate questions. They showed knowledge of the issues. They were spending a great deal of time with us, and I presume with others, during this period of time.

So from my perspective it's hard to see what they could have done differently. I guess they--as I said earlier, it wasn't that they recommended us to do other things, or pushed us to do something different; and I viewed that not as a failing on their part, but as they were generally comfortable with the way that we were dealing with an evolving situation that ultimately spiraled in an out-of-control way.

COMMISSIONER GEORGIOU: Okay. I mean, my fellow

Commissioner Wallison has made the consistent point that the subprime mortgages that underlay a lot of these mortgage-backed securities were suspect all along the way, and that their collapse was a significant factor in the financial crisis.

A number of the securities that you folks originated--that people under your direction basically originated at Bear Stearns were either mortgage-backed securities, or collateralized debt obligations which were constructs of very low-rated tranches of a whole variety of mortgage-backed securities which miraculously were sliced and diced into AAA and AAA+ related securities; then synthetic CDOs when there weren't enough tranches to turn in.

Do you think that that process--at what point do you believe that you should have known that the underlying elements that underpin those securities would at some point come to everyone's attention and create the impression among everyone that those securities were worth less than they were represented to be worth, and hence people refused to lend against them, or gave you such a haircut that it eliminated your liquidity pool. Mr. Molinaro?

CHAIRMAN ANGELIDES: Time is up. I will give two minutes to just answer the question, if we could do that quickly.

COMMISSIONER GEORGIOU: Thank you. Mr. Molinaro?

WITNESS MOLINARO: I was the Chief Financial Officer of the company. I was not directly involved in the mortgage securitization area. It would not have been something that I would have been particularly focused on.

COMMISSIONER GEORGIOU: But weren't those mortgage--weren't some of the assets that you held assets that people ultimately refused to lend against? Or only lent against with significant haircuts, which led to your liquidity--led in significant part to your liquidity losses? That's GSEs, private label mortgage securities, and others.

WITNESS MOLINARO: I think only a relatively small portion of the asset pool in question were actually subprime-backed loans. I think there were more of the prime and Alt A variety of loans, at least on our balance sheet, to my recollection.

COMMISSIONER GEORGIOU: Mr. Spector?

WITNESS SPECTOR: Yes. That--I can't talk about what happened in 2008, obviously--but that's consistent with my recollection, which was that the firm's market share was dramatically lower in the subprime area than actually in the Alt A, adjustable rate, and other primaries in the mortgage market.

COMMISSIONER GEORGIOU: But those also got marked down, and those became exceedingly difficult to finance in ways that didn't impact on your capital. Isn't that correct?

WITNESS MOLINARO: All of those securities became difficult to finance, yes.

COMMISSIONER GEORGIOU: Right. And nobody had any way to evaluate that prior to the end game? Is that what you're saying here today?

WITNESS MOLINARO: I think that the fact of the matter is that none of us foresaw the degree of problems that would exist in the U.S. housing market, and how rapidly we would see defaults rise, and how quickly home prices would decline. Was that an error? Obviously in hindsight we missed it, along with many, many others, but we did not foresee that at the time.

CHAIRMAN ANGELIDES: All right. Thank you.

Mr. Hennessey?

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman. I guess I'm batting cleanup here.

CHAIRMAN ANGELIDES: No, Ms. Murren is after you. I'm just rotating in the spirit of the bipartisan commission.

COMMISSIONER HENNESSEY: Second-to-the-last. Excellent.

Okay, just one quick comment, which is that I believe I agree with Peter that I'm not sure we've got Bear

Stearns in the right hearing. Because this is a hearing on the shadow banking market, and it seems to me that Bear should be in a hearing on what happens when you have too much leverage and too much reliance on short-term financing.

For this to be a story about different regulations in different financial institutions, we need to understand what happened to Bear relative to WaMu and Wachovia, insured depository institutions that also faced runs, and just failed in a different way because the FDIC bailed them out.

But let me go to my question, which is, I am helping teach a class at a business school now, and we're spending part of our time talking about the financial crisis. And what I've done here is I've tried to write down the story as I would explain it to the business school students of what I think happened with Bear Stearns.

So I want to read through that and then ask you all to comment on this explanation of what happened based on what I've heard here, and prior knowledge, and help me correct the story and see if I get it right.

So Bear Stearns was not one of the biggest investment banks. Bear Stearns tried to grow quickly to be much bigger. They did this by increasing their leverage to be in the range of 35 to 1, or 40 to 1, compared to tangible common equity.

They did this largely by betting on housing-related assets. Their bet was therefore largely concentrated in one sector.

Mr. Friedman, you were heavily involved in the implementation of these housing-related investments and this concentration of risk.

Like many other banks, Bear Stearns relied on overnight financing, short-term financing for liquidity. Short-term financing is significantly cheaper than long-term financing, allowing Bear to earn higher profits. Short-term financing is also riskier than longer term financing because of counterparty risk.

Now, Mr. Molinaro, you led a shift from unsecured commercial paper as a short-term financing mechanism toward secured overnight repurchase agreements. The idea was that the added counterparty risk of relying on overnight financing was outweighed by the reduced risk from having secured financing.

For awhile this strategy, combining extremely high leverage, concentrated bets in the housing market, and reliance on short-term financing worked well. Bear Stearns grew and was profitable.

Even after the housing market peaked, Bear continued to make highly leveraged bets on the housing market. They did not de-lever significantly, in effect doubling down on their prior bets. This strategy of big, concentrated bets financed by overnight financing failed even though that overnight financing was secured.

While Bear Stearns argued they were profitable and solvent at the time, some investors made judgments that Bear Stearns was a credit risk and refused to roll over repurchase agreements even though those borrowing needs would have been secured.

Whether those judgments were substantiated or not, legitimate or not, a liquidity run began against Bear Stearns. Bear Stearns argues that the liquidity, the tightened liquidity was system wide rather than firm specific, but we know there was something that differentiated Bear Stearns from other similarly situated firms because Bear Stearns failed first.

Either Bear Stearns's firm leaders were wrong and the problem was firm-specific credit risk, more than system wide liquidity risk, or Bear Stearns was more vulnerable than other firms to a system wide liquidity shock. Whichever reason is true, Bear Stearns was not prepared for a scenario in which they could not get secured overnight financing.

Bear quickly ran out of cash and faced impending liquidation. JPMorgan expressed interest in buying Bear Stearns, but only if the transaction was subsidized. The

Fed provided that subsidy, and JPMorgan bought Bear Stearns.

So maybe if we could start with Mr. Molinaro, then Mr. Friedman, and then Mr. Spector. Could you correct this story?

WITNESS MOLINARO: Where would you like me to start?

COMMISSIONER HENNESSEY: Anywhere you like.

(Laughter.)

COMMISSIONER HENNESSEY: Wherever you think I made the most grievous mistakes.

WITNESS MOLINARO: I think there--I don't want to be critical of your assessment of the situation--

COMMISSIONER HENNESSEY: I am asking you to be critical. I am asking you to correct it.

WITNESS MOLINARO: I think that there are--that it's much, much more complicated than even that quite articulate explanation was.

I think that you really--it's not a simple issue. It was not simply an issue of the shadow banking system, as you're calling it. You certainly have to look at what was happening in the housing market. You certainly have to look at what was happening with some of the policies that were being adopted to facilitate a more robust housing market, and the growth that we saw in housing ownership as well as in mortgage-origination activity, really from 2002 to 2007.

You have to look at the use of off-balance sheet vehicles. You have to look at the SIV market. You have to look at many, many factors that played into this issue.

Some of what you allude to is true. Bear Stearns was a large, relatively large investment bank. While it was the smallest of the five remaining, you know, biggest investment banks, it was certainly large with a $400 billion balance sheet.

We touched many counterparties in the market, not only repo lenders, both buyers of our long-term debt, buyers of our commercial paper, our equity holders, preferred stock holders, many, many constituencies.

COMMISSIONER HENNESSEY: Let me interrupt you. You've said that I've left out lots of elements of the story and it's more complex. What elements of the story that I've described are incorrect, rather than incomplete?

WITNESS MOLINARO: Well I would say we did not make a--I think you used the term we "doubled down," or we made a concentrated bet. We did not do that. We were pursuing a business strategy of trying to build our firm. And we had, I think, a pretty diversified organization.

In 2006 I believe we had almost $9.5 billion of revenues. That was widely diversified across the Firm--in fixed income and equities, prime brokerage, a number of different businesses.

COMMISSIONER HENNESSEY: So is it correct to say the Firm was highly leveraged? Or incorrect to say the Firm was placing a concentrated bet on housing-related investments? Or incorrect to say that as housing prices were declining that it's unfair to characterize it was doubling down to say that they maintained that concentrated bet? Which element is wrong?

WITNESS MOLINARO: I think it is unfair to say that we were doubling down, but that's just--that's my view of it. We had a large business in the fixed-income markets. And we had a large business in the mortgage-backed securities market that had been an industry leader for many, many years.

We were viewed as one of the top firms in the business of doing this. And that market came unglued. And should we have seen it? Should we have seen it coming? Should the whole industry have seen it coming, is probably the--is the question?

You know in hindsight I guess we should have, but nobody did. These are scenarios that nobody could envision--or nobody did envision, whether they should have or otherwise.

COMMISSIONER HENNESSEY: Mr. Friedman?

VICE CHAIRMAN THOMAS: Would the gentleman yield, briefly?

COMMISSIONER HENNESSEY: Please.

VICE CHAIRMAN THOMAS: Prior to extending the gentleman an additional three minutes, is it possible to structure this so that you would respond to the Commissioner's question with some specifics? But prior to that, could I ask each of you that if we submit additional questions in writing, that you would be willing to respond to us?

Because clearly some of these questions need a far stronger, longer, more complete base to get answers that we need. So could I put the question directly to you? Would you be willing to answer questions that we submit to you in writing?

WITNESS FRIEDMAN: Yes, sir.

WITNESS MOLINARO: Of course.

WITNESS SPECTOR: Yes.

VICE CHAIRMAN THOMAS: Thank you. Three minutes to the gentleman.

COMMISSIONER HENNESSEY: Right. Thank you.

WITNESS FRIEDMAN: Commissioner, I only started taking notes in the middle of what you were saying, so I may have missed it.

COMMISSIONER HENNESSEY: But some things must have jumped out at you as, no, that's just--

WITNESS FRIEDMAN: Yes, they did.

VICE CHAIRMAN THOMAS: Oh, you'll get them in writing.

WITNESS FRIEDMAN: Okay. You made the statement, I believe, that Bear Stearns made a decision to increase its leverage.

I think if you look you will see that the leverage, particularly the adjusted leverage which is how we looked at it, which is net of loans and other things where we did not have first-dollar risk, I think you will see that that was fairly consistent, if not trending downward over the years.

More importantly, this notion of Bear Stearns' reliance on overnight financing, which has been used a lot tonight, this morning. The reliance on our funding model was to rely on short-term financing only for the most liquid assets.

By the way, someone--I didn't correct it earlier. The question was asked about whether or not we were able to finance Treasuries the final week of Bear Stearns. There was no one who stepped away from financing Treasuries. Commissioner, I believe that was your question. I didn't feel it was appropriate to step in there.

So the most highly liquid assets were in fact financeable, even though they were on a short-term basis, even though Bear Stearns was perceived as a weak counterparty right up until the Friday where JPMorgan stepped in.

COMMISSIONER HENNESSEY: Well then let me press you on that, because we've heard that the issue here was that liquidity tightened up across the board. Then why did Bear fail, and not other firms, if it was not firm-specific?

WITNESS FRIEDMAN: I think what you saw, starting with Bear Stearns, was a--Bear Stearns followed by Lehman Brothers, Lehman was larger than Bear and smaller than the other firms. So Bear was the smallest. Bear went first. Lehman went second.

COMMISSIONER HENNESSEY: So it was size, and the same shock affecting Lehman six months later?

WITNESS FRIEDMAN: I believe so.

COMMISSIONER HENNESSEY: So you believe there were no firm-specific factors that caused Bear to fail other than it being smaller than the other four large investment banks?

WITNESS FRIEDMAN: I think the similarity between Bear and Lehman was a perception that the mortgage-backed securities market was a significant portion of their business--which it was for both firms--and a belief, not particularly founded in fact, that losses in that sector were going to destabilize or destroy the firms.

COMMISSIONER HENNESSEY: Okay, but then it was a firm--it wasn't that creditors were unwilling to provide financing to large investment banks; it's that, whether they were correct or not, they were looking at Bear and making a judgment that I don't want to loan money to this firm?

WITNESS FRIEDMAN: They made that decision about Bear Stearns, and then they made that decision about Lehman Brothers, and then they made that decision about Morgan Stanley, Merrill Lynch, and Goldman Sachs.

COMMISSIONER HENNESSEY: But that suggests to me that it's firm-specific counterparty risk, not a generalized liquidity problem in the market where nobody wants to loan to any of the large investment banks.

WITNESS FRIEDMAN: I would say that there's some truth to that. I would say but mostly lenders were doing some degree of triage. And to the extent that they had their own liquidity issues, and to the extent that they had their own concerns, they were starting with the firms that concerned them the most and we were the smallest.

COMMISSIONER HENNESSEY: Okay. Just following up on Mr. Thomas's point, what I would like to do is I will submit the little story that I told and ask if you could come in and help me correct that story, both pointing out where it is incorrect and where you think it is incomplete.

WITNESS FRIEDMAN: That would be fine.

CHAIRMAN ANGELIDES: Thank you, Mr. Hennessey.

Ms. Murren.

COMMISSIONER MURREN: Thank you.

Gentlemen, I would like to follow up on the discussions about corporate governance and compensation and corporate culture.

One of the charges of the Commission is to examine the causes of the financial crisis, and in particular the Wall Street culture. Also, to look not only at cross-cutting themes and how people are paid, especially as it relates to taking on risk, but also firm-specific issues.

And it is striking to me that we've heard now from you and also from Citibank, and I believe in exactly the same language, that you each believe that your firms had very robust risk management systems; that you felt that your compensation was not unduly weighted towards taking on more risk; and that you felt comfortable with your company's corporate governance.

Is that fair?

(The three witnesses nod in the affirmative.)

COMMISSIONER MURREN: Yes?

WITNESS MOLINARO: Yes.

WITNESS FRIEDMAN: Yes.

WITNESS SPECTOR: Yes.

COMMISSIONER MURREN: Let the record show that everyone affirmed that. Do you think--judging from what you've said, you believe that market participants and observers also had that same opinion, but from what I observe in looking at some of the commentary--and I would like to enter a document into the record, which is a report from the Corporate Library of 6/20/08. The Corporate Library Report is an analysis of corporate governance. It's often used by institutional investors when they vote their proxies. It's very well respected. You may be familiar with it.

(The report follows:)

COMMISSIONER MURREN: But what it says in here actually is that Bear Stearns' companies was given a D rating for its corporate governance; that in fact the rating reflects a high degree of governance risk; that the compensation merits a very high level of concern.

They further go on to note that the top five executives are paid almost as much as--or the top five executives are paid from one bonus pool, and everyone else is paid from another; that the four executives that immediately report into the CEO make almost as much as the CEO does. And I believe in the fiscal year 2006 that the combined income of those top five people was $156 million for the year.

And, that in 2006--and back to our question about return on equity--that there is a performance criteria portfolio that the management uses to determine its compensation. There are nine elements of that. But in the 2006 year the management team chose to only use one, and that was return on equity for pay in that year.

I am curious as to whether you could comment on whether you feel that this is an accurate reflection of your corporate governance.

If you could start, Mr. Molinaro, you are a member of the Executive Committee, I believe?

WITNESS MOLINARO: I was. I'm not familiar with that report, so I'm not going to be able to speak directly to that.

You mentioned that the management had selected return on equity. That is not the case. The Compensation Committee of the Board had selected return on equity. It had been return on equity for many years. That had been the measuring stick by which the executive management would receive their compensation.

We did get paid out of a pool that was tied to the firm-wide results, because we had firm-wide responsibilities. Other people in the organization were paid more specifically on their individual contribution to the firm, and their business unit's contribution to the firm.

So we spent a great deal of time trying to make sure that we had the interest of the senior management team and all of the employees properly aligned with the interest of shareholders.

And the way that we had attempted to institute that was by requiring significant stock ownership on the part of all of the senior managers, as we've talked about earlier in this discussion.

So we did what we thought was the appropriate course of action. We tried to run the company in a way that I read a lot about today--you know, that Wall Street needs to go back to the old partnership models, when it was the partners' money that was on the line, as being a better way to run these organizations. And we attempted to run our company in that way at all times.

COMMISSIONER MURREN: Any comments from Mr. Friedman and Mr. Spector?

WITNESS FRIEDMAN: I wasn't involved in the compensation process. I wasn't part of the--other than having been paid, I wasn't part of the Executive Committee, so I can't comment on that.

I will echo Mr. Molinaro's statement that, speaking for myself and for most other people, we did feel like it was a partnership. We did feel like it was our money on the line, and we behaved as if it were.

COMMISSIONER MURREN: If I could--if I recall correctly, though, you have in the past been critical of the corporate governance of Bear Stearns. Is that not right?

WITNESS FRIEDMAN: As I said earlier, in a moment of passion and anger I was critical, yes.

COMMISSIONER MURREN: And the nature of that criticism was what?

WITNESS FRIEDMAN: Um, I went looking for almost everyone I could find to blame for what had happened to Bear Stearns.

COMMISSIONER MURREN: But specifically on the issue of corporate governance, could you explain what your concerns, or what your feelings had been at that moment of passion?

WITNESS FRIEDMAN: I felt that the firm should have done more at the time to prevent what happened.

COMMISSIONER MURREN: Thanks.

Mr. Spector?

WITNESS SPECTOR: I'm sorry? What question do you have for me?

COMMISSIONER MURREN: It was just your comments on whether you think that these assessments of corporate governance of Bear Stearns and the compensation structure were accurate that were done, that were reflected in the report that I cited.

WITNESS SPECTOR: So I'm not familiar with this report. I know that various firms wrote reports and made recommendations on whether or not to vote in support of management on various proposals.

One of the things that was brought to our shareholders every years was the management compensation plan. And it received an overwhelming majority every time.

The compensation plan for the senior executives was based solely on profits. And it was only paid if in fact the firm was highly profitable.

In addition to that, it was approved, reviewed and approved by the outside directors who form the Compensation Committee of the Board.

You referred to there being two compensation pools, and I want to clarify that. We felt it was essential that the Executive Committee be reviewed by the Board and be approved by the shareholders. And the other senior managing directors were also reviewed by the Board, but primarily the work was done by the Management and Compensation Committee of the Firm.

Nevertheless, as a firm one of our targets was that we managed to firm-wide compensation ratios to net revenues. And when doing so, took into account all the compensation paid to all individuals within the firm.

COMMISSIONER MURREN: A point of clarification, though.

Mr. Molinaro, you just told us that the comp was based on return on equity. Was that what it was based on?

WITNESS MOLINARO: The Executive Committee's pool, as I recall it, that was part of the plan that Mr. Spector alluded to had a variety of potential metrics that the compensation could be tied to. And my recollection is that the metric that was used by the Compensation Committee of the Board was return on equity.

COMMISSIONER MURREN: Thank you.

On the issue of risk as it relates to governance, you have mentioned that you felt that the Firm had a fairly robust risk management process, and I assume that that went all the way up to the Board level. Is that correct?

WITNESS MOLINARO: That's correct.

COMMISSIONER MURREN: And there was a subcommittee of the Board that dealt with finance and risk?

WITNESS MOLINARO: There was a subcommittee of the Board--well, there was the Audit Committee, which dealt with many, many issues. And there was a Risk Management Committee that I believe was formed in the beginning of 2007 that dealt with market credit and financing risk, specifically.

COMMISSIONER MURREN: And do you recall why that was formed?

CHAIRMAN ANGELIDES: An additional minute.

WITNESS MOLINARO: My recollection is that we had felt partially in dialogue with some of the same organizations that rate corporate governance matters that this was an evolving best practice, and we chose to adopt that and remove the reporting of many of these items from the Audit Committee's already pretty full agenda and move it into a separate committee.

COMMISSIONER MURREN: Would it be fair to say that this move was undertaken in order to be viewed favorably by rating agencies and corporate governance advisory organizations?

WITNESS MOLINARO: I don't recall it being done for specifically that reason. I do recall it being what we viewed to be a best practice, and that other organizations were doing that, and that we should--it made sense to do the same.

COMMISSIONER MURREN: If I could please enter into the record the minutes of the Board meeting, which I believe takes place here on January 10th of 2007, which states that it was undertaken to be viewed favorably by rating agencies and corporate governance advisory organizations.

(The document follows:)

COMMISSIONER MURREN: How important was the subcommittee of the Board? How often would you say it met relative to the Executive Committee? And I note here that the Executive Committee was in fact comprised of the top five highest-paid employees at Bear Stearns. What was the relative importance of those two groups?

WITNESS MOLINARO: Well the Executive Committee was made up of the five senior-most executive officers of the company. I don't know if they were necessarily the highest paid, but they were the ones that were reported in the proxy.

The Executive Committee met at least weekly, and more frequently as needed. The Board committees that you're referring to, I think you're referring specifically to the Risk Management Committee?

COMMISSIONER MURREN: Um-hmm.

WITNESS MOLINARO: I believe it met at least quarterly.

COMMISSIONER MURREN: It would appear that in the document that I cited earlier from the Corporate Library that the Finance and Risk Committee met twice in the '07 year, as compared to the Executive Committee, which met 115 times.

So to me it would suggest that the Executive Committee was far more influential in terms of determining risk than perhaps the Risk Committee was itself. Would that be a fair statement?

WITNESS MOLINARO: I think it's a fair statement to say the Executive Committee was the committee that was managing the Firm, effectively, at that time and we were reporting to the Board on governance matters.

I think the Board--the committees in question at the Board were not only the Risk Committee but the Audit Committee. And again, I don't know exactly how many times those committees met in 2007, but we did have frequent dialogue with the Board members.

COMMISSIONER MURREN: Thank you.

CHAIRMAN ANGELIDES: All right. Thank you.

Gentlemen, just a couple of wrap-up items. That is, I want to pick up on something that Mr. Georgiou said, but also really following on the questions of other Commissioners just about the extent to which Bear Stearns had a responsibility and opportunity to manage its own affairs in a way to maximize its potential of survival.

And as I said in the beginning, throughout this whole hearing process, and again today if you were to listen to all the testimony it appears the financial crisis was an immaculate calamity. No one was responsible for anything.

But, you know, in the big picture, stepping back, even the other big investment banks, enormous leverage; very concentrated bets in areas like subprime and Alt A mortgages; reliance on short-term funding subject to a run; and therefore, to wit, setting up a situation where if market turbulence comes, there's going to be a problem.

And so I want to actually make this specific, though, because there seems to be this notion that no one could have told--or could have seen anything, and it was all beyond people's control.

And I think, just to make this real, Mr. Spector I want to ask you a couple of questions, because you did say that as a result--in your testimony--as a result of the mortgage department's success, I was given broader responsibility within Bear Stearns, became responsible for fixed-income, but you continued to be responsible for the continued growth in the mortgage area.

So let me just go right at you and ask you: What didn't you see in terms of the risks that were happening under your watch?

In September of 2004, the FBI warns of an epidemic of mortgage fraud which could become the next S&L crisis.

On June 16th, 2005--and you spoke a lot about robust risk management--The Economist Magazine has this cover: "House Prices After The Fall," and the lead on the story says: The day of reckoning is closer at hand. It's not going to be pretty, How the current housing boom ends--this is 2005--could decide the course of the entire world economy over the next few years. Housing price growth is 11 percent in 2003, 15 percent in 2004, 15 percent in 2005.

Subprime mortgages are growing like weeds. Jim Grant in his October 5th newsletter says, estimates that AAA tranches of CDOs would begin to experience losses in the event that national home prices were to fall 4 percent or less over 2 years.

He estimates that if prices were to fall 10 percent, investors of tranches rated AA- or below would lose all their investment.

From 2000 to 2006 in this country the amount of mortgage debt doubled. Americans borrowed more in mortgages in that six-year period than the whole 225 year history of this country.

I guess I would ask you, even as late as March 2007 you have a dozen subprime lenders who have closed, suspended businesses, or gone bankrupt.

I guess I would ask you: What didn't you see? Didn't you see the red and yellow warning lights? And what did you do responsible for fixed-income to build a fortress of protection?

WITNESS SPECTOR: Well first of all I want to make a distinction between being in the mortgage securities business and having a bet on housing prices.

Bear Stearns was in the business of originating or acquiring loans, securitizing them, and selling them in the marketplace.

We ran a book that had both long- and short positions. We did our best to manage our exposure as more information came out in the marketplace on a continuous basis over the years. And we tried to help our clients by giving them the best possible analysis that we could about the state of the mortgage market as we understood it.

We as a firm did reduce our market share and position in the subprime market in 2006 and 2007. We focused more of our origination and trading activity on areas that we thought were higher quality.

And so I believe that through my career through August 5th of 2007 we did a good job of managing the mortgage business.

I'm not saying that when I left that we had anticipated a dramatic fall in mortgage prices. Of course not. But I thought that we had managed the business well. The firm was profitable through my departure. And the business was in good shape.

CHAIRMAN ANGELIDES: So your position is that it worked well?

WITNESS SPECTOR: Yes, sir.

CHAIRMAN ANGELIDES: All right. So be it.

Mr. Vice Chair, you had a concluding comment?

VICE CHAIRMAN THOMAS: Actually a question based upon those responses, because in questioning I believe it was from Commissioner Murren of Mr. Molinaro, I believe, but the question was: Could you get purchasers for some of your securities? And you answered, I think, that you had no problem with Treasuries?

WITNESS MOLINARO: We were able to finance Treasuries.

VICE CHAIRMAN THOMAS: You were able to finance Treasuries. But I think you said you couldn't finance it from other agencies?

WITNESS MOLINARO: I think we had difficulty in that week of March, particularly in the last Wednesday and Thursday, because that was a very fast-moving environment, financing mortgage securities broadly, agency securities and non-agency securities.

VICE CHAIRMAN THOMAS: And did that have anything to do with what was happening to Fannie Mae and Freddie Mac at the same time?

WITNESS MOLINARO: I don't really know the answer to that.

VICE CHAIRMAN THOMAS: You don't know the answer to that. Do you know what was happening in terms of Fannie Mae and Freddie Mac during that period?

WITNESS MOLINARO: Well I do recall, but, but I wasn't the one on the line talking to the clients, so I don't know what the reasons were.

VICE CHAIRMAN THOMAS: All right. But it just seems to me that the impending failure of Fannie Mae and Freddie Mac certainly would have puckered up the market on agency-backed securities as opposed to Treasuries.

Thank you for your willingness to answer questions. And, Mr. Spector, I want to assure you that I will personally screen every question sent to you, and it will not pertain to anything after August 5th, 2007, so that it would be relevant to your role.

Did any of you ever compare or contrast yourself with other firms, the discussion about Solomon versus--or Lehman versus Bear Stearns? A lot of times people will, would I rather be me or him, would you rather be us or them, did you ever in any way compare yourself as you were getting into this problem area, with others and wonder how they were doing at the same time you were worried about what was happening to you?

Did you discuss it with anybody in other firms? Was there a familiarity with people in your positions?

WITNESS MOLINARO: I think that we certainly tried to compare ourselves to the other firms as the best we could from the standpoint of--

VICE CHAIRMAN THOMAS: And did you feel good about yourself right up until the end, compared to others?

WITNESS MOLINARO: I would say, as compared to others, generally speaking over a long period of time we always felt good about the way that our balance sheet and our business was run.

VICE CHAIRMAN THOMAS: And, Mr. Chairman, I do want to conclude on a very positive note. I want to thank you for coming before us, and frankly one of the interests that I had in Bear Stearns was that it seemed to be a very stable company, a lot of promotion from within, so that your perspective would cover not just as a company but as individuals that whole period of the significant shift from the '80s and the '90s into the 21st Century. And we will have additional questions as we learn more based on what you knew, felt, or saw during that period. And I want to thank you very much for your participation.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you very much. Thank you very much, Witnesses, for being here.

We will take a short break and we will recommence at 12:15.

(Whereupon, a brief recess was taken.)

CHAIRMAN ANGELIDES: The meeting of the Financial Crisis Inquiry Commission will recommence. Welcome to our second session of the day.

Mr. Cayne and Mr. Schwartz, thank you for being with us today. What I would like to do to begin this session is do something that is customary for all our witnesses. I would like to ask both of you to stand and raise your right hand as I administer the oath.

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

MR. CAYNE: I do.

MR. SCHWARTZ: I do.

(Witnesses sworn.)

CHAIRMAN ANGELIDES: Thank you.

Gentlemen, thank you for being here today. You have already submitted to us your written testimony, and we would like to ask each of you today, or to give you the opportunity to make an opening verbal statement of no more than five minutes.

So, Mr. Cayne, we would like to start with you. And by the way, in front of you there will be a monitor, and when the light goes to yellow that's one minute, and when it goes to red the time is up. And with no further ado, Mr. Cayne.

And can you turn your microphone on, Mr. Cayne, and pull it towards you.

WITNESS CAYNE: Is this it?

CHAIRMAN ANGELIDES: It seems to be.

WITNESS CAYNE: Thank you.

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

My name is James E. Cayne. I was CEO of Bear Stearns from 1993 until January 8th of 2008, and I remained non-executive chairman until the firm was acquired by JPMorgan Chase in June of '08. I appreciate the invitation to appear before you today.

Bear Stearns was a remarkable company and I'm proud to have spent my entire career there. I joined the firm in 1969 when it was a partnership with about 30 partners, and I worked there for almost 40 years.

Even after it became a public company, a large part of the firm--about one-third--was owned by its employees. To align the long-term interests of employees and shareholders, a significant part of its senior employees compensation--typically approximately one-half or more for the most senior members, and management--consisted of restricted stock units and stock options.

Like many employees, I rarely sold any of the firm's stock except as needed to pay taxes. Bear Stearns had a strong culture of risk management. The head of the firm's Risk Management Committee reported to the firm's Executive Committee. My office door was always open to any employee who had concerns about violations of our risk or compliance policies or any other inappropriate conduct.

Beginning in early 2007, the market for subprime mortgages and securities backed by those mortgages began to experience severe dislocation.

Although Bear Stearns had limited involvement in the subprime sector, the subprime crisis resulted in losses in two hedge funds managed by Bear Stearns' Asset Management, a wholly owned subsidiary of Bear Stearns.

Although we attempted to preserve the stronger of the two funds by extending $1.6 billion in secured financing to that fund, both funds ultimately failed.

I do not believe that the collapse of these funds was a significant cause of the later collapse of the Bear Stearns company itself. While Bear Stearns took some of the fund's assets onto its balance sheet in connection with the fund's bankruptcies, those assets represented less than one-half of one percent of the firm's total assets.

Over the course of 2007 the market for subprime, and increasingly other mortgages, continued to decline. In view of Bear Stearns's leading role in the mortgage industry, these developments gave rise to market uncertainty about the firm.

We believed that that concern was unjustified and that the firm had ample capital and liquidity. Nevertheless, we worked aggressively to address the firm's--excuse me, the market's concerns.

During the fall of 2007 the firm raised an additional $2.5 billion in long-term debt. We also entered into an agreement in principle for a joint venture with a major Chinese securities firm that would have increased Bear Stearns's marketing strength in Asia.

As I mentioned, I stepped down as CEO in early of January 2008, and was not involved in the day-to-day management of the firm following my departure. Nevertheless, I would like to offer my opinions about the reasons for Bear Stearns's collapse.

Despite the efforts we made prior to 2007 to reduce our exposure to the subprime sector, the scale of our activities in other sectors of the mortgage market caused widespread concerns about Bear Stearns's solvency.

Those concerns were unfounded. Our capital ratios and liquidity pool remained high by historical standards. Nevertheless, as a result of those rumors, during the week of March 10th, 2008, brokerage customers withdrew assets and counterparties refused to roll over repo facilities.

These events resulted in dramatic loss of liquidity. The market's loss of confidence, even though it was unjustified and irrational, became a self-fulfilling prophesy.

Subsequent events show that Bear Stearns's collapse was not the result of any actions or decisions unique to Bear Stearns. Instead, it was due to overwhelming market forces that Bear Stearns, as the smallest of the independent investment banks, could not resist.

Only a few months after Bear Stearns collapsed, the same market forces caused the collapse and near-collapse of much larger institutions such as Lehman Brothers. The efforts we made to strengthen the firm were reasonable and prudent, although in hindsight they proved inadequate.

Considering the severity and unprecedented nature of the turmoil in the market, I do not believe there were any reasonable steps we could have taken, short of selling the firm, to prevent the collapse that ultimately occurred.

I look forward to answering any of your questions.

CHAIRMAN ANGELIDES: Thank you, Mr. Cayne.

Mr. Schwartz?

WITNESS SCHWARTZ: Good morning, Chairman Angelides, Vice Chairman Thomas, Members of the Commission:

My name is Alan Schwartz. I appreciate the opportunity to testify before the Commission and look forward to assisting the Commission in its very important work.

People from Wall Street to Main Street have suffered as a result of the financial crisis, and Americans deserve answers to the vital questions your Commission is exploring.

I was the President and the Chief Executive Officer of Bear Stearns from January 2008 until March 2008 when it became the first firm to fall victim to the credit and liquidity crisis.

Bear Stearns was my professional life for over 32 years. I joined Bear Stearns in 1976 at age 25 and worked my way up through the research, sales, and investment banking side of the business.

I served on the firm's Executive Committee since 2001. My colleagues at Bear Stearns were among the finest groups of people I have ever been associated with, and I will always be proud to have been a part of that organization.

Throughout the period when I held these positions, Bear Stearns's management in my view attempted to manage the firm prudently to meet the difficult financial conditions as it foresaw them.

As my colleagues have mentioned, one step that we took during my tenure at Bear Stearns was to increase our secured funding lines and reduce Bear Stearns's reliance on unsecured financing.

We took this step because we believed that secured funding was more reliable, and that financing against liquid, high-quality collateral would enable Bear Stearns to finance itself even in a challenging economic environment.

Over the course of 2007, the stress of the mortgage markets expanded beyond subprime and began to impact other areas of the market. We took markdowns of $700 million for the third quarter of 2007, and $1.9 billion for the fourth quarter.

In connection with the declining values of our mortgage-backed assets, although 2007 was a profitable year for the firm we reported a net loss for the fourth quarter, the first quarterly loss in the firm's long history.

Despite the firm's profitability that year, we made the decision that no member of the Executive Committee would be paid a bonus for that year.

It is important to note that, even as it negotiated the stormy economic environment, Bear Stearns was well capitalized and had liquidity well in excess of regulatory standards.

We had taken steps to build up our parent company liquidity pool in 2007, and by early 2008 we had a significant liquidity cushion.

At all times, Bear Stearns was compliant with the SEC's Consolidated Supervised Entities Program's capital and liquidity requirements. As we closed the books on the first quarter of 2008, that quarter was projected to be a profitable one.

Despite these facts, during the week of March 10th, 2008, unfounded rumors and attendant speculation began circulating that Bear Stearns was in the midst of a liquidity crisis.

Due to the stressed condition of the credit market as a whole and the unprecedented speed at which rumors and speculation travel and echo through the modern financial media environment, the rumors and speculation continued throughout the week.

The rumors thus became a self-fulfilling prophesy. There was, simply put, a run on the bank.

On Thursday of that week, our liquidity cushion dropped precipitously and we worked through the night to find emergency funding of sufficient duration to stabilize Bear Stearns and to find a partner willing to enter into a transaction to salvage the company.

Our efforts ultimately resulted in a transaction to which JPMorgan Chase agreed to acquire Bear Stearns for $10 a share. Through that transaction we were able to preserve Bear Stearns's value to the greatest extent possible under the circumstances for our shareholders, our 14,000 employees, and our creditors.

I have given much thought to the events that led up to the fateful week in March and believe that we took all the appropriate steps that we could to try to survive the storm that was breaking upon us.

In the end, however, it was not enough, although I wish it were otherwise. I believe that we did not foresee the extent to which housing prices had been driven to unsustainable levels.

We, like many other financial institutions, relied on the belief that the market for highly rated tranches of structured securities, including those supported by Fannie Mae and Freddie Mac would remain liquid, but when the market for those securities became frozen it left the firm susceptible to rumor and speculation.

Despite all of our efforts, Bear Stearns was unable to weather this period of unprecedented market dislocation. I am optimistic that policymakers will consider a regulatory solution that minimizes these kinds of risks in the future.

Thank you for your time. I'm here to answer any questions that you have.

CHAIRMAN ANGELIDES: Thank you, Mr. Cayne and Mr. Schwartz.

Let me start with a question, and let me pick up with some of the questioning I understood during our last session.

Mr. Cayne, let me start with you. Stepping back and looking at how Bear Stearns was structured, it does seem to me that there was an extraordinary level of risk taken that, to a certain extent when you combine high leverage, concentration of mortgage assets, and short-term funding, there's a form of financial Russian roulette that Bear Stearns was playing, along with other investment banks.

You had a leverage ratio, depending on how you measure it, from 38 to 1 in tangible assets to tangible common equity; on an average monthly basis it was more like 42 to 1. You did have, as of November 30th, 2007, about $46 billion of exposure to mortgages, mortgage-backed securities, other asset-backed securities.

You had Level 3 assets that were 269 percent of tangible common equity, and you combined that with extraordinarily short-term funding, $50- to $60 billion you've got to roll over each night.

I want to ask you the same question I asked the other folks from Bear Stearns who were here. How was that model sustainable in the event of any market disruption of significance?

WITNESS CAYNE: Well I appreciate the question, and I believe I was watching when you asked that question of the first panel.

That was the business. That was really industry practice. In retrospect, in hindsight, I would say the leverage was too high.

CHAIRMAN ANGELIDES: Succinct. Let me ask this question. And that is: Leverage was too high. Was the funding model on the other side a flawed model, given the lack of any kind of backstop like access to the Discount Window, or obviously any form of insurance on the funding?

WITNESS CAYNE: Well we didn't have access to the Discount Window.

CHAIRMAN ANGELIDES: Correct. I'll ask you about that in a little while. But in other words, was the model exacerbated just not only on the asset side, the high leverage, but by the nature of the funding available to the firm? And was it also exacerbated by perhaps a transformation in the investment bank business over time where the firm held more and more assets for its own account?

WITNESS CAYNE: I believe that's accurate. I believe that analysis is correct.

CHAIRMAN ANGELIDES: Okay. Mr. Schwartz--I like that, very good, succinct answers; we'll get through a lot today--Mr. Schwartz, do you want to comment on my question?

WITNESS SCHWARTZ: Both question? Take both questions, or which question?

CHAIRMAN ANGELIDES: The questions about the level of leverage--

WITNESS SCHWARTZ: And funding?

CHAIRMAN ANGELIDES: --and combined--the extraordinary risk profile--

WITNESS SCHWARTZ: Okay.

CHAIRMAN ANGELIDES: --from the combined extraordinarily high leverage, and these are of course my characterizations--and the short-term funding, $50 to $60 billion you've got to roll over each night.

WITNESS SCHWARTZ: Right. So, yes, I'd like to comment on that.

I think that the leverage, the leverage was high but I think that the way you've characterized the leverage I would disagree with a little bit.

I think that the implication is that we had exposure, that a small drop in the value of the assets on the balance sheet would expose us to great loss. And the answer to that is: I don't believe that's true. Because a number of the assets that are on our balance sheet were assets that we were lending against securities that other people had exposure to.

So I think, I've always believed that gross leverage is one of the most misleading statistics you can look at in financial institutions. I think that you have go get underneath--

CHAIRMAN ANGELIDES: So can I ask you, I don't want to interrupt you but I want to ask you something very quickly on that.

What kind of--why don't you finish, and then I have a follow-up. I apologize. Go ahead.

WITNESS SCHWARTZ: No problem. So I think that the way that risk tends to be looked at in financial institutions, and certainly by all of the regulators, is to look at capital requirements for the types of assets that you have on your balance sheets, and different assets have different levels of risk and should have different amounts of capital held against those assets.

By those measures, which I think are the measures we were most looked at by agencies and regulators, Bear Stearns had very strong capital ratios.

As it relates to the funding model, I think that the reliance on the amount of our funding that had to roll overnight is not something that we entered into consciously. I think that was something that occurred over a period of time as the markets in the repo business, as you went--as you took on term repo, as the repo matured counterparties increasingly decided that they'd rather just go overnight.

And since there were no alternatives, starting I would say maybe in the Fall of '07 into the Spring of '08, you become increasingly reliant on overnight funding.

And I think that, you know, the model for noncommercial banking had always been to make sure you had a lot of collateral to borrow against. So I don't know another model that we could have pursued.

CHAIRMAN ANGELIDES: All right.

Mr. Cayne, back to you. You said you thought leverage on reflection was too high. Were there any significant steps made to adjust that through 2007? Were there ample discussions around that? What were the nature of discussions around as an alternative to reducing the asset base, increasing the amount of equity?

WITNESS CAYNE: Well there were conversations about it, and I would add to Alan's comment about the short-term funding, the short-term rolling, which you've described as sort of hand-to-mouth, and you hope they're there the next day.

We made a conscious decision to go to short-term funding as opposed to commercial paper, even though it was more costly, because we felt it was more safe and more secure for our investors.

The idea of equity, and the idea that we didn't have enough equity, there was always a discussion about that. My personal belief was that we had enough equity. And to raise equity at the level that we would have had to go to to raise that equity was, in my opinion, far lower than what the company was worth. A.

B, I didn't see what raising equity, unless it was an enormous amount of equity, or in other words sell yourself to somebody else, would change the picture.

CHAIRMAN ANGELIDES: But let me press this equity point. I mean, you had I think about $11 billion, $11.9 in equity at the close of '07, against assets of $395 billion.

But more on an average, more like $450 billion because there was balance sheet management to bring down your leverage ratio at the year end.

And even taking into account what you've said about obviously different types of assets, you know to I think most people the notion of having that thin an equity base against that large an asset base I mean seems, you know, on the aggregate basis would be a 2 percent diminution in asset values and you're wiped out.

So I want to press this a little. You didn't see going into the turbulent waters that it would be necessary to build a higher levy?

WITNESS CAYNE: Correct.

CHAIRMAN ANGELIDES: All right. Was the fact that compensation was based on return on equity a factor there? Because obviously the more highly leveraged you were it would affect compensation?

WITNESS CAYNE: Absolutely not.

CHAIRMAN ANGELIDES: All right.

Let me talk a little bit--and I'll ask you both to comment on this--some of the internal debates. Because as you may have listened this morning, if you did, which would have been a good thing probably, one of the items I think that we're grappling with is the extent to which the very investment bank business model, and as it was practiced, was an unsustainable model; or the extent to which firms could have put themselves in the position to survive the tsunami, which often people know is coming. There tend to be warning signs.

There appears to have been some debate internally about what ought to be done. Folks, apparently like Wendy De Monchaux, Ace Greenberg, Steve Meier, Bobby Steinberg, all urged reduction, apparently, according to the interviews that have been given to our staff, of mortgage-related positions in the fall of '07.

In fact, the former Treasurer, Mr. Upton, quoted Mr. Greenberg as saying, quote, "the best hedge is a sale." When you get to your September 18th Board of Directors meeting, there's a note, which I would like to enter for the record by the way, "Mr. Mayer focused on the turbulence that occurred in the fixed-income markets during the third quarter by highlighting the re-pricing of corporate credits, the impact of rising delinquency rates and reduced home prices in the market for mortgage securities, and the general crisis of confidence impacting CLOs, CDOs, SIVs, and the commercial paper markets."

There was a report, which I would also like to enter for the record, which was a Merrill Lynch report in November 7th, '07, which I'm not sure you would have seen, but it was about the Bear Stearns Asset Management situation. And it was called "Bear Stearns Asset Management: What Went Wrong?" Because obviously they were affected. They seized $800 million worth of collateral.

But in it, their own assessment was: Bear Stearns did too little too late. They naively assumed Wall Street creditors would hold off on margin calls, failed to move quickly to back the less troubled high-grade fund.

And I guess what I would ask you is: Was there enough internal debate? And could you have done more to position yourself for that week in March? Or was it simply a run fueled by unsubstantiated rumors?

Could you have built a higher levy? Mr. Cayne? Mr. Schwartz?

(The reports follows:)

WITNESS CAYNE: Well again, I don't think that equity would have changed the picture at all. I mean, you're talking about a run on a bank where historically equity will save you, but it would have been an inordinate amount of capital, far more than the company itself.

So my point is that, first of all on the report that Merrill Lynch gave, I believe they might have said "too little too late" as far as us boarding some of the material? Is that accurate? I just want to be sure I got that report, because I don't remember specifically the report itself.

CHAIRMAN ANGELIDES: It was called "Crisis Management: Bear Stearns Did Too Little, Too Late." It was their document about their position, so I'm not sure you would have seen it, Mr. Cayne.

WITNESS CAYNE: Okay. But did that concern the funds, or did that concern--

CHAIRMAN ANGELIDES: It concerned the funds and your reaction to the funds.

WITNESS CAYNE: Okay.

CHAIRMAN ANGELIDES: Which I know, by the way, you apparently opposed the infusion of the $1.6, you did?

WITNESS CAYNE: Personally?

CHAIRMAN ANGELIDES: Yes.

WITNESS CAYNE: Yes, I did.

CHAIRMAN ANGELIDES: All right, so your view is the higher levy wouldn't have mattered.

WITNESS CAYNE: Right.

CHAIRMAN ANGELIDES: So it was, in your view, rumors, people trying to bring the firm down? I'm not trying to be nefarious here, but how would you characterize it? Rumors? Folks who had an interest in bringing the firm down?

WITNESS CAYNE: Well, I have tried to avoid--when I've been asked that question about conspiracies and rumors, and I've really tried to avoid answering it. For this panel, I'll be happy to answer it.

CHAIRMAN ANGELIDES: Okay.

VICE CHAIRMAN THOMAS: Oh, good.

WITNESS CAYNE: I was enthusiastic about the response that the SEC had when Mr. Cox looked at it and said there might be something here.

I heard the same rumors everybody heard: that hedge funds had gathered together, and they ganged up, and there was an uptick rule, and that was all part of a picture of a big fat goose walking down a lane that's about to get eaten up alive.

Now whether it's competitors, or people angry at it, or whatever, I don't know. But regardless of whether there was a conspiracy or not, the bottom line was that the firm came under attack. We feel that if there was a conspiracy and the SEC was going to find that conspiracy, that would be a miracle.

I'm not an expert on--

CHAIRMAN ANGELIDES: Did they attempt to find one, to your knowledge?

WITNESS CAYNE: To my knowledge, no.

CHAIRMAN ANGELIDES: So your comment about being enthusiastic when Mr. Cox said it, is you hoped there would be an inquiry?

WITNESS CAYNE: Correct.

CHAIRMAN ANGELIDES: And to your knowledge, there has not been?

WITNESS CAYNE: Well if there has, then there is no conspiracy. So the answer is, I don't know.

CHAIRMAN ANGELIDES: Okay. I want to just keep on this for a minute, because I know some other Commissioners--I know Ms. Murren would like to talk about those end days--but in the panel earlier today I cited some emails between Hayman Advisors and Goldman. There was that moment on March 11th, and maybe I should address it to both of you, where initially Goldman did not consent to Bear stepping in the shoes of Hayman, and the email said we don't want to face Bear.

I believe you were being interviewed on CNBC when those rumors were rife. How damaging were those rumors?

WITNESS SCHWARTZ: You're asking me?

CHAIRMAN ANGELIDES: I'll start with you, since you were the interviewee, and I'll ask Mr. Cayne next.

WITNESS CAYNE: I wasn't there, so--I mean, I had left in January.

CHAIRMAN ANGELIDES: Right, you were the non-executive chair.

WITNESS CAYNE: Right.

CHAIRMAN ANGELIDES: Were you watching any of this? I know you were--

WITNESS CAYNE: I watched Alan on television.

CHAIRMAN ANGELIDES: You were in Detroit, right, at a bridge tournament.

WITNESS CAYNE: Correct.

CHAIRMAN ANGELIDES: Okay. So maybe since you watched on TV, I will ask you, though.

Go ahead, Mr. Schwartz.

WITNESS SCHWARTZ: So in terms of any particular one rumor? It's hard to know which rumor different people want to listen to.

In the days of that week of March 10th, each day that went by there were new rumors. And the only thing I can tell you that I remember, for example, one of the reasons we decided, which we may get into, to be interviewed that day was there seemed to be a widespread rumor that Bear

Stearns had lost a lot of money in the first quarter.

Upon reflection, I think I realized that the most vulnerable time for a financial institution, or frankly any public company, is probably in the period between when a quarter ends and before they report it publicly, because starting rumors about what's going to come out in that quarter can get people nervous because there's an announcement coming and they want to get out in front of it.

So one of the things we wanted to do was, we couldn't report the quarter until the books were closed, but we could make some public comment about the general tone of the quarter, which we hoped would calm people down. To say, okay, gee, if they didn't lose a lot of money, it sounds like they made money, let's wait until the quarter and we get more information about the company.

A couple of hours after that interview, I heard from several people that there was a new set of rumors going around that, okay, Bear Stearns actually hadn't lost money in the first quarter, but the rumor was they took a horrendous loss in the first week of the second quarter.

So the types of rumors that were running around, it's impossible to say that's the one rumor that people responded to.

CHAIRMAN ANGELIDES: All right. But it was a rumor of concern.

WITNESS SCHWARTZ: There were a lot of rumors of concern.

CHAIRMAN ANGELIDES: Do you have a comment, Mr. Cayne, having watched the interview?

WITNESS CAYNE: I thought Alan handled himself very well.

CHAIRMAN ANGELIDES: All right. Let me ask you, and I'll reserve the balance of my time, but let me ask you both one other question which is just on a slightly different point, and I want to ask your opinion of it.

You may or may not know of the specific conversations or transactions, but apparently John Paulson was one of Bear Stearns's top ten institutional clients--that's per an email in January of 2008, looking back at 2006-2007 from a gentleman named David Rawlings to Mr. Mayer and Mr. Molinaro--but apparently Mr. Paulson approached, and we interviewed Mr. Eichel and Mr. Wagner.

Scott Eichel was approached by Mr. Paulson, had three meetings with him. At the second meeting, Mr. Paulson asked Mr. Eichel to structure a synthetic CDO that Mr. Paulson could short. Mr. Eichel told us, and I believe he said it on the record in other places, that he was uncomfortable with the transaction and turned it down.

And according to Mr. Wagner, Mr. Wagner also said that he was involved in it being turned down because it was a fundamental conflict of interest.

Were you aware of this decision? And whether you were or not, do you think you made the right decision and Goldman made the wrong decision to do that transaction?

WITNESS CAYNE: I wasn't aware of it at all.

CHAIRMAN ANGELIDES: Do you have an opinion about whether you made the right decision and Goldman made the wrong decision?

WITNESS CAYNE: No.

CHAIRMAN ANGELIDES: Mr. Schwartz?

WITNESS SCHWARTZ: No, I wasn't aware of it and it's not enough detail to know whether it was the right or wrong decision.

CHAIRMAN ANGELIDES: All right. Thank you, gentlemen.

All right, Mr. Vice Chairman.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

Again I want to thank both of you for coming. As a case study, given the stability and longevity over a period of time where there was great flux and change in the structure of these entities, your experience I think is very helpful to us.

It's been repeatedly said that there were five, and you were the smallest of the five. I assume that didn't bother you too much because you were stable. You were very good. And all of the other arguments that you have made.

Did you--was it possible to have sufficient information to compare yourself with others, to compare yourself with Lehman, on profiles as to how comfortable you were?

In your testimony you talk about you were well capitalized and had liquidity well in excess of regulatory standards. Well to me if anybody is going to set a regulatory standard it's the floor, it's not the ceiling. So you would hope that you would be above the floor.

But did you do any direct comparison to others, either on scale size, or some other relationship?

WITNESS SCHWARTZ: Yes, we did. We and others did, as well. And so on most of the measures of capital adequacy, we came out, versus our competitors, as being at the highest ends of our capital ratios.

As a matter of fact, one of the pressures that we faced the most in '05, '06, and into '07 was every time we had a meeting with investors they actually got on us because they kept saying that we had too much capital. We had more capital relative to our balance sheet than all of our competitors. And the pressure from shareholders was we should be returning capital through stock buybacks or dividends, which we resisted.

VICE CHAIRMAN THOMAS: Well I mean that's a little bit like fans screaming for you to take the shot in the last two seconds from the half-court line. If you do and miss it, then you're at fault. Rarely do you make it.

As the husband of the business, you really have to listen to them but in the end isn't it your judgment that's put on the line, and you're either continued on in your position or you're not.

And so their attitude toward your equity has to be based on something else, doesn't it?

WITNESS SCHWARTZ: No question.

VICE CHAIRMAN THOMAS: I mean, obviously it was.

WITNESS SCHWARTZ: Well, yes. I think I was answering your question as did we compare ourselves to other institutions.

VICE CHAIRMAN THOMAS: Yes, and they did, too, and therefore they wanted you to be more risky.

WITNESS SCHWARTZ: And I'm saying when we did that--when we did that, it looked like we were in safer ground.

My point about investors, point number one was that when investors looked at it, when a group of independent people compared us to our peers, they came to the conclusion that we had too much capital.

To your point, Mr. Vice Chairman, we didn't agree with them. So we kept our capital instead of returning it to them.

VICE CHAIRMAN THOMAS: Now it was mentioned that you were not that heavily involved in subprime mortgages. But at the bottom of page 2, quote, "We, like many other financial institutions, relied on the belief that the market for highly rated tranches of structured securities, including those supported by Fannie Mae and Freddie Mac," were those then alt-As, as opposed to subprime?

WITNESS SCHWARTZ: Well the answer to your question directly, as to what I was referring to, was the process of securitization and the impact that it had on fueling a liquidity crisis, which I would be happy to go into.

But if you're asking a specific question about Bear Stearns's exposure in the mortgage markets, the answer is: Yes, we had very light exposures to subprime; and we had heavier exposures to the Alt A market.

VICE CHAIRMAN THOMAS: And you felt that they were significantly different to place yourself in a position of going much heavier on Alt As?

WITNESS SCHWARTZ: I think that at the time, the people that were doing the research felt that Alt A loans were superior to subprime loans in terms of quality.

VICE CHAIRMAN THOMAS: And when it comes to how much capital is enough capital, I had a community in my district when I represented them that suffered a 100-year flood. And so we began to go through the motions of talking about building a dam, and everyone said, well it was a 100-year flood so we don't have to worry about it.

Two years later, a second 100-year flood occurred. And it was fairly persuasive. Following that second 100-year flood, that maybe something needed to be done.

I am somewhat impressed by the statement that you could have had enough equity if you were a larger company. You simply--if you had the entire company on the line, which you ultimately did; it wasn't enough.

So questions after the fact about whether you were well capitalized have to do with whether it's a 100-year flood, or two 100-year floods in three years, and I appreciate that.

You ended your testimony, Mr. Schwartz, on page 3 that you're optimistic that policymakers will consider, quote, "regulatory solutions that minimize these kinds of risks in the future."

Do you have any suggestions?

WITNESS SCHWARTZ: As opposed to suggestions, I guess I would just comment that I'm watching and actually discussing with a number of people the various proposals that are coming through in the bills. And I think that what

I was referring to in my statement was that I believe that, while you've questioned us about equity appropriately, I don't believe equity was the issue that caused the problem at Bear Stearns.

I don't think that we had a solvency issue. Equity relates to solvency in the end. I think we had a liquidity issue that was driven by confidence.

Now if one asks, why wasn't there enough confidence? I believe that with the benefit of hindsight the whole system was relying on the fact that the senior tranches of mortgage debt securities that were very highly rated would be of the quality of securities that were rated as high as they turned out--as were put on them. And, that when the market perceived that some of those very highly rated tranches were actually not high-quality securities, the lack of transparency in the instruments made it impossible to determine which ones on anybody's balance sheets were actually very risky versus less risky.

So there was a reliance on ratings to figure out what somebody's balance sheet looked like. And then when the ratings failed, there was no other way to distinguish who was holding risky instruments, and who was holding safe instruments.

So specifically to your question, I believe that in all of the bills I am seeing a trend, and the details are obviously important, but there is a movement to get many of these products, derivative-type products, moved on to exchanges or clearinghouses. And I think that is a very positive development for transparency of people's balance sheets.

VICE CHAIRMAN THOMAS: Well our primary function as a Commission is to find out the cause or causes of the financial crisis. And Mr. Wallison is constantly focusing us on that, our primary function.

So I guess, based upon what you said, it would be appropriate for me to ask you, do you believe the rating agencies were the cause of the financial crisis?

WITNESS SCHWARTZ: You know, I don't believe that any one participant in the game was the cause of the crisis.

VICE CHAIRMAN THOMAS: 20 percent? 30 percent?

WITNESS SCHWARTZ: So I think that the rating agencies were part of the problem, but I think that the biggest part of the problem was a reliance on the rating agencies without any other measure of transparency.

VICE CHAIRMAN THOMAS: Creativity of products that were packaged in new and clever ways without really fully appreciating what they were?

WITNESS SCHWARTZ: Yeah--not only, not appreciating what they were is an important point, but not having a way to compare one to the other became in my mind the more important point.

VICE CHAIRMAN THOMAS: Thank you.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Ms. Born.

COMMISSIONER BORN: Thank you very much.

Let me start by asking this about Bear Stearns. It was a very, very large organization, and a very complex one. It had $400 billion worth of assets, lots of different businesses, many employees, many affiliated companies under the umbrella of Bear Stearns. Did you ever consider Bear Stearns too big to manage?

Mr. Schwartz, do you feel--in other words, do you feel as though you had sufficient information about the operations to manage the business effectively?

WITNESS SCHWARTZ: It's a good question. As has been mentioned in other questions, we were the smallest of the investment banks, and certainly smaller than the large commercial banks. So, no, I don't think we were too big to manage. I don't think we were too complex to manage.

I think that the situation of the lack of transparency of our balance sheet versus everybody else's, which I think with the benefit of hindsight I believe our asset quality was higher than a number of other financial institutions. But relying on a system where nobody could tell what we own versus what they owned, and therefore it was just rumor that drove it, I think that was the cause. I don't think complexity or size was the issue.

COMMISSIONER BORN: Does that suggest that there should be more transparency in balance sheets, and other financial statements?

WITNESS SCHWARTZ: I think--first of all, I think transparency is always good. But what I'm referring to in this case is that--see, I believe that originally we came up with all these structured securities as an industry with regulators' blessing, et cetera, there was a perception that it was actually better to disperse the risk of the underlying loans out into the broader marketplace.

So I think it was encouraged. I think, with the benefit of hindsight, it was done in a way that was too custom-tailored, program by program, rather than finding instruments that you could say, okay, if you own one of these and somebody else owns two of those same things, we can compare your two balance sheets.

But if you own one of these, and somebody else owns five, we don't know which one has more risk because we don't know what any of those instruments are compared to each other.

COMMISSIONER BORN: So nobody could really assess the exposure of their counterparties. Nobody could assess the value of others' assets. This was really a problem of a lack of transparency.

WITNESS SCHWARTZ: That is my belief, yes.

COMMISSIONER BORN: What about your interconnectedness? I mean, you had thousands, and thousands, and thousands of counterparties, didn't you?

WITNESS SCHWARTZ: Yes, we did. And I think that interconnectedness is another issue. It's related to transparency of these types of assets, and it is why I believe these instruments cleared somewhere where you're not facing the counterparty but you're basically facing the market for those securities, is just a direction that we should go in.

COMMISSIONER BORN: Because it would give not only transparency but also it would take care of the counterparty credit risk issue?

WITNESS SCHWARTZ: Correct.

COMMISSIONER BORN: Do you think that the reason that the Federal Reserve was willing to step in and assist in JPMorgan's purchase of Bear Stearns was because of concerns that essentially the institution was too large and/or interconnected to fail?

WITNESS SCHWARTZ: Well I think there were probably several things that went on through their mind, and too-interconnected was possibly one of them. I think that part of it, though, was that they could find a commercial solution. They could find somebody who was willing to actually step into the shoes of Bear Stearns and take on their balance sheet, with the exception of one package of assets that my understanding was just too large a concentration compared to the amount that was already sitting on the balance sheet of JPMorgan.

And I think that, had the Discount Rate Window been available, they might have been able to finance those assets and there wouldn't have been a liquidity problem. But I think they were able to assess the quality of those assets and believe that the Fed could step in, and they believed they would be in a position to take on what they thought were reasonable quality assets, and at the same time have an independent, private entity to take over Bear Stearns, that that was a better solution than finding out interconnectedness.

COMMISSIONER BORN: Yes. The opening of the Discount Window for primary dealers came too late for Bear Stearns, didn't it?

WITNESS CAYNE: Just about 45 minutes.

COMMISSIONER BORN: Mr. Cayne, why do you think the Federal Reserve Board of Governors and the Federal Reserve Bank of New York were willing to assist in the acquisition by JPMorgan?

WITNESS CAYNE: So obviously I don't know. I just would be guessing. I believe that JPMorgan knew Bear Stearns better than any bank. Our conversations with Jamie Dimon over the years was extensive. We had a very strong corporate relationship. He was our clearance bank. And he really knew the company better than anybody else.

It was a marriage of convenience that was facilitated by the Fed. I think that, as it turns out, I have no opinion about this too-big-to-fail thing, because it seems to me that Bear Stearns wasn't really big enough to be too big to fail, on the one hand.

On the other hand, its counterparty risk all over the world perhaps might have been affected and that might have gone into the thinking of the Fed when they decided to take on this obligation.

So the answer is, I don't know. I wasn't part of the conversation that he had with the Fed, and at the end of the day I know that they walked away with a very good purchase. He's done a very good job with the company.

There are an awful lot of ex-Bear Stearns' employees who are employed by JPMorgan, and I'm happy that it came out to the extent that it came out as opposed to worst-case being somebody else I don't have to mention who it is, but the outcome I believe was the best that could be anticipated when the world ended for a lot of us.

COMMISSIONER BORN: Let me ask you how you think the market reacted to the government assistance in the acquisition. Did this lay the groundwork so that the financial markets then assumed that larger and potentially more systemically important institutions would be in effect bailed out?

WITNESS CAYNE: I don't know the answer to that question.

COMMISSIONER BORN: Mr. Schwartz?

WITNESS SCHWARTZ: The issue of moral hazard is obviously an important one. It has certainly been around before this cycle. It's been around for a long time. I think what got introduced in this cycle was how many types of institutions might be too interconnected to fail.

But my own personal view on the reaction of the marketplace to the Fed supporting the JPMorgan acquisition is I don't think that increased moral hazard. Because, again, it looked like a solvent institution being taken over by a third party with a little support.

I think in fact by opening the Discount Window afterwards they hoped that they wouldn't need to step in in another situation. And I think, while a number of people in the marketplace might have thought they would step in to do, quote, "whatever it takes," for a Lehman situation, as an example, I think speculation that it wouldn't happen is part of what might have driven Lehman's situation.

So it's really--I don't know the specific issue as to how they handled Bear Stearns relative to moral hazard, but I think it's a very thorny issue for people to figure out.

COMMISSIONER BORN: Well it seems to me it may open up a bigger issue about under-regulated and un-government-guaranteed financial conglomerates.

As you probably both know, the SEC adopted in 2004 a program to have Consolidated Supervised Entity supervision for safety and soundness for the first time, a kind of supervision we had only had for commercial banks and their holding companies up until then.

And one of the reasons I think we had never had that kind of supervision of investment bank holding companies was because there wasn't thought to be quite the same public interest in preserving them since the government wasn't insuring their obligations; it wasn't acting as a lender of last resort for them.

Now I think an issue is raised as to whether large holding companies of financial institutions, whether or not they hold the commercial bank, need both government support, which they're getting today in many respects, and more rigorous supervision.

What would your view be on that, Mr. Schwartz?

WITNESS SCHWARTZ: I think in substance I would agree with that. I think that we have to remember that a lot of the apparatus, not only the regulatory apparatus but the support apparatus for commercial banks, was created in an environment where commercial banks were separated by law from being in the same business as the investment banks.

And so there was, in my view anyway, there was a sort of backstop of lender to last resort to what was the securities business, because in times of strife the securities firms would turn to the banks who didn't have a lot of the same securities on their balance sheet, and they would go to the Discount Window.

Once you put Glass-Steagall out of business and you put the two business models together, it created I think some unintended consequences. And I think that if you're going to have large financial institutions who are basically in each other's businesses, then they should be regulated on some consistent basis.

You know, I don't profess to know what agency should do what, but it does make sense that as the business models are now becoming more and more alike that both the supervision and the mechanisms to deal with them should be consistent.

COMMISSIONER BORN: Mr. Cayne, do you have a view on this?

WITNESS CAYNE: I agree with Alan. He's right.

COMMISSIONER BORN: Let me go to another topic. Your leverage was quite high. That was not unusual for the investment banks, the big investment banks. I think during 2007 your assets-to-equity ratio was 33.5 to 1; and tangible assets-to-tangible common equity were 37.5 to 1.

We noticed that in your financial statements you disclosed that reported assets in the fiscal year 2007 financials were 12.2 percent lower than the average month-end asset amount over each of the previous 12 months.

And I understand this is called "window dressing," getting your asset balance down at the end of the reporting period. And I wondered what the motivation for doing that was on the part of Bear Stearns, and what you hoped to accomplish?

CHAIRMAN ANGELIDES: I would like to yield additional time. What do you think? Three minutes?

COMMISSIONER BORN: Three minutes, at least to get a reply.

WITNESS SCHWARTZ: It depends on how long the answer is, right?

COMMISSIONER BORN: Yes.

WITNESS SCHWARTZ: I think that for as long as I've been in the industry over the last 30-something years, I've never been that involved with the actual balance sheet, putting together of the balance sheet, but my understanding of it as a participant in the industry has always been that financial institutions always wanted to show that their assets and their inventories could move; that it was considered good discipline.

And I think it's been industry standard to show by period ends that you had the flexibility to bring your balance sheet down, if necessary. I think that's what a lot of investors looked at, and agencies looked at.

I don't think, as some people might imply, that it was hiding anything because you basically told them that it's lower at quarter-end than it was during the quarter, and that's what I always understood was the reason to do it.

COMMISSIONER BORN: Mr. Cayne, can you answer that?

WITNESS CAYNE: I would add only that it seemed that that was a way of showing the investor base and the rating agencies that you had the capacity to do that and remain in line.

So I don't agree with the word "window dressing." "Window dressing" connotes skullduggery and we frown on that.

COMMISSIONER BORN: Well I certainly was just saying that that's what I had heard it referred to, I--

WITNESS CAYNE: I didn't say that you said it.

COMMISSIONER BORN: --didn't mean to characterize it that way.

Thank you both, very much.

CHAIRMAN ANGELIDES: Yes. Just for the record, that phrase was used by the former treasurer of Bear Stearns in the interview with our staff, the term "window dressing."

I am going to take just one minute before we go to actually the Vice Chair, and this is on my time, and then to Mr. Holtz-Eakin.

I just want to follow up on one point Ms. Born was talking about. I understand your position you were not an insolvent firm. That's what you have articulated today. And compared to Lehman, at least, when the Window was open the Federal Reserve said later in the year, we can't extend credit because we don't believe the asset values are there.

I think I'm going to ask you this, Mr. Cayne. You mentioned 45 minutes after you went under the Window came open. Had it been open, might the fate of the firm been different?

WITNESS CAYNE: I don't know. I know that it had no chance. So if you're asking me if the Window had been open would we have survived? I would say there would be some chance.

CHAIRMAN ANGELIDES: Was the judgment made a fair one by the Federal Reserve of New York, or an unfair one?

WITNESS CAYNE: I wouldn't deem it unfair. I would deem it that's their responsibility. They had an opinion about what should happen, and they exercised on it.

CHAIRMAN ANGELIDES: But was their opinion that the firm should not survive?

WITNESS CAYNE: On their part?

CHAIRMAN ANGELIDES: Yes.

WITNESS CAYNE: I don't know. I would guess that they would not want the firm to fail, but that's a guess. I had no conversation with them.

CHAIRMAN ANGELIDES: No conversation with Mr. Geithner at the time? You had no conversations with Mr. Geithner at the time of the New York Fed?

WITNESS CAYNE: No.

CHAIRMAN ANGELIDES: All right. Mr. Vice Chair, you had a comment?

VICE CHAIRMAN THOMAS: No. I wanted to give Mr. Cayne a change. Do we have to read it in your book, or will you tell us who the lesser choice was between JPMorgan and some other institution?

WITNESS CAYNE: No. That wasn't the question. I was talking about a firm that looked like us, and I didn't want--and I mentioned who it was. Alan mentioned who it was. It was Lehman Brothers.

VICE CHAIRMAN THOMAS: Okay.

WITNESS CAYNE: So it wasn't--it was a firm, it wasn't a regulator.

VICE CHAIRMAN THOMAS: It was a firm.

WITNESS CAYNE: Right.

VICE CHAIRMAN THOMAS: Thank you. I don't have to wait for the book.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman. Thank you both for taking the time to come today.

Mr. Cayne, you said in your opening statement that in the end there were unfounded rumors about Bear Stearns's financial condition that brought the real crisis upon you.

I want to push on that just a little bit. Would you still think that was true if an investor standing in March of 2008 knew perfectly the future of national house prices, of delinquencies, defaults, foreclosures, and the entire future of the subprime, Alt A, and other sort of mortgage origination? If they really knew that future, would you still feel it was an unfounded judgment about your outlook?

WITNESS CAYNE: No.

COMMISSIONER HOLTZ-EAKIN: No? So the fundamentals as it turned out weren't in favor of the assets you held on your balance sheet?

WITNESS CAYNE: At the time, they were unfounded.

They became founded after the fact. In other words, when you look back you say, well, they were really founded, weren't they?

COMMISSIONER HOLTZ-EAKIN: So there was no investor who could look at your balance sheet and make their judgment about the housing market and decide that you were in fact in deep financial distress?

WITNESS CAYNE: Well the point--the question that you said was basically were they, at that time, unfounded? And I answered, yes, at that time they were unfounded. Did they turn out--

WITNESS SCHWARTZ: Could I step in?

COMMISSIONER HOLTZ-EAKIN: I'm certainly going to ask you, as well, so do it in whatever order you want.

WITNESS SCHWARTZ: And I didn't mean to override him, I'm sorry.

WITNESS CAYNE: He likes doing that to me.

(Laughter.)

WITNESS CAYNE: Go.

COMMISSIONER HOLTZ-EAKIN: Mr. Schwartz?

WITNESS SCHWARTZ: If I understand the substance of your question, you're saying if somebody could of looked inside our balance sheet they would have found out we were in significant, or serious financial distress. I don't believe we were. I don't believe on any of the forecasts that have even since come out--

COMMISSIONER HOLTZ-EAKIN: Even the reality that we have experienced in the years since?

WITNESS SCHWARTZ: Yes. Because one of the things that hasn't played out yet is how the most senior tranches of a number of the better securitizations are going to work out.

And the fact of the matter is that there's lots and lots of AAA tranches that have yet to experience their first dollar of default. And so this is where I get to the point that I'd like to make, is that not all mortgage securities are created alike. And the whole concept of tranching the actual securitizations of loans as opposed to the securitizations of securitizations--

COMMISSIONER HOLTZ-EAKIN: Right.

WITNESS SCHWARTZ: --is still an open questions as to how they were going to play out, number one.

And number two, one of the things that we decided to do in the Fall of '07 and into '08 was, when we took a look at the balance sheet and we saw that there was now an illiquidity to types of securities that we had previously assumed that if there was stress in the market at least there would be liquidity in the upper tranches and we could just sell, we found that we didn't believe we could sell.

So we put on significant hedges that were going negative on many of the measures of the mortgage markets. So the net position and the next exposure, it's not clear to me how that would have played out. So I don't think that somebody with the inside knowledge of our balance sheet would have said, oh, my goodness, this is a company in trouble.

COMMISSIONER HOLTZ-EAKIN: So I just want to make sure I understand, because that came up in the earlier panel. Which is, in the aftermath of the decline of the hedge funds, you did in fact change your net positions but you did it by entering into hedges?

WITNESS SCHWARTZ: Correct.

COMMISSIONER HOLTZ-EAKIN: Because you were unable to move the kinds of securities that were in fact in the hedge funds, and were also on your balance sheet? Is that fair?

WITNESS SCHWARTZ: I think that's a fair assessment. I think that there was risk on both sides, right? If you tried to sell very large amounts of nontransparent securities, then you had to go out and be known in the market to be trying to liquidate very large amounts of securities.

And as I think one of the constant themes of what happened here is we had to try and balance confidence, right? And so not knowing whether you could actually execute on that sale, there wasn't a liquid market where you could say, okay, we will take our 5-point hit, let's just get out. You had to guess as to what the bid would be and sit there for a few weeks while people did their work, and have the rumors as to what that would imply.

The risk on the other side, which I know some institutions didn't want to take and maybe stayed long, was that the things that you would short were more liquid than the things that you owned. And so you end up with what's known as basis risk.

COMMISSIONER HOLTZ-EAKIN: Right.

WITNESS SCHWARTZ: And if there was a rally in confidence in those securities, you might have seen the shorts go up more than your longs.

When we sat there and debated that, we decided that the risk that the housing market would actually get decidedly worse would have put us in a much worse situation, and the risk that we would lose money in a recovery in the housing, but then we'd be able to get out, was the better risk for us to take.

COMMISSIONER HOLTZ-EAKIN: So you said if someone could look inside your balance sheet, they wouldn't have come to the conclusion you had trouble. Do you think it was possible for market participants in general to make that judgment about your balance sheet?

WITNESS SCHWARTZ: No. I think that because the things that we owned, each one has its own CUSIP number and you can't tell from the outside, you know, what's a good one and what's a bad one, I think that's what froze the market. And it made our balance sheet and all other balance sheets opaque.

COMMISSIONER HOLTZ-EAKIN: Why would you hold so many securities that your counterparties couldn't understand? Why is that a good business practice?

WITNESS SCHWARTZ: I think it's, as I think I testified earlier, I think that the perception was broadly in the market that by tranching these things into securities and securing ratings that the ability for people to see what rating categories of securities you held was a good indicator of the healthier balance sheet.

If you were sticking to very highly rated instruments, people would assume you had less risk than if you were in lower rated instruments.

When these particular--or when, when one portion of the structured product market turned out to be the ratings really were not even close to accurate, then it meant that nobody knew if the ratings could be relied on. And I believe that was a flaw in the architecture of the way the market developed, even though most participants thought that it was an improvement in the financial markets.

COMMISSIONER HOLTZ-EAKIN: So I guess I would be interested in both of your opinions on this. During the Fall of 2007, during the period when there's increasing scrutiny on Bear Stearns, I'd be curious, when you were looking at others of your counterparties, Lehman, Morgan Stanley, Merrill, Goldman, did you increase your assessment of their risk in any way? And who did you perceive as being more risky? And why? How did you do that evaluation?

WITNESS CAYNE: Well I'll try to answer. I didn't know that any effort was made to look into them. All you had was market rumor. Because your basis is the rating agency. The rating agency is rating this stuff, and the stuff is AAA. And I don't think that we were really capable of looking at Merrill's AAA as opposed to Morgan Stanley's AAA, as opposed to Lehman's AAA. If that answers your Question.

COMMISSIONER HOLTZ-EAKIN: It's part of it, but I was just--you know, the focus, for natural reasons, is on you. You are at the table. The hearing is about you. But we are interested in finding out about what happened to the financial system in general.

So I was wondering what you were doing in looking at the counterparties in the industry, at Lehman in particular, at Goldman, at Merrill. Were you changing your assessment of their risk as a counterparty? And on what basis were you doing it?

WITNESS CAYNE: We had no basis. We had an opinion based on just being in the market for as many years as we were, and whose stuff was better than other stuff, and no mechanical or no structural way of assessing it to a point where we would bet on it.

I mean, the bottom line was that everybody was sort of in the same boat. And we didn't, in answer to your question, really spend too much time discerning whether or not A was better than B, or B was better than C. They were all sort of the same.

COMMISSIONER HOLTZ-EAKIN: Mr. Schwartz?

WITNESS SCHWARTZ: Well, I mean I think that's essentially right. I think that, especially for the large, more diversified companies. I think we spent a lot of time, however, trying to get underneath that. You would try and look at what concentrations you had by sector.

But unfortunately, you know, beyond looking at the big buckets of how much exposure you had to certain types of assets, and pouring over their statements as to how they described their assets, and how they described their hedge positions, you didn't have a lot left, except market indicators like CDS spreads. And that's another issue, you know, within the market, whether CDS spreads are accurately reflecting, or are being used to create a perception is something that was hard to discern.

COMMISSIONER HOLTZ-EAKIN: I guess one of the things I have found surprising is, you know, we had the great luxury of talking to people in regulated commercial banks--Citi for example. We've talked to people at Fannie Mae and Freddie Mac, GSEs. We've had the chance to talk with you today. And regardless of where people were in the industry, and the particulars of their governance, regulation, those with greater exposure to mortgages did not seem to in any way change their risk management, or seem to recognize that somehow they were tied to a larger economy where houses were going straight down the tubes.

And in thinking about Lehman versus Goldman, no one seems to have done that math either. It's a perplexing situation where this large and transparent risk does not appear to enter into calculations about how people behaved.

WITNESS SCHWARTZ: I don't agree with that.

COMMISSIONER HOLTZ-EAKIN: Lehman had much more exposure than other counterparties. Why wouldn't you view them as more risky?

WITNESS SCHWARTZ: I think that, first of all, I don't know that from the outside that you could measure Lehman's exposure as being that much greater than Goldman's.

I know, you know, later you found out that Goldman had put on a lot of hedges. Lehman supposedly also had on a lot of hedges. So from the outside you cannot tell what somebody's net exposure was to the mortgage market, point number one.

Point number two, at least in our case again I don't think it was that we just sat there and said, oh, we can stay exposed to the mortgage market regardless of the conditions in the market. I think that there was a tremendous amount of research done. I think that the fact that we pulled back from the subprime market in '06 and into '07 and were very light in that market was because of our perception of where the risks in the market were.

But, you know, you were constantly trying to figure out how bad the market could get in housing, but also how protected you were by what kind of quality of mortgages, and where you ranked in seniority in the securities.

So I don't think that just saying everybody just said, oh, I'm going to just stay exposed to mortgages, just to me doesn't feel like an accurate statement.

COMMISSIONER HOLTZ-EAKIN: Okay. In retrospect, it feels like a consensus between the two of you that the investment banks all failed for essentially the same reasons; that there wasn't any great difference among them. Is that fair?

WITNESS CAYNE: I think it's fair.

WITNESS SCHWARTZ: No, I think that dif--

WITNESS CAYNE: I hope he thinks it's fair, too.

(Laughter.)

WITNESS CAYNE: Got to be careful.

COMMISSIONER HOLTZ-EAKIN: I'm just trying to get the party line here.

WITNESS SCHWARTZ: I think that the market's loss of confidence spread to every investment bank; and that’s what it took to support them was bigger and bigger steps as the market went along.

So I think if you say did the market lose confidence in all investment banks, or did liquidity--was liquidity drying up to all investment banks, I think the answer to that question is yes.

COMMISSIONER HOLTZ-EAKIN: So two questions on rewriting history.

If you were looking back, to sort of change one piece of the business model, the leverage, the reliance on short-term finance, your liquidity strategy, your risk management and underlying assets, what is the piece that you in retrospect would do differently?

Mr. Cayne?

WITNESS CAYNE: Well that's a question I've asked myself for close to three years that I've been retired, and I don't have an answer.

COMMISSIONER HOLTZ-EAKIN: Mr. Schwartz?

WITNESS SCHWARTZ: It's also, unfortunately, a question I've asked myself probably every day since March. And, you know, I guess I would say I can't think of anything we could have done within the context of our business model.

I think that '08--'07 turned out to be a year where at some point, step one, you had to really get bearish on the overall mortgage market. And that's a big, big thing to do as a business, as opposed to as an investor.

But I guess with the benefit of a lot of hindsight and knowing how the market has worked out, we could have taken down our inventories dramatically, even though we were a major dealer, and/or put on very significant shorts against the housing market.

But it's just rare when you're running a business that you have to make one decision like that and get it 100 percent right in timing and magnitude.

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the Commissioner an additional three minutes.

COMMISSIONER HOLTZ-EAKIN: So I want to ask two questions, which everyone has danced around but I'll just ask them, to each of you:

Did you think Bear was too big to fail?

WITNESS CAYNE: No.

COMMISSIONER HOLTZ-EAKIN: Mr. Schwartz?

VICE CHAIRMAN THOMAS: I've got to have more than 'no.'

COMMISSIONER HOLTZ-EAKIN: I'm going to come back. Let him answer.

WITNESS CAYNE: I'm sorry?

VICE CHAIRMAN THOMAS: I said, I need more than 'no.'

COMMISSIONER HOLTZ-EAKIN: I'm getting a performance evaluation from my boss. It happens.

(Laughter.)

WITNESS SCHWARTZ: It happens to me, too.

(Laughter.)

COMMISSIONER HOLTZ-EAKIN: Welcome to my life.

WITNESS SCHWARTZ: No, I don't believe we were too big to fail.

COMMISSIONER HOLTZ-EAKIN: So the second part of the question: Did you expect at any point leading up to March, either you or you, that the Fed would in fact open the Discount Window to you and that you would get some assistance? Did you ever expect that in any way?

WITNESS CAYNE: I think it's a better question to ask Alan, because my role was totally different in March than his. I was the Non-Executive Chairman of the Board, and I was not part of management, and I didn't attend management meetings, and I was simply informed as a board member where we stood. So that question really should be referred to him.

COMMISSIONER HOLTZ-EAKIN: But in your gut, you didn't have any sort of feeling that, yeah--

WITNESS CAYNE: I was shocked beyond belief.

COMMISSIONER HOLTZ-EAKIN: That they did not?

WITNESS CAYNE: That it happened. That we failed.

WITNESS SCHWARTZ: I was not optimistic that the Fed would actually open the Discount Window to dealers.

COMMISSIONER HOLTZ-EAKIN: Or do anything else for Bear in that moment?

WITNESS SCHWARTZ: I didn't--I didn't have any anticipation that they would do anything special for Bear Stearns. I had a belief, which I actually think was born out, that they were trying to think of ways to enhance liquidity for high-quality securities that were on dealers' balance sheets.

So they went through a couple of processes. I'm going to say it was late '07 or Fall of '07, if my memory serves me correctly, where they announced a program to cut the differential and the discount rate from the funds rate, and that they had a conference call with all dealers and they said they would consider it a sign of strength to see banks come to the Discount Window.

And I think that was an attempt to get banks to use their access to the Discount Window to provide funding lines to the securities dealers, but it didn't happen.

I believe, if I remember correctly, on the Monday or Tuesday, somewhere in the early part of the week of May 10th, March 10th, I'm sorry, when we had our problem, they announced that they were creating a new facility for dealers that would allow them to bring high-quality, certain securities to a window that was similar to the Discount Window.

The only problem was they said that that would be available in 30 days from now, which may have only pushed some of the rumors.

But I didn't think that the Fed would preemptively open the Discount Window to the dealer community.

COMMISSIONER HOLTZ-EAKIN: Is it a fair summary, then, Mr. Cayne, for you to say that, while you didn't think Bear was too big to fail, you were surprised that a firm situated as Bear was permitted to fail? And would it be fair for me to say that--

VICE CHAIRMAN THOMAS: I yield the gentleman an additional minute.

COMMISSIONER HOLTZ-EAKIN: --so I can do an unfair summary of their comments--I've learned this from my boss--is it fair that while you did not feel there was an expectation, the Fed wouldn't step in and help Bear, but there was an expectation the Fed was going to move and help firms situated like Bear because of their liquidity issues and their holdings? Is that a fair summary?

WITNESS CAYNE: Well again, I was in a far different position at that point in time. In the Monday of the week, it was business as usual. On Thursday night I got a telephone call saying it was bad, very bad.

COMMISSIONER HOLTZ-EAKIN: But you were shocked that Bear was permitted to fail?

WITNESS CAYNE: I think I was just shocked. I mean, something happened that I never envisioned would ever happen. So I wasn't really a good judge of whether or not there were more motivational things that I had to think about, including your question. So I just wasn't prepared--I'm not prepared to answer.

WITNESS SCHWARTZ: Well I was shocked that we got in the situation we did, but I didn't have any illusions that if we did that somebody had our back.

COMMISSIONER HOLTZ-EAKIN: Thank you.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Senator Graham.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman, and thank you to our witnesses.

I have two lines of questioning. The first is on risk management, and the other is the 2004 decision to go to the SEC for Consolidated Supervision.

Mr. Molinaro said this morning that, quote, "No one could have foreseen the mortgage collapse." In hindsight, the fact that there was an event of such magnitude just over the horizon and someone who was in such an advantaged position as the CFO of one of the major investment banking firms felt he had no ability or concept of that imminent collapse, knowing what you know now what could have been done, what should have been done, what could be done today for the future, to give you a better over-the-horizon capability to see an event of this magnitude that was impending?

WITNESS CAYNE: Well that's an interesting question only in that if you had the answer to it you would be unique. Really unique. Because you're basically saying, I see something coming, and in all fairness 99.9 percent of the rest of the people on earth don't see it coming. But I do see it coming.

And that's unusual, highly unusual; it's unique.

COMMISSIONER GRAHAM: But you are substantially less than 1 percent of the human race was in this position of Mr. Molinaro to (a) be focused on the importance of knowing what's over the horizon; and with access to the kinds of information that would have given you a clue. But the fact that he, as that fraction of 1 percent, has stated that he was so unaware, to me it was surprising.

And now that it has actually happened, have we learned something from this experience that might make us more attuned to future circumstances of over-the-horizon major events?

WITNESS CAYNE: I will stand by what I said. It's simple. Very few people, including people who were right in the middle of it, as Mr. Molinaro, had any inkling that this could happen.

The people that bet against the housing market--obviously few and far between--I mean, they've become legends. They've become legendary as far as winning an inordinate amount of notoriety and success, and it's rare.

COMMISSIONER GRAHAM: Is there something to be gleaned from what those few who did see this, what were their divining rods of perception?

WITNESS CAYNE: I would be better able to answer that question if I was one of the people that did it.

WITNESS SCHWARTZ: Well I think that clearly there is at any given time in the marketplace--and I would emphasize there is a difference between running a business and running a portfolio where you can make a decision on a given day that you just want to short a market--at any given time, however, if you look at the prognostications of the experts, you are going to find people on each end of the bell shaped curve.

You are going to find some people who are predicting tomorrow that the economy is about to collapse and go into a world-wide global depression; and you are going to find some people over here that are going to say we're about to enter a new boom that nobody is expecting, and most of the world is somewhere in between.

And if you were to rely on in running a large business that when you're on this end of the bell shaped curve that you're not only going to be right, but you're going to be right now.

So there were people who were predicting the decline of the housing market since 2004. And if you went and bet on your business on that fact, you would not be around in 2007 when things happened.

But I would just say, sir, that I don't believe that the issue here is trying to figure out how to make financial institutions that prescient. I believe that we've never believed we had the ability to predict the next market movement, and that what we've always tried to do was have your balance sheet, especially for firms like ours, in very liquid securities.

That's what you wanted: all your exposures to be quite liquid. You wanted lots of cushion in case there was a period of some illiquidity so that you could work your way out, or you could support those positions.

I think what happened this time was, candidly, not, well, you didn't predict that the mortgage market might go through a once-in-a-generation event; it simply was the lack of liquidity in even the most highly rated tranches.

And I think that the focus needs to be: How do you create transparency in the securities that are dispersed out there in the system. Because it wasn't just Bear Stearns or investment banks; money market funds, SIVs, all of these kinds of instruments that relied on these securities being very liquid, when they froze they created the systemic problem. And I think that is the bigger issue.

COMMISSIONER GRAHAM: Let me turn in my remaining time to the second question, which is the decision in 2004 to go to the SEC requesting consolidated supervision of the five major investment banks.

Mr. Cayne, I assume that you were part of the decision to do that. What underlay the request that the SEC, that you voluntarily submit to their supervision?

WITNESS CAYNE: Why, is your question?

COMMISSIONER GRAHAM: Yes.

WITNESS CAYNE: Well we had a lot of subsidiaries all over the world, and it became very clear that you had to deal with the regulators, for an example, in Great Britain, as well as the regulators here.

And when you have entities all over the world, and you have therefore money all over the world, you're probably better off if you consolidated and have it under one consolidated regulator. It was a clear, easy decision to make. This wasn't complex. Once the opportunity was there to join that group, we took it and thought it was a very easy decision.

COMMISSIONER GRAHAM: And the SEC retained that for, what, three or four years and then they abandoned the program.

What, from your perspective, happened that caused the SEC to terminate its Comprehensive Supervisory--

WITNESS CAYNE: I don't know.

COMMISSIONER GRAHAM: Do you have an idea, Mr. Schwartz?

WITNESS SCHWARTZ: No, I really don't. I agree with Mr. Cayne's statements that I think consolidation--I think merging regulatory standards around the world is a real challenge, but it's going to be very important.

And I don't know whether the SEC ran into problems with disputes over how to deal with things on a global basis, but it's something that increasingly will become important.

COMMISSIONER GRAHAM: If I could ask just one--

CHAIRMAN ANGELIDES: Two minutes.

COMMISSIONER GRAHAM: --more question.

CHAIRMAN ANGELIDES: One minute.

COMMISSIONER GRAHAM: Our next panel is going to be the SEC. What question would you like us to ask of them to try to get to the answer to the issue of (a) why did they abandon the Consolidated Supervision that they had provided beginning in 2004; and (2), where did they see this globalization of standards going in the future?

WITNESS CAYNE: I think you're on the right track. I think--

WITNESS SCHWARTZ: I actually think those would be the right questions.

WITNESS CAYNE: That's what you should do.

WITNESS SCHWARTZ: Yes.

COMMISSIONER GRAHAM: Well I will accept that as an A grade, so I'm going to quit.

(Laughter.)

COMMISSIONER GRAHAM: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Mr. Wallison.

COMMISSIONER WALLISON: Thank you, Mr. Chairman. I also want to thank you two for coming here and spending so much time with us.

I would like to deal with this question of overwhelming market forces, because it came up in much of the testimony this morning, exactly the same words, and I heard it again at this table.

My first question would be of course what were these overwhelming market forces? Mr. Cayne, what's your view?

WITNESS CAYNE: I think I referred to rumor, innuendo, I'm not going to use the word conspiracy, but it was part of it. The overwhelming facts of Bear Stearns being condemned for--

COMMISSIONER WALLISON: Let me stop you there. I understand. I heard that this morning. But the trouble with this is, as I said this morning, is that the banks also had this problem. So it wasn't--I mean the regulated banks. We had a number of them fail.

So they were also hit by overwhelming market forces. There weren't rumors about them. This was not a problem that they faced. So it's not--it couldn't be just rumors about Bear Stearns that were the overwhelming market forces. No?

WITNESS CAYNE: Well that's probably correct. Can you give me a time frame?

COMMISSIONER WALLISON: Well in late 2007, early 2008, extending all the way through actually just several months ago, there were many banks in difficulty, including Citi, which we've had before us, talking about their problems in dealing with their assets.

So apparently these overwhelming market forces were much larger than simply things that were being said about Bear Stearns.

WITNESS CAYNE: Well then they were equal.

COMMISSIONER WALLISON: Right.

WITNESS CAYNE: So what's your question?

COMMISSIONER WALLISON: Well my question is: Do we know what they are? Do you have any idea what these market forces were?

WITNESS CAYNE: It's going to boil down to analysis ultimately of the status and the health of the housing industry.

COMMISSIONER WALLISON: Okay. Mr. Schwartz, do you agree with that?

WITNESS SCHWARTZ: I think that was--I guess I would say I would agree that the housing industry was the piece that started the ball rolling downhill. But if you ask what were the overwhelming market forces, I just think it's a combination of things. But I think it relates to things that I've testified about.

I think that there was a view that having the loans that were made historically by banks and stayed on banks' balance sheets when there was a credit cycle and there was a downturn, new credit couldn't get through the market because the old loans were stuck on bank balance sheets.

And there was a view that by pushing those assets out into the marketplace with a phrase that people talked about, "democratizing the credit markets," that by more broadly distributing the risk of the loans that were made, the economy could actually afford to make more loans. And, that that would enable more growth.

And so I think that, like in any new system, that system grew to be very, very large on a foundation of the ability to know what the risks were out there broadly across the system were determined by the ratings of the tranches.

And when that turned illiquid, I think the overwhelming market forces were there was enormous sums of money that wanted to be in very short-term, very liquid, very safe instruments that all headed for the exits at once.

COMMISSIONER WALLISON: Right. But again, we're talking about banks as regulated entities, and your organization and others similarly situated as unregulated organizations both affected by the same forces, I take it.

So what I'm trying to get at is, well, first of all, let me step back and say I have some question about whether the term "shadow banking system" is accurate. Because I see banks as quite a bit different from your business model, for example.

Banks actually had illiquid assets on their balance sheets. That's the unique thing that banks do. They convert short-term liabilities into long-term assets. That was not your business model. Your business model, if I understand what I've been told, is to buy these assets, securitize them, and sell them off.

So that you wouldn't expect to have much in the way of long-term assets on your balance sheet. And do you think that you held too many long-term assets? Is that one of the problems that you faced? You accumulated too much, and held too much?

Or was it simply a question of the market just suddenly falling apart, an entire asset class, mortgage-backed securities simply disappeared from everyone's balance sheet?

WITNESS CAYNE: I think it's the latter.

COMMISSIONER WALLISON: This asset class disappeared. Do you agree with that, Mr. Schwartz?

WITNESS SCHWARTZ: You said a lot of things leading up to that sentence, right, or to the question, so, one, you mentioned all of the differences between regulated commercial banks and investment banks. And since 2000, the differences aren't as black-and-white as you would imply.

COMMISSIONER WALLISON: Well are you saying then that you were holding a lot of illiquid assets? Or were banks holding fewer illiquid assets?

WITNESS SCHWARTZ: So I was simply saying that the banks' model wasn't necessarily the same as the model in the past.

In terms of ourselves, I don't think that we were voluntarily holding illiquid or long-term assets. As a market-maker, as the markets grew, you had a lot of inventory of things that in all markets in your experience had been liquid, and therefore those were the assets that you were willing to have as a market maker. The amount of them, long and short, and how you did it, was the risk that you had to measure. But having large amounts of what you thought were very liquid assets, what I think happened to the entire system, banks and other financial institutions, was that instruments that were expected to be liquid through all markets turned highly illiquid, and there was not anticipation that people were going to be holding now what were very illiquid assets at the same time that the market couldn't see what the quality of those assets was.

COMMISSIONER WALLISON: So the question--

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the gentleman an additional five minutes.

COMMISSIONER WALLISON: Oh, okay. Thank you, very much.

So the question of regulation, or lack of regulation, didn't really matter in this circumstance. Whatever it was that banks were doing that might be similar to what you were doing and was regulated didn't save them. Nor were you saved, of course, by the CSE program that the SEC ran, or any other kind of regulatory structure. Would that be an accurate way to look at it?

WITNESS SCHWARTZ: Yes, I think that's reasonably accurate. I think that the difference between the regulated commercial banks and the investment banks was that the regulated commercial banks had a program in place with a liquidity backstop that had been proven through many, many years, and the investment banks didn't.

I don't think the differential was the regulation of either one.

COMMISSIONER WALLISON: It turns out of course that the Fed opened the Discount Window for the other investment banks after you had been acquired. Yet that did not solve their problem, it appears.

What is your analysis of that? It apparently wasn't just a liquidity problem, because the Discount Window was there for them; and yet they all had to be in one way or another brought under the wing of some stronger institution.

WITNESS SCHWARTZ: Yes. Well actually not all investment banks had to be brought under the wing of a stronger institution, at least to my knowledge.

But I do think that this lack of transparency in the securities markets created an environment where, you know, the difference between insolvency and liquidity is really what the trick is. And I think that the markets couldn't tell.

And there was also--there were a lot of instruments, credit swaps and other instruments, that could overwhelm the market's appetite for supporting some of those institutions.

COMMISSIONER WALLISON: Mr. Schwartz, you talked about the fact that highly rated mortgage-backed securities had not yet suffered dollar one, I think was your phrase--

WITNESS SCHWARTZ: There are some.

COMMISSIONER WALLISON: --in losses. There are some?

WITNESS SCHWARTZ: Yes.

COMMISSIONER WALLISON: And I'm wondering what you thought, in light of that, about how those assets were treated under prevailing accounting rules. Did you encounter problems of that kind yourself? And what effect did that have on the way Bear Stearns was treated, or how it looked in terms of the way investors looked at it, and other financial institutions, if you care to comment on that?

WITNESS SCHWARTZ: Well I think that historically investment banks used mark to market accounting, and commercial banks didn't, because of the perceived difference in the liquidity of the assets on their balance sheet and the ability to look at a market and see what an actively trading market was at any given point in time for those securities.

So when the securities were created they stayed under mark to market regimes. And yet what happened from Fall of '07 through Fall of '08 was there was no discernible market.

And I feel that, you know, it's possible that the mark to market accounting forcing people to write down assets when there's no discernible market can then lead to more pressures on the same assets. And, you know, I'm not exactly sure how that played, but it was certainly a factor.

COMMISSIONER WALLISON: Was it a factor for Bear Stearns?

WITNESS SCHWARTZ: It was a factor, but I don't think it was by March of '08 as significant a factor as it became later.

COMMISSIONER WALLISON: Now we understand that Bear Stearns--and this is my last question--we understand that Bear Stearns held about $49 billion in mortgage-backed securities, I guess, not whole mortgages but mortgage-backed securities--

WITNESS SCHWARTZ: I thought it was a little, more like $47, but you might be right.

COMMISSIONER WALLISON: $47 billion? Fine. A little over 10 percent of your total assets. Was this what one would call pipeline risk? That is, you were intending eventually to securitize those? Or were you holding those for some other purpose?

WITNESS SCHWARTZ: It's a good question. I think, I couldn't tell you the exact proportions but some significant amount of it was pipeline, both RMBS and CMBS; and some of it was our--

VICE CHAIRMAN THOMAS: I give the gentleman an addition two minutes to finish his answer.

COMMISSIONER WALLISON: Thanks, Bill. I can't ask another question.

WITNESS SCHWARTZ: So what I was saying, I think some of the inventory was pipeline risk. It was inventory that was being put together to be securitized. Some of it was--and some of that for counterparties who actually were supposed to be on the hook for losses if they were incurred, but then some of those counterparties weren't in a condition to pay.

And some of it was market-making positions where you would be long or short in order to be able to make an active market for types of securities.

COMMISSIONER WALLISON: We would be able to reconstruct that from your financial statements at the time?

WITNESS SCHWARTZ: Um, it would be hard now. I don't think so.

COMMISSIONER WALLISON: Okay. Thank you very much.

CHAIRMAN ANGELIDES: Thank you, Mr. Wallison. Mr. Georgiou.

COMMISSIONER GEORGIOU: Thank you--

CHAIRMAN ANGELIDES: Mike on?

COMMISSIONER GEORGIOU: Thank you, gentlemen, for joining us today.

I want to ask you some general investment banking questions about securitization, if I can, because, you know, what happened to you in part was that these securities that everybody was treating as essentially sound, the counterparties were deciding that they weren't so sound as they wanted to lend against them, or certainly didn't want to lend against them without a significant haircut.

And, you know, we've heard from a number of people over the last sets of hearings that really in the securitization process all the players were compensated in cash at the inception of the creation of these securities--from the mortgage brokers who originated these loans, to the banks that purchased them and securitized them, to the lawyers who wrote the prospectuses, to the accountants who wrote opinions on them, to the credit rating agencies that rated them, sometimes getting a percentage of the issue as part of their structure, their fee.

And none of them really had any consequence in the event that the security didn't perform as expected. If the mortgages, if the people couldn't pay back their mortgages, the mortgage broker, nobody went back to the mortgage broker really. In some circumstances they had the right to do so, but it was very rarely exercised and frequently the people didn't have the money, in any event.

One thought that has been argued is that everybody's due diligence along the process here might have been better had they had to take the security themselves, or some significant portion of their fee in the security itself rather than in cash. So that you would be long that security. You would know it when you were creating it. All your people within your system that were creating it would know it. Their bonuses would be in part dependent upon the success. They might get the security as part of their bonus rather than in cash. That everybody would be aligned with the investors to whom you were selling those securities and representing them to succeed.

And I wonder--and when I asked this question to Mr. Blankfein when he was here a couple of hearings ago, he said: Well, if we had those securities we'd just hedge them on the other side so we'd be neutral.

But of course the idea that I was trying to express was that it really ought not to be neutral. As an investment banker, you are underwriting it. Underwriting it means you are supposed to be doing the due diligence and representing to the people you're selling it to that it will perform as represented.

I wondered if you could comment on whether you think that might be a healthy development. Or whether, more importantly, whether you think diligence failed with regard to certain creations of mortgage-backed securities, the collateralized debt obligations that were created from the low-level tranches of mortgage-backed securities, the synthetic CDOs, and a variety of other instruments, that if people had had to hold them, the institutions that created them, would that have increased the diligence and maybe made them better quality securities in the first instance?

Mr. Cayne?

WITNESS CAYNE: You want my opinion?

COMMISSIONER GEORGIOU: Yes, sir.

WITNESS CAYNE: I think you're right. I think you neglected to mention one party that I believe should have been included.

COMMISSIONER GEORGIOU: Yes, sir?

WITNESS CAYNE: That's the rating agencies.

COMMISSIONER GEORGIOU: I think I did try to--if I left them out, I didn't intend to. The rating agencies that rated them certainly also were incentivized, paid in cash when they rated them, and of course most of the institutions that bought them couldn't buy them unless they were rated AAA because they were pension funds or other people who had to have them AAA in order to buy them. And then nobody got paid if the issue didn't go forward.

Mr. Schwartz?

WITNESS SCHWARTZ: I think that you're on to a very good point. And I like to believe that our due diligence was pretty thorough. I remember in '06 we were being criticized by mortgage brokers because we were sending so many loans back that they had originated, and we were getting a bad reputation in the market from mortgage brokers.

But I think it's a very hard system to put back together. I think at the point of underwriting is the most important point. The origination part of the loan is the most important part. And then as you keep going down the line, I do think if you're securitizing them a move in the direction to force people along the line to eat some of their own cooking is the right direction. I think it's going to be complicated.

COMMISSIONER GEORGIOU: Why would that be?

WITNESS CAYNE: It's going to be hard to do.

COMMISSIONER GEORGIOU: And why is that?

WITNESS CAYNE: They're not going to like it.

COMMISSIONER GEORGIOU: Well, but that's--we're not here to worry about whether they're going to like it or not.

WITNESS CAYNE: I understand, but if it was as easy as just saying it and then doing it, it would have been done already.

COMMISSIONER GEORGIOU: I understand that. I understand that. But at the end of the day, a lot of these securities ended up losing their value. They really weren't as solid as they were represented to be along the way, and obviously that led to the collapse of a variety of institutions, not just yours.

COMMISSIONER GEORGIOU: Okay, well thank you for your answers in that regard. Probably if I were smart I would stop there, but I'm going to ask a couple of other things.

Mr. Cayne, this House of Cards book that Mr. Cohen wrote had you quoted as saying some sort of unfavorable things about Mr. Geithner, who we're going to hear from tomorrow.

Do you recall what those were?

WITNESS CAYNE: Do I recall saying unfavorable things about Mr. Geithner?

COMMISSIONER GEORGIOU: Well I'm just saying, do you think--

WITNESS CAYNE: I didn't read the book.

COMMISSIONER GEORGIOU: --there are questions we ought to be asking--I've read the book.

WITNESS CAYNE: I didn't.

COMMISSIONER GEORGIOU: Oh, you didn't read the book?

WITNESS CAYNE: No.

COMMISSIONER GEORGIOU: I'm sorry. Okay, well then I can't--it wouldn't be fair to ask you.

Let me ask you, at the risk of being the oldest person who sometimes reads Rolling Stone, I'm going to ask you about whether you read this article the 15th that ran the 8th of April of this year by Matt Taibbi in The Rolling Stone entitled "Wall Street's Naked Swindle: A scheme to flood the market with counterfeit stocks helped kill Bear Stearns and Lehman Brothers and the Feds have yet to bust the culprits."

WITNESS CAYNE: I hope this panel isn't the buster. I--

COMMISSIONER GEORGIOU: We're not--

WITNESS CAYNE: I have no idea. I don't read Rolling Stone, and I--

COMMISSIONER GEORGIOU: Well, we're definitely not the busters. There's no question about that.

WITNESS CAYNE: Okay.

COMMISSIONER GEORGIOU: But in it, it suggests that there was a major bet, a very significant bet, against--that Bear Stearns's securities would drop. It would only pay off basically if Bear Stearns's securities dropped by half in a very short time. And there's a suggestion that there were quite a lot of naked short sellers who were running a Bear hug, or whatever they call a Bear raid, against Bear Stearns, if you will; that they were selling securities they didn't really own, that they never covered; and that they drove your stock price down very dramatically; and that this question was raised. The question was whether this was an insider manipulation of some sort? And I guess Chris Dodd asked Chris Cox about it at some hearing and Cox said that he was going to investigate into it, and of course we've never learned much about it since then.

I wondered if you have any thoughts in this regard? I know you mentioned something about it earlier.

CHAIRMAN ANGELIDES: Another minute to wrap up.

WITNESS CAYNE: I did earlier.

CHAIRMAN ANGELIDES: Another minute just to wrap up. Go ahead.

COMMISSIONER GEORGIOU: Do you have any thoughts?

Do you think that that happened? Do you have any evidence to indicate that it happened?

WITNESS CAYNE: I have no evidence.

COMMISSIONER GEORGIOU: Have you been asked by the SEC whether you knew of anything about it? Was there any investigation that you're aware of that was conducted?

WITNESS CAYNE: No.

COMMISSIONER GEORGIOU: Mr. Schwartz?

WITNESS SCHWARTZ: Yes, I did speak to the SEC. I believe they did investigate. I don't know if that's past, or continuing.

In my heart I believe there was some stuff going on. Can I prove it? I think, you know, the only analogy that's been drawn is it's very hard to distinguish when a bunch of people are running out of a crowded theater which one yelled 'fire' and knew it wasn't a fire, and which ones reacted. And I think that with all the activity, I just don't know if the SEC has been able to pinpoint who was reacting, and who was starting.

CHAIRMAN ANGELIDES: All right, Mr. Georgiou--

COMMISSIONER GEORGIOU: Were the volumes--let me just finish up this line of questioning, if I could.

CHAIRMAN ANGELIDES: One more minute, and then we want to move on.

COMMISSIONER GEORGIOU: Thank you.

Were there any--was there any evidence, was your volume higher, volume of sales higher during those days than had been customary? And was it higher than you thought?

WITNESS SCHWARTZ: The volume was huge. There were some very unnatural trades put on. But, you know, part of this gets into in today's world you can't only look at the stock and the short volume in the stock. You have to look at credit spreads and other things that are accelerants in this process.

I have every belief that the SEC has investigated. I just don't know if they were able to separate people who were starting rumors and people who were responding to rumors.

COMMISSIONER GEORGIOU: Okay. Thank you very much, Mr. Chairman.

CHAIRMAN ANGELIDES: Mr. Hennessey?

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

So the story that I've heard is that in early March of 2009 Bear Stearns was both profitable and solvent, and then--

WITNESS SCHWARTZ: 2008?

COMMISSIONER HENNESSEY: 2008, pardon me--and that some unfounded rumors then caused a run. And as I understand it, it was both a run on short-term financing and liquidity run, and then also customers were pulling out.

So let's stipulate that all that's true, and I want to focus on the actual run itself and understand it. What we heard this morning was that Bear's reliance on very short-term financing for liquidity purposes was basically following the industry model--basically, everybody does it.

Then we heard discussion of how Bear had shifted from unsecured commercial paper as the source of short-term financing to secured repos.

My two questions are:

One, did Bear's use and the industry's use of short-term financing, very short-term financing, increase significantly over the prior, I don't know, five years, or a decade?

And then two, without the existence of a backstop, in retrospect was that model flawed because at some point in time if some unfounded rumor was going to be out there somebody was going to be vulnerable to a liquidity run?

Mr. Schwartz, we'll maybe start with you.

WITNESS SCHWARTZ: Well I don't recall all the numbers, but I believe that we balanced short-term funding and long-term funding. I know we raised a lot of long-term funding over the two, three, four, five years leading up.

I think that the proportion of short-term funding that we held was related more to what kinds of inventory we were financing, or what kind of assets we were financing.

And so what was most important was not the percentages but when you had very highly liquid collateral you could rely more on lending that out, or if you had things that were less liquid you wanted to make sure that you had long-term funding. And we looked at that on a continuous basis.

COMMISSIONER HENNESSEY: So you believed that you were, as best you could, balancing the duration of the assets with the duration of the liabilities?

WITNESS SCHWARTZ: Yes.

COMMISSIONER HENNESSEY: Then what happened in the run? Let's assume that there are unfounded rumors out there. How did that model fall apart and force Bear to spend all of its cash and then end up having to have the Fed step in?

WITNESS SCHWARTZ: It's hard to know what's in the minds of people, but I think that what happened was probably as related as anything else to a fear of the unknown. That, you know, all of a sudden people started anticipating what would happen.

I know our clearance clients that have been with us for a long time would have their investors calling them and saying why are my assets being held at Bear Stearns when I'm hearing these rumors, and I hear about this, and it becomes easier, even if you don't think that you have a lot of exposure, it's just easier to move across the street and say, okay, now I'm holding it at another place.

And there's a lot of prisoners' dilemma that goes on in these markets on the run on any banks. It's, you know, even if I think the institution is safe, if everybody else is running for the exits, do I want to be sitting here?

And I think when it gets to the repo markets, people in the repo market are looking for a very small return. They're short-term lenders, and again if, yeah, I'm sure if there's a problem with Bear Stearns, if I have enough margin I can take the collateral, I can liquidate the collateral, I can send them back a check for the difference, but do I want to do that?

COMMISSIONER HENNESSEY: Yeah. My question is a little different. It's not about the underlying psychology of the run, which I assume there's some amount of irrationality there, but more if we don't--if other firms, other broker-dealers were not to have a liquidity backstop, a Discount Window from the Fed, aren't they vulnerable to exactly the same scenario that happened to Bear in March of 2008?

WITNESS SCHWARTZ: Yes. I think that if you're asking if I think that, going forward do I think that whatever the rules of the game are they ought to be consolidated? Yes, I do.

COMMISSIONER HENNESSEY: Okay, can you be a little more specific in terms of either what changes in other broker-dealers financing practices, or what rules would prevent this from happening in the future, assuming that at some point in the future there will be an irrational panic about some other broker-dealer?

WITNESS SCHWARTZ: The only thing that I can think of is that I believe that securities that were created that were one-off, that would be much better off if we can move many more of the same types of instruments that accomplish a lot of the same things for the economy, be blended into securities that are more transparent and more similar to each other.

So clearing houses and exchanges and more transparency as to what, if there are assets on an investment bank's balance sheet, just in the same way you can look and say if they have stocks I know there's a market, if they have corporate bonds I know there's a market, if they have all of these other kinds of structured securities, I think financial institutions--that the more of those instruments that you move to exchanges and clearing houses it reduces the dependence on who the counterparty is, or when you get these markets lending.

And if there are legitimate needs for structured type of financing, I think that the capital charges held for those kinds of assets should be much, much higher than against normal securities.

COMMISSIONER HENNESSEY: Okay. I think the second part of your answer is getting to what I'm getting at.

The first part seems to be trying to reduce the risk that somebody will lose confidence in a firm in the future and that there will then be a run. What I'm trying to get at is: What can harden the firm so that it is better able to withstand a run when one occurs?

WITNESS SCHWARTZ: And I think, I hope I'm understanding your question, and I think it's responsive because I don't think capital adequacy or long-term funding is going to be the issue.

I think that the system just can't rely on that. Somebody mentioned that forever banks have turned the public's desire for long-term loans and yet short-term deposits into an industry.

COMMISSIONER HENNESSEY: Right. And what I'm wondering is, were the funds so short-term and such a large proportion of the financing that they made the firm particularly vulnerable to a run unrelated to whether the firm was actually solvent or profitable?

WITNESS SCHWARTZ: I think if you're saying "the firm" in general--

COMMISSIONER HENNESSEY: Yes.

WITNESS SCHWARTZ: --I think that that's what--if you're asking how do we keep that from happening, I think that the more transparency of the balance sheets, and the more transparency of the instruments you're trying to finance. As long as--for a long time, securities firms did fine. They did use secured funding overnight, but they used it against marketable securities. And those marketable securities people could get an idea of, they're down 10 percent, or they're down 20 percent, but they understood what they were.

And so I just--I know I keep emphasizing it, but I think without transparency the markets just simply won't work.

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the gentleman an additional five minutes. You're good? Thanks.

CHAIRMAN ANGELIDES: Ms. Murren?

COMMISSIONER MURREN: Thank you.

Thank you for being here. I wanted to follow up on the dialogue with regard to the Bear run, no pun intended, on your company. Because there seems to be a tone of disbelief both in the articles that I've read about your commentary from the observers, and also I think from some of the people that you've spoke to about this.

But when I look at it, there are many other companies in various industries outside of the financial services sector, including companies that are in the energy industry, or even technology companies, that have undergone similar circumstances where companies that may have for a period of time relatively sound fundamentals, or certainly not ones that would argue that they would be on the verge of a financial collapse, that because of pressure on their equity, their debt, their credit, whatever it may be, lead them to a point where they simply cannot recover.

And I wonder from your perspective, do you think that a more transparent regulatory environment that relates specifically to looking at the positions taken by hedge funds would allow people to observe any kind of motivations that may surround the behaviors that sometimes come along with short positions? Some of the things that may cross the line into manipulative behavior outside of simply taking a position because of your belief, or disbelief in fundamentals?

WITNESS CAYNE: I think on paper I think you have a very good idea. First of all, you're going to have a problem taking a look at what the hedge funds are doing, I believe.

Secondly, there are indications from time to time that will wake up anybody to the fact that there's something going on. I'll give you a good example.

In Chicago, either there is the Board of Trade or the Merc, one of the two, has got what they call puts and calls. And if a stock is selling at 80, you very well may make a bet on a put at 70, or a call at 90, something within the realm of the existing price.

At the very end, the--it was either the Merc or the Chicago Board of Trade, I'm not sure which, there was a request, and I believe it might have been granted, when Bear Stearns was selling at about $70, $75 a share, somebody wanted a market made on puts at $20.

COMMISSIONER MURREN: Do you know who that was?

WITNESS CAYNE: Nope.

COMMISSIONER MURREN: And have you asked either the CBOE or the--

WITNESS CAYNE: No, I've not pursued it at all. I could be wrong, and I will stand corrected if I am wrong, but if I'm accurate that that actually in fact did happen, there should be an investigation take place and see who the parties were that did it, who were the people who insisted that there be a market for Bear Stearns at $20 when the stock was selling at $75 or $80.

So I'm just passing that along as a thought of why I think possibly something was askew, something was wrong with the picture. A.

B, the uptick rule. When you talk to the SEC today you want to talk about something that in my opinion is completely illogical. That is, the removal of the uptick rule created I believe in a self-fulfilling drop, precipitous drop, that couldn't be checked.

If you--on the other hand, I don't even know why they called it off. At one point there was an uptick rule. Now there is no longer is an uptick rule.

I believe there was also a rule about shorting financial stocks. I don't have any opinion about that, but I do have an opinion about the uptick rule.

So on those two points alone, there is a reason for me as a big ex-shareholder of the company to feel that something might have happened untoward.

COMMISSIONER MURREN: Thank you. And you, Mr. Schwartz?

WITNESS SCHWARTZ: Yeah, I think I testified before that, you know, I think there was activity that was motivated by profit motive. To start rumors, I think it's very hard to find. I think that I do want to make a point, though, while it is an issue for any company, it is an acute issue for financial companies.

Financial companies have always been different than other companies as it relates to rumors, because the nature of short-term deposits and long-term loans makes financial companies a self-fulfilling prophesy of rumors.

I.e., when rumors started one week before Bear Stearns announced its first quarter, an industrial firm would have stayed in business until they could have announced that quarter and let people assess the company. It's very hard to drive an industrial company out of business in a week. But financial companies can be driven out of business by a run on the bank.

So there is a big difference. Some of the issues, though, are still the same. And I think that, you know, I personally believe the SEC is looking hard at the issue, or at least has. I just can't really comment on why they have or haven't been able to uncover something.

COMMISSIONER MURREN: I do think that it extends into other industry groups. I mean, the ability to access credit is important to a number of companies for a number of reasons.

The timing obviously will depend and vary, but I guess what frustrates me a little bit is the lack of specificity and the inability, it seems, for whether it's the agencies, or whether it's us, or the general population, or the two of you who are very knowledgeable about this field, to be unable to pinpoint exactly what has crossed the line, where it happened, and who it happened with.

Because I think that understanding those dynamics can help us to understand the difference between a free market situation and also something that's flat out manipulative and damaging to the economy. And that is where I think, you know, your insights into that would be helpful.

Thank you.

CHAIRMAN ANGELIDES: Thank you.

Ms. Born, you wanted a couple of minutes?

COMMISSIONER BORN: Please.

CHAIRMAN ANGELIDES: Great.

COMMISSIONER BORN: I just wanted to follow up on one thing, Mr. Schwartz. You had stressed that transparency of balance sheets and instruments is very important going forward you think to try to forestall a repeat of this sort of panic and confusion we've had.

And you've talked about how complex, customized securities you think should be more transparent. They should tend to be standardized, traded on exchange, cleared, have capital requirements imposed.

While you were talking about securities, do you think the same applies to derivatives?

WITNESS SCHWARTZ: Yes, I do.

COMMISSIONER BORN: Thank you.

CHAIRMAN ANGELIDES: Mr. Thomas?

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

I would like to ask both of you, each of you, if you would be willing to respond to questions that we have at some future time in writing so that, as we learn more, we can come back and revisit you, as Commissioner Murren said. There are a number of questions that we may decide we would very much like to ask you, based upon your background and this testimony, at a future date; that we don't bring you back, you just supply us with the written answers? Is that okay?

WITNESS CAYNE: No problem.

WITNESS SCHWARTZ: Sure.

VICE CHAIRMAN THOMAS: Good. I know it was hard and difficult to sit there and listen to us ask you questions about what you should have known, and why didn't you. I would like to switch that and say: Let's visit the past based on, obviously, what we know now.

Several times, Mr. Schwartz, you have indicated that you had Glass-Steagall clearly separating financial functions. The so-called shadow banking world developed in part because of those limitations on commercial.

At what point when you look back--and we can easily start with for example the repeal of Glass-Steagall, but it's pretty late in the history to use that as a hinge, but if you're comfortable with that we can use that--at what point do you think there should have been, and I don't care whether it's the SEC, the Fed, Treasury, some other institution, creating the kind of backstop that you saw that commercial banks had in investment banks or shadow banking, in hindsight when was it foolish to believe that short-term risk with no backstop which could kill you in liquidity as we've described what happened, should have been in place, in your opinion?

And would you have known it at that time that you were really on very thin ice in the way that you continued to carry out your business model?

WITNESS SCHWARTZ: I don't think I would have known it at the time. I do think there were people who were looking at the subject at the time, and I guess I would say the repeal of Glass-Steagall is probably an appropriate point in time because I think that if you're going to have a bunch of financial institutions who in essence are going to own the same things--

VICE CHAIRMAN THOMAS: Yes, at that point--

WITNESS SCHWARTZ: --at that point, if they're going to end up owning the same things, then relying on one to make credit available through say a discount rate or a discount window mechanism is less likely to happen. I don't think maybe people saw to the extent that that allied with that the securitization of things like mortgages and other things, created this tremendous growth in securities that would become less liquid.

But I think at the time it did make sense to say, if we're going to change the rules of the game we ought to be thinking about how we backstop these institutions.

I actually believe it was looked at pretty hard in the period right after Glass-Steagall, and I think that my understanding is that people looked at it and said, well the market is big enough and broad enough there will always be a market for liquid collateral out there, and we don't need to worry about it.

VICE CHAIRMAN THOMAS: Mr. Chairman, I think that's a sufficient bridge to the next panel. I want to thank you very much for coming before us, and especially your willingness to answer questions as we go forward.

Once again, we are very pleased to have folks who are alive and who were alive and who have first-hand knowledge of what happened at that time. We have read a lot of books and estimates of what happened, but as my father used to say it's always worth it to get it from the horse's mouth. So thanks a lot for being here.

WITNESS SCHWARTZ: Thank you.

CHAIRMAN ANGELIDES: Just a couple of wrap-up questions. We're not quite done yet.

VICE CHAIRMAN THOMAS: Yes, but I am.

CHAIRMAN ANGELIDES: But Mr. Thomas is.

But let me just ask you a couple of questions, and make one observation.

First just a clarification question. I want to ask this, because we started out talking about risk management, to the extent to which you could have controlled your fate versus outside forces, and I had mentioned earlier that according to interviews there were folks in the company--Mr. Greenberg, Ms. De Monchaux, Mr. Mayer, Mr. Steinberg--who argued for repositioning. I don't know if that's accurate or not. You can tell me that.

Yes? No?

WITNESS SCHWARTZ: I believe that's accurate.

WITNESS CAYNE: I believe it's accurate to a degree.

CHAIRMAN ANGELIDES: To a degree?

WITNESS CAYNE: Correct.

CHAIRMAN ANGELIDES: All right. Oliver Wyman, the consultant, identified--

WITNESS SCHWARTZ: Well, let me--just, I'm sorry, Mr. Chairman--

CHAIRMAN ANGELIDES: Yes.

WITNESS SCHWARTZ: --but I don't want to just say that's accurate and let it sound like we just decided to ignore it.

CHAIRMAN ANGELIDES: Okay.

WITNESS SCHWARTZ: I think that appropriate risk management is getting people in a room and everybody getting a chance to put out every idea they have to get us out of this situation.

Some of the people you mentioned were in our Risk Policy Committee, and I would say pretty much every week--

CHAIRMAN ANGELIDES: I guess here's the question---

WITNESS SCHWARTZ: --we had a discussion--

CHAIRMAN ANGELIDES: Yes--

COMMISSIONER HOLTZ-EAKIN: If you would like to interject--

COMMISSIONER HOLTZ-EAKIN: Yes, I just wanted to make sure I understand, because I thought we had this conversation where in fact you did preposition, but you didn't--

WITNESS SCHWARTZ: We prepositioned differently than some people thought.

COMMISSIONER HOLTZ-EAKIN: --by adding your shorts--

WITNESS SCHWARTZ: Right, so--

COMMISSIONER HOLTZ-EAKIN: --and restricting your longs.

WITNESS SCHWARTZ: Correct. But that's not the same--

CHAIRMAN ANGELIDES: But apparently not as far as some people thought you should.

WITNESS SCHWARTZ: No, it's not not as far, it's the mechanism we used. So some people said, let's not hedge; let's sell. And they said that every week in the meetings, and we'd say, okay, let's sit down. Tell us exactly what you would sell. Show us what you think the market is. And by the time the meeting was over, it would be, well, you know what, that probably isn't going to work. The hedge is probably a better way to go.

CHAIRMAN ANGELIDES: All right, let me make one statement and ask one last question.

Which is, I do want to take issue, Mr. Cayne, with something I think you said to Senator Graham about 99.9 percent of the world did not predict what would happen.

I mean, I just want to make an observation that that seems to be said broadly, but I think that there were a lot of indicators along the way, and a lot of folks--there was a very robust debate.

And I doubt that the position of Bear Stearns would be to tell their clients: Invest with us and we have no ability to predict the future. I mean, the fact is: Strip it all away, the housing market was going hog wild in many respects. And there were many indications of a market out of tilt from states fighting unfair and deceptive lending, to the level of mortgage fraud rising to home prices going up 11, 15 percent a year, which was unprecedented, to defaults coming well before unemployment started to rise and early payment defaults.

So I at least just wanted to put that--because there seems to be a constant refrain, and you are not unique in this, that no one saw it coming. And also we had a level of mortgage debt in this country, as I said earlier, that was extraordinary, particularly in an era when incomes were flat.

But here is I think the one thing I want to close on and ask both of you. There does seem to be a disconnect between what Bear Stearns and others, by the way--by no means the Lone Ranger, so I'm going to step back for a minute--what Bear Stearns and other financial institutions were engaged in, and what caused the crisis.

At a certain level, everyone keeps saying that there's nothing we could have done, but it's clear that there were a lot of things that perhaps shouldn't have been done.

The creation and trading of over-the-counter credit default swaps. The creation of products like CDOs that magically took BBB tranches into AAA tranches. The origination, in which you were very active, of subprime product into the marketplace, loans that never should have been made; negative amortization loans; low teaser loans;

and evidence they never should have been made by the extraordinary levels of early payment defaults.

And I guess at one point I think you said, Mr. Cayne, well, it was industry standard. I don't know who referred to the word "industry standards," and maybe it was the prior panel, but it does seem as though your firm and other firms--and by the way, was sanctioned by regulators--were participating in a range of activities that put the system at risk as a whole.

Would you agree with that? That it wasn't just we were doing what we were doing, and then somehow there were third-party forces, but it was the cumulative and collective effect of the very practices that were being engaged in that created the jeopardy?

WITNESS CAYNE: In hindsight, I agree.

WITNESS SCHWARTZ: I don't think that--I wouldn't take us to say that everything we did was right. I wouldn't take us to say that with hindsight you wouldn't change anything. You know, most of our questions have been about how could we have stopped the run on the bank, and I'm not sure we could have--as much as we've thought about that.

As it relates to what creates any kind of a bubble--and these things have been created repeatedly for many, many centuries--it takes a lot of participants. And it certainly took those of us in Wall Street. It took people in government. It took regulators. It took consumers. It took people who wanted to fill out fraudulent forms on their mortgage.

So there is certainly a whole group of people who participated in creating something that turned out bad, and certainly we were part of that.

CHAIRMAN ANGELIDES: All right. Thank you.

Any other questions from members? Or shall we take our break now?

(No response.)

CHAIRMAN ANGELIDES: Thank you very much for coming here today.

WITNESS SCHWARTZ: Thank you.

CHAIRMAN ANGELIDES: Thank you for your testimony and your answers to questions. We will take a ten-minute break.

(Whereupon, at 2:35 p.m., the hearing was recessed, to reconvene at 2:45 p.m., this same day.)

AFTERNOON SESSION

(2:51 p.m.)

CHAIRMAN ANGELIDES: The meeting of the Financial Crisis Inquiry Commission will come back into order. We are now on our third session of the day. It is the regulation of investment banks by the Securities and Exchange Commission.

Thank you very much for being here today, gentlemen. As we do with all witnesses, we are going to swear you before your testimony. So I would like to ask all of you to please stand up and raise your right hand to be sworn.

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

MR. COX: I do.

MR. DONALDSON: I do.

MR. KOTZ: I do.

MR. SIRRI: I do.

(Witnesses sworn.)

CHAIRMAN ANGELIDES: Thank you.

Gentlemen, thank you for being here. We appreciate you having submitted written testimony to us. We would also now like to give you the opportunity to provide verbal testimony of no more than five minutes.

And so with that, Mr. Kotz, we are going to start with you and we will go from my left to my right. So if you would please begin. Thank you, Mr. Kotz.

WITNESS KOTZ: Thank you.

Thank you for the opportunity to testify today before this Commission on the subject of the implementation of the Securities and Exchange Commission's Consolidated Supervised Entities, CSE, Program, and the adequacy of the SEC's oversight of Bear Stearns and other CSE Program participants.

I appreciate the interest in the SEC and the Office of Inspector General. In my testimony today I am representing the Office of Inspector General and the views that I express are those of my office and do not necessarily reflect the views of the Commission or any Commissioners.

The Office of Inspector General's mission is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the SEC. This mission has become increasingly important in light of the current economic crisis facing our Nation.

Our audit unit has issued numerous reports involving matters critical to SEC operations and the investing public. One of the most significant audit reports that we have prepared to date was a comprehensive report issued in September 2008 analyzing the [SEC] Commission's oversight of the SEC's CSE Program.

We initiated this audit based on a Congressional request received on April 2nd, 2008, from Charles E. Grassley, the Ranking Member of the United States Senate Committee on Finance.

Senator Grassley requested a review of the Division of Trading and Markets Oversight of the five CSE firms, with a special emphasis on Bear Stearns, and asked that we analyze how the CSE Program was run, and the adequacy of the [SEC] Commission's monitoring of Bear Stearns.

The audit was not intended to be a complete assessment of the multitude of events that led to Bear Stearns's collapse, and accordingly did not purport to demonstrate any specific or direct connection between the failure of the CSE Program's oversight of Bear Stearns and Bear Stearns's collapse.

Given the complexity of the subject matter, we retained an expert, Albert P. Kyle, to provide assistance with the audit. Professor Kyle, a faculty member at the University of Maryland, is a renowned expert on many aspects of capital markets and has conducted significant research on numerous finance-related matters.

Our audit identified deficiencies in the CSE

Program that warranted improvement. The CSE Program's mission was to allow the [SEC] Commission to monitor for and act quickly in response to financial operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including U.S. and foreign-registered banks and broker-dealers, or the broader financial system at risk.

Our audit found that the CSE Program failed to carry out its mission in its oversight of Bear Stearns because, under the [SEC] Commission's and the CSE Program's watch Bear Stearns suffered significant financial weaknesses, and the Federal Reserve Bank of New York needed to intervene during the week of March 10, 2008, to prevent significant harm to the broader financial system.

Overall, our audit found there were significant questions about the adequacy of a number of CSE Program requirements, given that Bear Stearns was compliant with several of the requirements but nonetheless collapsed.

In addition, the audit found that prior to Bear Stearns's collapse the SEC became aware of potential red flags regarding Bear Stearns's concentration of mortgage securities, high-leverage shortcomings of risk management and mortgage-based backed securities, and the lack of compliance with the spirit of international standards, but did not take action to limit these risk factors.

The audit also found that certain procedures and processes were not always strictly followed. For example, the [SEC] Commission issued an order that approved Bear Stearns to become a CSE prior to the completion of the inspection process.

The SEC authorized the CSE firms' internal audit staff to perform critical audit work involving risk management systems, instead of this work being performed by the firm's external auditors, as the rule that created the CSE Program required.

Further, our audit found the Division of Corporation Finance did not review Bear Stearns's latest 10K filing in a timely manner.

The audit identified 26 recommendations intended to improve the Commission's oversight of the CSE firms. The recommendations included:

A reassessment of guidelines and rules regarding the CSE firms' capital and liquidity levels;

Requiring compliance with the existing rule that requires external auditors to review the CSE firms' risk management control systems;

Developing a formal automated process that tracked material issues identified by the monitoring staff to ensure they are adequately resolved;

Improving collaboration efforts among the

Division of Trading and Markets, and Corporation Finance, and the Office of Compliance, Inspections, and Evaluations, OC, and the Office of Risk Assessment;

The development by Corporation Finance of internal guidelines for reviewing filings timely and tracking and monitoring compliance with its internal guidelines;

And the creation of a task force led by the Office of Risk Assessment with staff from Trading and Markets, Division of Investment Management, and OC, to perform analysis of certain large firms.

On September 26th, 2008, a day after we issued our report on the SEC's oversight of Bear Stearns and related entities, former SEC Chairman Christopher Cox announced that the SEC would end the CSE Program.

Notwithstanding the closure of the program, the SEC has made efforts to implement the recommendations contained in our report, and to improve its operations accordingly.

As of March 31, 2002, management had completed 23 of the 26 recommendations contained in our audit report.

In conclusion, we appreciate this Commission's interest in the SEC and our office, and in particular in our audit report. I believe that the Commission's analysis of these matters is beneficial to strengthening the accountability and effectiveness of the SEC.

Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Kotz.

Mr. Donaldson?

WITNESS DONALDSON: Chairman Angelides--

CHAIRMAN ANGELIDES: Turn your mike on, please, Mr. Donaldson. There's a button, there should be a button on the--and one thing I should add for the witnesses is, the light will go to yellow when there's one minute remaining on your time. And then to red when your time is up.

WITNESS DONALDSON: Thanks for inviting me to testify today.

I particularly appreciate the opportunity to offer my views at this hearing on the shadow banking system, given my long-standing interest in strengthened oversight of unregulated and opaque sectors of our financial markets, including during my tenure as chairman of the Securities and Exchange Commission from February of 2003 until June 2005.

You have asked me to discuss the origins, approval, and structure of the SEC's Consolidated Supervised Entity, CSE Program, and the impact of that program on the leverage of CSE participants.

You have also asked that I comment on several additional issues. These issues included first my understanding of the term "shadow banking;" second, the ability of federal regulators to oversee the shadow banking system; third, the SEC's ability to oversee systemic risk; and fourth, the role over-the-counter derivatives played in the financial crisis.

In my remarks today I will briefly summarize my views on these topics, a fuller discussion of which is included in my written testimony.

Before I discuss the topics further, I want to remind you that the views I express are my own and not necessarily the views of the SEC, any current or former Commissioners, or Commission staff.

Now, first I would like to discuss the CSE Program. While some public reports have mistakenly suggested that this step was deregulatory in nature, just the opposite is the case. The program in fact extended SEC oversight into new areas--namely, the activities of unregulated holding companies and other affiliates of U.S. broker-dealers.

The SEC does not have the legal authority to impose mandatory capital requirements on holding companies or large securities firms. Before 2004, the SEC had required regulatory capital computations only for broker-dealer subsidiaries of such holding companies.

The CSE Program established for the first time in SEC history a framework for consolidated oversight of the capital liquidity and risk parameters of such holding companies.

The global activities carried out by those holding companies through their non-SEC registered affiliates were of concern to regulators, including regulators in certain non-U.S. jurisdictions.

In 2004 during my tenure as Chairman of the SEC, the Commission adopted the CSE Program by a unanimous vote. Under the CSE Program, the holding company was required to compute on a monthly basis risk-based consolidated holding company capital.

The holding company was also required to provide the SEC with information concerning its activities and risk exposures on a consolidated basis, and to submit its non-regulated affiliates to SEC examinations.

The CSE Program relied on the agency's existing authority over broker-dealer affiliates as a basis of imposing examination and regulatory reporting requirements on a parent holding company.

The CSE rules adopted the Basel Standard as the benchmark for holding company capital reporting. The Basel Standard was generated through the collaborative efforts of bank regulators from the world's most advanced financial markets, and serves as the standard for internationally active financial institutions.

Consistent with Basel, the SEC amended its Net Capital Rule so that the broker-dealer affiliates of CSE holding companies would use their internal mathematical models to calculate the net capital requirements for the market risk of certain positions, which is how commercial banks have been computing market risk for their trading positions since 1997.

The [SEC] Commission recognized that utilizing these models might result in lower capital requirements than otherwise would be required under the Net Capital Rule. Accordingly, the [SEC] Commission decided to include a requirement that CSE participants provide an early warning to the [SEC] Commission if their net capital before utilizing the models fell below $5 billion.

The SEC also modified the rules to require CSE holding companies to hold more liquid assets than otherwise required under Basel.

The CSE rules did not, contrary to the suggestions in some published reports, eliminate leverage ratio restrictions on broker-dealers. Large broker-dealers have not been subject to leverage ratio requirements under the capital standards that have been in place since 1970.

Moreover, the Net Capital Rule never constrained leverage at a broker-dealer's holding company or other regulated affiliates. As a result, the many risky activities such as OTC derivatives, dealing and trading in real estate loans, were usually conducted outside the SEC registered broker-dealer.

Additionally, even at the holding company level the simplistic comparison of CSE leverage ratio to leverage ratios at banks is misleading. The product mix of securities firms typically differs significantly from that in banks. In particular, securities firms have relatively more extensive holdings of highly liquid assets and market making books and more limited exposure to off-balance sheet vehicles.

The CSE Program in other words represented a significant forward-looking effort to improve oversight of the unregulated affiliates of U.S. broker-dealers. It also required--

CHAIRMAN ANGELIDES: Can you wrap up? How are you doing, Mr. Donaldson?

WITNESS DONALDSON: I'm just going to stop right now.

CHAIRMAN ANGELIDES: Oh, sorry.

WITNESS DONALDSON: I was going to go on, but I won't, to talk about shadow banking and a couple of the other questions you asked, which I would be glad to do at the end of the session. Thanks.

CHAIRMAN ANGELIDES: Thank you very much, Mr.

Donaldson. We do have your written testimony, and we have got many hardworking Commissioners here, and we have read it.

Mr. Cox?

WITNESS COX: Thank you very much, Chairman Angelides, Vice Chairman Thomas, Members of the Commission, for this opportunity to offer my views today.

You have asked me to address the shadow banking system and the role that it played in the financial crisis, as well as the SEC's experience through a voluntary program to regulate one portion of that system.

The shadow banking system most often refers to borrowing and lending using nonmonetary instruments, as well as money, outside of the traditional banking system.

It includes money market mutual funds, insurance companies, investment banks, securitization vehicles, hedge funds, and most significantly the GSEs Fannie Mae and Freddie Mac which, with roughly $6 trillion in business, are by far the largest elements of the shadow banking system.

Even the commercial banks have been large elements in this shadow banking system through off-balance sheet entities and also through their investment banking subsidiaries.

In the run-up to the financial crisis, the abrupt devaluation of mortgage-backed securities and other credit risk transfer instruments led to many parts of the shadow banking system, including investment banks, facing a run on the bank. And that sudden devaluation of mortgage-backed securities was itself the result of an asset bubble, a bubble in the housing market inflated with high-risk mortgage products such as the notorious "liar loans" and the "no-money-down financing."

It is abundantly clear, as the SEC's former Chief Accountant Lynn Turner has testified, that if honest lending practices had been followed, much of this crisis quite simply would not have occurred.

Most of this of course took place within the traditional banking system, but the shadow banking system helped spread the contagion to every sector.

The failures and the bailouts of so many regulated commercial banks, as well as investment banks and nonbanks, highlighted the inadequacy of the capital and the liquidity standards in both sectors.

One might expect to see these problems in the unregulated part of the system, but what about the failures throughout the system?

To answer this question, a good starting point is the Basel Capital Standards for commercial banks, which didn't provide an adequate early-warning system. These standards, which are still in place today, assign risk weights to bank assets that treat mortgages, and in particular the securities of Fannie Mae and Freddie Mac as far less risky.

Even without the benefit of hindsight, commercial bank regulators had recognized the problems with the Basel Standards--for example, that they encouraged people to put risks off-balance sheet. That led to the Basel II Standards, which the SEC incorporated into its voluntary program that Chairman Donaldson just described, in 2004.

The program was voluntary, as he mentioned, because the [SEC] Commission lacked the statutory authority over almost all of the businesses within the investment bank holding company.

This program, the CSE Program, was built entirely on the SEC's jurisdiction over the regulated broker-dealer of the investment bank holding company. But Bear Stearns demonstrated that this reliance on the internationally accepted Basel Standards was a fundamental flaw.

The CSE Rules required an early warning, a notice if the firms were even coming close to the 10 percent capital ratio that the Fed uses to determine a well capitalized bank. And yet at all times, even during the weekend of its sale to JPMorgan Chase, Bear Stearns had a Basel Capital cushion well above that.

That is why in March 2008 I formally requested the Basel Committee to address the inadequacy of the standards in light of these experiences. Since all of the world's major banking regulators rely on the Basel Standards, this remains a matter of the utmost urgency.

While the SEC and the Fed and the Treasury were surprised by the speed of Bear's run on the bank, the decision that week that Bear Stearns was too big to fail was even more surprising.

The SEC, throughout its history, had seen investment banks fail or be acquired to save themselves--Drexel, E.F. Hutton, Kidder Peabody, Solomon Brothers, and more--and while the voluntary CSE Program certainly meant to give early warning of investment bank failures, it was not capable of preventing them, because no government regulation without taxpayer guarantees and backstops could do that.

Mr. Chairman, an important lesson from this is that the concept of too big to fail must be eliminated, along with regulatory and market uncertainty that follows from it. And the freedom to fail, which is a cornerstone of risk taking in a well functioning market, has to be restored.

I would add to this that transparency is a powerful anecdote for much of what happened in the financial crisis, and that is nowhere more true than in the OTC derivatives market.

Mr. Chairman, Members of the Commission, thank you. I look forward to your questions.

CHAIRMAN ANGELIDES: Thank you, Mr. Cox. Mr. Sirri.

WITNESS SIRRI: Thank you for the invitation to testify about the SEC's regulation of investment banks and the shadow banking system. I am currently a Professor of Finance at Babson College in Wellesley, Massachusetts.

From September of 2006 until April 2009 I was the Director of the Division of Trading and Markets at the U.S. Securities and Exchange Commission.

The SEC's regulation of broker-dealer finances aims to ensure that in the event of a firm's failure customers obtain the return of their cash and securities held at the firm.

Some broker-dealers are subsidiaries of investment bank holding companies, complex firms with hundreds or even thousands of subsidiaries. The vast majority of these subsidiaries, as well as the holding company of the entire investment bank, lacks a statutory regulator under the U.S. Financial Regulatory Regime laid out in the 1999 Gramm-Leach-Bliley Act.

That law provides for the mandatory consolidated supervision by the Federal Reserve Board of commercial bank holding companies, but not for holding companies of investment banks.

Thus, the U.S. regulatory system currently contains no statutory provision providing for substantive regulation of investment bank holding companies, including the setting of capital requirements at the holding company.

Nor does the statute provide any regulator the authority to impose liquidity standards or other requirements intended to guard the financial or operational condition of the holding company.

Finally, the law does not provide for a consolidated supervisor that is knowledgeable in the core securities business of these firms, and that has the authority to impose requirements that would be recognized for this purpose by international regulators.

Following the demise of Drexel Burnham Lambert in 1990, the SEC realized that the failure of the holding company, or a non-broker-dealer subsidiary, could cause problems for the regulated broker-dealer.

One of the measures taken by the SEC to address this serious regulatory gap was the Consolidated Supervised Entities Program for U.S. investment banks in March of 2004.

The CSE Program constructed an alternative net capital regime for the broker-dealer subsidiary which carried as a condition the affiliated holding company's consent to group-wide supervision by the [SEC] Commission.

This was a significant regulatory extrapolation that the [SEC] Commission believed in 2004 was necessary to fill a significant regulatory gap. For the five CSE firms the [SEC] Commission oversaw, not only the U.S. registered broker-dealer but also supervised the holding company and affiliates on a consolidated basis.

The CSE Program was tailored to reflect two fundamental differences between investment banks and commercial bank holding companies.

First, the CSE regime reflected the resilience of securities--the reliance on securities firms of daily mark to market accounting as a critical risk and governance control.

Second, the design of the CSE regime reflected the critical importance of maintaining adequate liquidity for holding companies that did not have access to an external liquidity provider.

It is important to note that the CSE program was not the only oversight regime applicable to these firms. The broker-dealers within the CSE holding companies were regulated and supervised by additional SEC personnel and by FINRA, a broker-dealer self-regulatory organization with extensive examination and enforcement staff.

And, there were functional regulators of other subsidiaries, including for example foreign broker-dealers, insurance companies, and thrifts.

The SEC required the CSE holding companies to maintain overall Basel II capital ratio of not less than 10 percent, consistent with the Federal Reserve's well capitalized standard for bank holding companies.

There has been much confusion surrounding the [SEC] Commission's alternate net capital rule for CSE firms, including the mistaken believe that the rule allowed investment bank holding companies to increase their leverage.

This is not the case, since prior to the CSE regime there was absolutely no regulation either by statute or by rule over investment bank holding company capital or leverage.

In addition to capital adequacy, the SEC required each CSE to adopt funding procedures designed to ensure that the holding company had sufficient standalone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment, where access to unsecured funding was not available for a period of at least one year.

The SEC viewed applying such a liquidity standard alongside a capital standard to be critical to the effective supervision of a CSE and, as noted earlier, was a critical distinction between the supervisory regime for commercial and investment banks.

The CSE Program adopted by the Commission was developed to fill a serious regulatory gap left after the Gramm-Leach-Bliley Act broadly restructuring the regulation of financial institutions.

A remaining imperative is the need to address explicitly how and by whom large financial firms with a primary securities business should be regulated and supervised and, in the case of financial distress, unwound.

Thank you for this opportunity to testify, and I would be pleased to answer any questions.

CHAIRMAN ANGELIDES: Thank you very much. We will now go to Commissioner questions, and I will lead off.

Mr. Cox, I want to start with you. I am going to focus my questions mostly on the SEC's specific supervision of Bear Stearns. I know other members will have comments generally, or questions generally about the CSE Program.

So just kind of a quick recounting of the facts. My understanding is that Bear entered the program in November of '05. As it happens, prior to the completion of the entrance exam that was required.

In 2006 there is no on-site exam, full books and records exam, because there is a reorganization of staff at the SEC. As it turns out, because the firm collapses in March of 2008, there is no exam for '07, which means essentially Bear is part of a regulatory program in which there's no on-site exam or examiners for the full length of time they're in the program.

I do understand that there are monthly monitoring reports where the SEC would talk to folks at all five of the investment banks, and I do understand that Bear would present quarterly liquidity and funding reports, and after August 5th, after Bear Stearns asset management hedge funds blew up, there were either weekly or daily liquidity reports, depending on the time frame. But all-told, as I look at this, and I want to clarify, I'm talking about on-site exams for the holding company--but as I look at this, it doesn't seem to be a regulatory program as we would normally conceive of it. And certainly not a regulatory program anything akin to the other supervisory programs.

And so when I look at it, to some extent it looks like a placebo, not a regulatory program. In what respect do you think it was a credible regulatory program for holding companies?

WITNESS COX: Chairman Angelides, as Chairman Donaldson just explained, this was additional regulation layered on top of what already existed for the regulated broker-dealers of each of the CSE firms, of which Bear Stearns was of course one.

For the first time as a result of the rules that the [SEC] Commission adopted in 2004, a year and a half before I became Chairman, the SEC was getting a look at all of the information at a consolidated level about risk management, metrics, and so on, that from its standpoint first might affect the regulated broker-dealer; and second, might affect the environment in which these firms, and in particular their regulated subsidiaries, were operating.

So in those ways, this was a broad expansion of the SEC's vision. As you know, because you are looking at the whole picture, what was going on inside the SEC's line of sight was only part of the whole picture.

The bank holding company, supervised by the Federal Reserve and by other bank regulators, as well as state regulators and other federal regulators, each had their own visions.

So this question of systemic regulation and, more to the point, systemic vision that is very much on everyone's minds these days, back prior to the crisis was a little bit closer to the blind man and the elephant. Some people got bigger views of the elephant, some people smaller.

So it was very clear, once the SEC started seeing this information, that it had to be more closely coordinated with other regulators, and that was the next step.

So it was even before Bear Stearns that I began talking about MOUs with the Federal Reserve, and with the CFTC, in just the same way that we had been concluding those MOUs with foreign regulators.

I did over a dozen of those while I was Chairman. Knitting this all together, both domestically and internationally, was vitally important because more than anything else this is a question about being able to see beyond the narrow stovepipes that certainly the statutes had set up for any regulator.

CHAIRMAN ANGELIDES: Well but that's really my point. I mean, you were the consolidated supervisor overseeing the holding company, therefore being in a position not to be just one person touching the elephant.

And, you know, on reflection did you apply the resources and regulatory regime to this program that were warranted?

WITNESS COX: Well there are two ways of looking at it--

CHAIRMAN ANGELIDES: As I understand it, from the very onset--and I know some other Commissioners may want to talk about program design, so I will leave that to them--but from the very onset the idea was that you'd have examiners on-site two, you know, a couple of weeks out of the year kind of like SWAT teams, but not of the nature of a normal regulatory program that's really going into books and records particularly of the holding company?

WITNESS COX: I think that's exactly right. It was never the vision of the program, and it wasn't built into the architecture, that it would move in and actually redo or double-check all the work; but, rather, this was a program that was receptive. It was meant to review the information that was provided to the SEC, and then commence a dialogue about the reasonability of, for example, the metrics that were being used.

Each of the firms of course was using different metrics. Although I was not there in 2004, I have had the opportunity to listen to the open [SEC] Commission meeting at which this rule was adopted. I've had the opportunity to read the release that was issued by the [SEC] Commission and the rules that were set out.

And I was about to say there are two ways to look at this, and so I will describe the first and then the second way.

The first way to look at it is through the lens of the [SEC] Commission in 2004, which as you know I wasn't there, and it's very easy for me to do. The [SEC] Commission believed that it was taking a very bold step forward into additional areas of regulation that were not open to it in statute, but that would give it a broader field of vision. And it carved out of agency resources the people to do that.

To put this in perspective, the entire Division of Market Regulation, later renamed the Division of Trading and Markets, was less than 200 people. And they are responsible for overseeing 5000 broker-dealers, all the Nation's markets, and so on.

So inside this box now you're going to build in the CSE Program that comes out of existing agency resources. Nonetheless, it was budgeted for and it grew. It was more than doubled during my chairmanship.

And the architecture of the program made it clear that it had to be reliant on information provided by the firms. So it was very different, as you point out, Mr. Chairman, from other kinds of, for example, bank examiner programs where they have people on-site in every firm, and they are doing a very different job.

This was a review function, and it was a broader field of vision.

CHAIRMAN ANGELIDES: So is it fair to say it was a review--really, it ended up being a review program, not a regulatory program?

WITNESS COX: Well I don't think that it's fair to say that it wasn't a regulatory program because clearly it was. It had rules, and those rules said, for example--this was the centerpiece of it--that you've got to maintain a Basel ratio that meets the Fed's 10 percent well-capitalized requirement. You've got to have liquidity, which the Fed doesn't require. You've got to compute your Basel capital ratio monthly, even though the Fed only requires it four times a year, and so on.

Those were real rules, and they were enforced. In fact, the program relentlessly worked against those metrics.

One of my points today is that it's the wrong metric. But I've said there are two ways to look at this question--

CHAIRMAN ANGELIDES: Right, and then I do want to just, in the interest of time, do that very quickly and I want to go to Mr. Donaldson.

WITNESS COX: The other way, the other way to look at it is from the standpoint of now; or indeed the standpoint of post-Bear in 2008.

The reason that I shut down the program was what happened during 2008. So knowing what we know now, or even what we knew then, it was manifest that a program that limited itself to this, even though this may have been ambitious given the lack of statutory authorization, was not all that was needed.

You need a lot more resources to do this. Otherwise, you couldn't muscle the banks around. You couldn't say you've got to change your business; you've got to do everything different. Even though it's your shareholders and you're the one that's taking the risk, we're telling you you've got to do it differently.

You're going to tell Goldman Sachs, and you're going to tell Morgan Stanley, and you're going to tell every one of these firms, you don't understand your own risk models. We understand them better.

If you're going to get to that point where you tell people how to run their business, you're going to need an army.

CHAIRMAN ANGELIDES: Well let me just ask very quickly. Did you ever ask for more resources for this program?

WITNESS COX: Yes, I did. After Bear Stearns--

CHAIRMAN ANGELIDES: After Bear Stearns? Okay.

WITNESS COX: Yes.

CHAIRMAN ANGELIDES: Not prior to that time.

WITNESS COX: But literally days after.

CHAIRMAN ANGELIDES: All right, but not prior to that time. All right--

WITNESS COX: No, Bear Stearns caught I think the world by surprise--

CHAIRMAN ANGELIDES: Well--

WITNESS COX: --the CSE Program up to that point had been functioning as everyone expected it to.

CHAIRMAN ANGELIDES: Well, yeah. And in fact I know that right before Bear Stearns's collapse, I think on March 11th, you said you had a good deal of comfort about the capital cushions of these firms.

But I want to go to this issue of leverage. And actually having reviewed the information around the 2004 decision, I don't find a direct cause between that decision and the increase in leverage in the bank holding companies-- I mean, the holding companies.

So let me put that issue aside, but let me go right to the facts. Which is, if you look at Bear Stearns, the tangible assets to tangible equity ratio goes from 31 percent to 38 percent from 2004 to 2007. At Goldman Sachs, from 26 to 1 to 32 to 1. At Morgan Stanley, it goes from 29 to 1 to 40 to 1. At Merrill Lynch from 25 to 1 to 45 to 1. Lehman Brothers, 34 to 1, and then close to 40 to 1.

Also with respect to I think your comment, Mr. Donaldson, about the nature of the assets. If you look at all these institutions, by '07 their Level 3 assets, which are the illiquid assets that are not--for which there's no discernible market, hard to price illiquid assets--greatly exceed their equity.

At Bear Stearns it's 296, 69 percent of tangible common equity. At Lehman it's 243. At Goldman it's 200 percent. At Morgan Stanley, it's 266. At Merrill Lynch it's 216.

Fundamental question: Did you guys ever look at that and say, you know what, in terms of a business model these kinds of leverage ratios are just crazy. Forget whether the 2004 decision triggered it. It really means in the aggregate you have a 2 percent, a 3 percent diminution in asset values and you've wiped out equity.

Did the SEC under either of you look at these growing ratios and say this is a problem?

WITNESS DONALDSON: Well I can only say that--

CHAIRMAN ANGELIDES: Is your mike on? Mike on, Mr. Donaldson.

WITNESS DONALDSON: Sorry. You know, during my tenure, which ended in June of 2005, we only had two fall in under the CSE Program.

And I go back to what I think cannot be emphasized enough, which was the reason for starting this program in the beginning, which was the leverage and the activities that were going on at that period of time were beyond our purview.

We needed to have more information. And as a result of that, we felt that we should start the program. We recognized that using Basel it was going to be a different set of criteria. It never was leverage. I want to emphasize that again. There was never leverage restrictions on these firms.

There were--

CHAIRMAN ANGELIDES: You have the ability to say you can't stay in this program with this level of risk. You did have that ability. And there would have been consequence for the firms.

WITNESS DONALDSON: I'm not sure I understand your--

CHAIRMAN ANGELIDES: Well you had the ability to take action in the sense that the SEC, at least Mr. Haloran who was your senior advisor, Mr. Cox, in interviews with our staff, has expressed the view that you did have ample authority and ability to press the firms to reduce leverage, to increase liquidity, and of course the ultimate sanction would have been to say you're out of this program.

WITNESS DONALDSON: That was not the criteria prior to the program. The criteria was net capital. Net capital had to do with your ability to discharge the obligations of the firm. It had nothing to do with leverage. And we had that ability, and we used that ability where net capital wasn't adequate.

CHAIRMAN ANGELIDES: So I'm kind of a simple guy. I mean, was this a safety and soundness regime? And was it effectively implemented?

WITNESS DONALDSON: Well I can't comment on what happened after, after I was there. I believe we effectively implemented the installation of the program, yes.

CHAIRMAN ANGELIDES: All right. Let me do this. I know that other Commissioners have questions. Let me reserve the balance of my time at this moment and go to other Commissioners. I will circle back after they've had a chance to answer their questions.

Mr. Vice Chairman.

VICE CHAIRMAN THOMAS: Thank you.

Let me try to ask the question a slightly different way. Because of the Bear Stearns panel we had just prior to you looking back at what happened to them from their perspective going forward--and this is both for Mr. Donaldson and then Mr. Cox:

Because we were all aware of the contests that went on as the traditional banking system saw a significant shift from them to the so-called shadow banking or investment banks because of the ability to create more modern instruments, or more creative, or more bespoke for what they wanted, and it reached a point of then with Gramm-Leach-Bliley passing in '99, which changed that traditional structure, so the traditional structure could blend--and the terms may not be technical--but could blend a little more into the activities of the investment banks, what was the mental set--and I'll start with you, Mr. Donaldson? Because obviously the CSE had no legislative structure. And, frankly, given the mental set that led to Gramm-Leach-Bliley you probably couldn't then put something else in place, although there were some arguments at the time that we were going to get rid of yesterday and try to bring in tomorrow--I guess we're still working on tomorrow after what happened yesterday afternoon to all of us, and quite surprisingly--but if you have this attempt to, what, take the SEC's given jurisdiction and regulatory power and see what you could do with it to solve, or at least address a blank in the regulatory structure because of what happened with the repeal of Glass-Steagall?

Or, because you felt it was necessary to deal with these people regardless of what happened in the old traditional statutory structure that was no longer there?

Am I making sense?

WITNESS DONALDSON: Well--

VICE CHAIRMAN THOMAS: Was the CSE the best thing that you could create, given what you created it out of? I.e., your regulatory powers that were there?

WITNESS DONALDSON: Yes. Speaking for the period of time that I was there, I think we were increasingly concerned--

VICE CHAIRMAN THOMAS: Is your mike on?

WITNESS DONALDSON: I think it is. Yes, it is on. I'm just not speaking into it. Sorry.

VICE CHAIRMAN THOMAS: Get closer.

WITNESS DONALDSON: We were increasingly concerned with what was going on in the shadow areas: the new instruments, the activity in the holding companies that we had no access to. And I think that we felt that we had to do something about that, to at least gain access to what was going on.

In addition to that, I think it is important to understand that the foreign, non-U.S. jurisdictions were putting pressure on the investment banks in the United States to be overseen at the holding company level.

That is a very important thing to note. The investment banks were to be frozen out of doing business in one of their largest markets, the European Union, unless we did something to make it possible for them to operate.

VICE CHAIRMAN THOMAS: So the CSE was created within, and an extension of, the regulatory power that you already had?

WITNESS DONALDSON: It was--yes. That's correct.

VICE CHAIRMAN THOMAS: And you could have used various criteria, but you chose particular ones such as Basel, et cetera.

Let me then shift over to Mr. Cox.

Where was the pressure coming from? And I'll transition over. My assumption is it wasn't coming from the industry--or was it?--to create an oversight structure?

WITNESS DONALDSON: Have you gone to Mr. Cox?

VICE CHAIRMAN THOMAS: Not yet. I'm transitioning from '04 to '05, since it was created in that--

WITNESS DONALDSON: Yes. I think the pressure was, was induced upon the industry by specifically the European Union which said that you're not going to be able to do business over here unless you're regulated under a holding company format.

VICE CHAIRMAN THOMAS: So was that one of the reasons you chose Basel?

WITNESS DONALDSON: And if we don't--we'll do it for you if you don't do it for yourselves.

VICE CHAIRMAN THOMAS: Yeah.

WITNESS DONALDSON: We will plug you into our system unless your SEC or somebody over there does something to put you inside a holding company structure.

So that was where the real pressure came from. And conversely, the pressure came from the industry wanting not to be frozen out of this market and also, frankly, I think wanting to be regulated by us, by an American regulator.

VICE CHAIRMAN THOMAS: So it has to be a voluntary system because you can't impose it on them?

WITNESS DONALDSON: Right. Yes.

VICE CHAIRMAN THOMAS: And now, to your regime.

Bear Stearns is one of the first ones in, the first one into the CSE structure?

WITNESS COX: Yes. There were five total, and Bear Stearns came in--do you remember the date, Eric?

WITNESS SIRRI: It was November of '05.

WITNESS COX: November of '05.

VICE CHAIRMAN THOMAS: They were the first in. And then the others came in. So at some point you had--

WITNESS COX: Well there were others in already.

VICE CHAIRMAN THOMAS: There were others in already? You had five banks in there at one time, and you shut it down in '08. Were there any banks left?

WITNESS COX: Merrill had been, by agreement, acquired at that point.

VICE CHAIRMAN THOMAS: So there weren't any banks in there.

WITNESS COX: They didn't close until after.

VICE CHAIRMAN THOMAS: And what I'm trying to do is remember--and picture the environment at that time. Was there any push or pull among the other regulatory instruments that oversee what used to be the old commercial banking system?

Was there a tug, or a pull that FDIC maybe could move in that direction, or that the Fed should? Did the SEC take it upon themselves to do this? Or were they encouraged to do it by virtue of the appropriateness of what you could do?

WITNESS COX: Well questions going to the formation of the program I think need to go to Chairman Donaldson simply because I wasn't there for that part. The program was created before I got there.

But, you know, speaking for myself, it was a freshly minted program when I arrived.

VICE CHAIRMAN THOMAS: Right.

WITNESS COX: It had just been the subject of several years of consideration by the SEC's top professional staff. It represented their best thinking. It had been developed by rule, adopted unanimously by all of the Commissioners. Indeed, when I became a Commissioner, I was in this room for my confirmation hearing sitting next to the Director of the Division of Market Regulation, Eric's predecessor, who became a member of the [SEC] Commission.

So she was extensive continuity for this program because she had been there when the thing was designed. So we had all the same people in place who authored the program: the Deputy Director of the Division who is a 30-

year veteran of the SEC. By the way, all these people seemed to be connected to Harvard University.

VICE CHAIRMAN THOMAS: So was it as robust as you wanted it to be? Or as robust as it could be under your structure?

WITNESS COX: Well since I was just getting to know the program, all the people who were briefing me on it were the architects of the program, and it represented the agency's best thinking at the time.

So I had no reason, out of the box--

VICE CHAIRMAN THOMAS: Just let me say, Mr. Cox, I know you outside of that environment and so if someone told you the way the world was, you wouldn't necessarily accept it.

WITNESS COX: Well of course. But in addition to being natively critical, I also when I went to the SEC had a lot to learn all at once. And this was one of those things that I was briefed about during the transition, and I'm sure that Chairman Donaldson and I spoke about it, as well.

But the view of this program at least in the agency was that this was the best thinking of the agency. The standards that it used, the Basel Standards, were in use by banking regulators around the world. As Commissioner, formerly Director Nazareth, explained it, it was patterned on the Fed's program. That's where the 10 percent well-capitalized metric came from.

The Basel standards were in use by banking regulators around the world, and indeed the U.S. was on track to get these I think in 2009. So the program was very advanced in that sense.

Basel II, as you all know, was constructed as it was because under Basel I there were too many incentives to move risks off balance sheet, and earlier today we've heard a lot about those problems, off-balance sheet risks even post-Basel II now are still going to be an issue, and this is still something that needs to be worked on.

But I think taking a snapshot of the program pre-Bear it was thought that this program was well constructed and a very aggressive use of the SEC's rather narrow statutory base, which went only to the regulated broker-dealer.

VICE CHAIRMAN THOMAS: So you have at some point all five investment banks under the CSE Program. And Bear Stearns fails. Is it conceivable that, in your mind looking at the structure and the environment at that time, that one of the investment banks could fail and in fact failed, and that the other four could have remained standing without any extraordinary government support?

I'm kind of getting at the too-big-to-fail concept through the backdoor.

WITNESS COX: Well that had certainly been the norm prior to Bear Stearns. As I mentioned, the SEC's most recent prior experience had been Drexel Burnham Lambert. What the SEC set out to do in those instances is to be the regulator during the liquidation of the regulated broker-dealer.

Even in the events of 2008 which were cataclysmic, what we saw is that the customer protection rule worked. We saw that the segregation of assets and customer cash and securities worked.

That what the SEC by statute was supposed to do, which is protect the investors and the customers in those broker-dealers even if all around them is collapsing, worked.

So the SEC was fully prepared in the case of Bear Stearns to play that role again. As it was, we played a different role and we provided all sorts of emergency regulatory approvals for weekend transaction involving JPMorgan Chase.

What I said at the time, or at least very contemporaneously in testimony before Congress about that event, is that the way things happened we'll now never know. I mean, this Commission may have the best opportunity to dig into it that we've seen thus far, but we will never know what would have happened if we'd played the game the other way.

I mean, in the social sciences, unlike the physical sciences, once you run the experiment you can't go back, recreate the conditions, and do it again and see what happens.

VICE CHAIRMAN THOMAS: I don't think any of us would want that as a model, if in fact we had the chance.

WITNESS COX: It would be difficult to live through twice, that's certainly true.

WITNESS DONALDSON: Can I just go back to 2004-2005 period?

VICE CHAIRMAN THOMAS: Yes.

WITNESS DONALDSON: Where there was considerable concern on our part as to what was going on outside our jurisdiction. And we had the traditional turf battles, if you will, with other regulatory agencies as to whose jurisdiction it was.

We were so concerned that we set up an internal risk department for the first time in the SEC. The assignment there was to look over the hill and around a corner an see if we couldn't identify risk.

And this was the beginning I think of a concern for the systemic programs that were out there that were falling through the cracks.

VICE CHAIRMAN THOMAS: Well and it's really refreshing to note that in the most recent battle to try to create some structure of regulation that none of the regulatory agencies are in a contest with each other, and the industry desires are not being reflected in any way as they attempt to move legislation through the Congress. So we apparently learned a lot.

(Laughter.)

VICE CHAIRMAN THOMAS: Byron is getting to know me.

Could I ask all of you to say yes, please, to the offer that, as we continue to learn more, given the resources that you provide to us, that we could get to you with written statements, or questions, and you could respond to us with written statements? Even so far as to what do you think about where we are now, and whether we're going in the right direction or not?

Because we're not supposed to talk about where people ought to be, but it's very hard to figure out where you ought to be if you don't have a full understanding of where you were.

And right now we find that's actually a whole lot more difficult than some people would think it would be, and I know you wouldn't from the position you're in. But we need all the help we can get. And would you be willing to respond in a written fashion to a written question?

WITNESS DONALDSON: Absolutely.

WITNESS COX: Yes, of course.

WITNESS KOTZ: Yes.

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

CHAIRMAN ANGELIDES: All right, Ms. Born, just quickly before I turn to you, just one follow-up question to my earlier questions. And I think this goes to an issue that's been raised here as to whether this was ever intended to be a true regulatory regime, or whether it was an accommodation for the investment banks who faced a problem with the European Union.

And so this is really actually to you, Mr. Cox. So I've read the work of our staff. I've read the Inspector General's report. We've looked with respect to Bear Stearns the Monthly Monitoring Reports, which we entered into the record earlier today.

Here's the one thing that strikes me. Pulling away from all the detail, I don't see any--and I noted earlier there weren't any real on-site exams during a two-plus-year period. Just in very simple terms, I didn't see any action taken at any time by the SEC to change the business practices at Bear, to change their risk profile, or to in any way alter the activities that might have given rise to their safety and soundness or the safety and soundness of the system in the record I've seen.

Am I wrong? I mean, I don't see anything of significance where there's a change made in any practices.

WITNESS COX: Well I think I would yield to Director Sirri on the details here, but since you're addressing this in a general way I think the answer is that Bear Stearns changed rather dramatically in response to the CSE Program.

I can illustrate that in the following ways:

First, the CSE Program set up a minimum $5 billion liquidity standard. That's something that, by the way, commercial bank holding companies don't have to do. They don't have a minimum liquidity number at all.

So that was an additive metric that the CSE Program--

CHAIRMAN ANGELIDES: Did they not meet that on entrance?

WITNESS COX: No, they didn't, and they had to raise their capital to $5 billion. Then under CSE supervision, they raised their liquidity to $12 billion by 2007, and ironically in March of 2008 the firm had reached its highest liquidity ever of $21 billion.

I think that if you consider the VAR testimony that you heard earlier, you recognize that that was a change that was made also at the behest of the Securities and

Exchange Commission. They forced them to start looking at this on a firm-wide basis.

So there were a lot of things about the way Bear Stearns was run that were changed by the program. But to take the even more broad point, as I say on the details I will certainly defer to Director Sirri--

CHAIRMAN ANGELIDES: I would just point out, I would just point out the Inspector General found that the activities were deficient on leverage and risk. They found they were deficient in terms of mortgage concentration. And they found that there were really no changes made by the SEC with respect to Bear's risk management.

WITNESS COX: Well I think that it's difficult to disagree with the conclusion that the IG report reaches because it's syllogistic. It says that the failure of the program is manifest in the failure of Bear Stearns itself, since the main purpose of the program was to provide an early warning system and it didn't.

I fundamentally agree with that. I also would point out that IGs for the Federal Reserve just last week, with one of the Regional Feds last year and so on, have found exactly the same things with respect to the same metrics, not coincidentally, that were being used across the system. And it wasn't just in the United States, it was around the world.

With respect to the question of whether this was, you know, meant to be an accommodation or a real regulatory program, I can tell you that since I wasn't there in 2004 when it was done I have every--but I did listen to the meeting. I did look at the release, and so on. I have every reason to believe that the story is exactly as I have heard it throughout my service at the SEC, exactly as Chairman Donaldson has explained it, the SEC was very, very interested in gaining more information, as much as it could, and the CSE Program represented a much broader vision than it had ever had before.

CHAIRMAN ANGELIDES: All right, I am going to stop at this point. Ms. Born?

COMMISSIONER BORN: Thank you very much, and thank you for all of you for appearing here today.

I am going to start off, before we get to the Consolidated Supervised Entities Program, just to ask Mr. Cox and Mr. Donaldson about a topic you both addressed in your written testimony, and we haven't talked about yet this afternoon, which is the role that over-the-counter derivatives and the lack of transparency and oversight of them played in the financial crisis.

I wondered, Mr. Cox, if you would comment on that?

WITNESS COX: I would be happy to comment on that. And I have to say that on many occasions I have been finding myself reviewing the debates that you had a very long time ago, it seems now, certainly in another context, but when you were at the CFTC and a member of the President's Working Group. When I served as a member of the President's Working Group, I know how valuable that interchange is and how difficult it is sometimes to reconcile the different agency points of view.

And one of the things that I recognized, looking through the distance of time and the fog of memory, is that there were in addition to regulatory concerns and market concerns and so on, there seemed to have been turf concerns. And it seems that some of the recommendations that were provided flowed in addition to flowing from the good reasons that all such recommendations should flow from, also flowed from the sort of 'our team is better' sense that is the worst kind of rivalry when you've got the county sheriff over here and the city police over here and they're both supposed to be chasing after the culprit.

I think there was a pride of brand at both the SEC and the CFTC at that time. And so even though the SEC's formal regulation--pardon me, formal recommendation was we should not regulate, I also got a sense that this was a blocking move as well, and that possibly the SEC would have had a different view if they had had a regulatory program ready.

I don't know if that's true or not, and I'm almost inviting a question from you instead of answering yours.

So let me move immediately--

COMMISSIONER BORN: Well I'm not going to testify here as to what motives were in '98--

WITNESS COX: No, of course. But I just say I noticed--

COMMISSIONER BORN: But I'm interested in--

WITNESS COX: --that's all a precede to saying that I think, looking forward, that we still have this problem. And if we don't have it in the agencies, we do have it in Congress. And I served 17 years there, and I know how that works.

In order to solve this problem, you are going to have to get the Ag Committees in the House and the Senate, the Financial Services Committee and the Banking Committee to behave differently--and this doesn't in any way serve as a criticism of any members--but behave differently than those committees have been able to behave in their DNA over decades.

And so I think that's one of the reasons we find ourselves here. The reason that this market was able to grow up so far outside the regulatory structure, when at least transparency would have been not only acceptable to the market but hugely beneficial, is that Congress was incapable of legislating on the subject.

And as we've seen, when the regulatory system tries to work in the spaces and the interstices of the law, and the laws are too ancient, then it comes up short, as it did here.

So if we're going to fix this problem--and the problem, I don't want to assume everybody's definition of the problem is the same, so I'll just state my view--the problem with, in particular CDS but other synthetic products and other derivatives, during the financial crisis was largely a function of ignorance.

People didn't know where the exposures were. It wasn't so much that there was something inherently wrong with a contract, or even the concentrations, or where they were, or what have you, it's that these things are so easily traded and the original authors of them substituted with new people and so on, that it's difficult for people to put together a spreadsheet and say I know what's going to happen; I know where the risk is; I know what the second-order effects are, and so on.

The kind of transparency that we have in other markets applied to the CDS market would have caused a lot of people to calm down. But if you're looking at a notional value which, even with the lower estimate, we've raised them subsequently, but even with the lower estimates that we had in 2008 of what the notional value of these contracts were, was more than the gross domestic product of every nation on earth.

And so if you have a lack of--

COMMISSIONER BORN: I understand--

WITNESS COX: --transparency around that, then you're going to have market problems.

And so when other parts of the financial system started showing signs of weakness, there was a crisis in confidence, and so on, this lack of transparency, this uncertainty that people had, served as another reason for investors to feel the markets.

COMMISSIONER BORN: In your view, what do you think we should do going forward?

WITNESS COX: Well I made very specific recommendations when I was Chairman, and I stand by those recommendations now. And I am happy to see that two years later, even though when I testified about them as Chairman I said it was a matter of urgency and do it this week, at least this month, and not later, I'm glad we're doing it now.

But what we are going to do, as I understand it, is move as much as possible of this market on exchange, or something exchange-like. We're going to have a central clearing house and counterparty, and we're going to have, to the extent that these are non-standardized contracts and cannot be moved on exchange, we're going to have transparency because there will be dealer reporting and you'll have a well functioning market because there will be pricing transparency in volumes and so on.

COMMISSIONER BORN: Mr. Donaldson, do you think that they played a role, over-the-counter derivatives, played a role in the crisis?

WITNESS DONALDSON: Absolutely. I was just going to comment that I think there was an attitude toward derivatives in the early days, a very positive one, of risk dispersion. That was an attitude throughout many of our government agencies, that the derivatives were a positive.

As time went on and the derivatives got more exotic, it became obvious that there was an increasing danger there. And I would agree totally with Chris Cox that we need to trade these things in a central location as much as we can, and we need to know what's out there. And we need to have a clearing arrangement that makes sure that there is credit when these things blow up.

COMMISSIONER BORN: Thank you. Let's turn now back to the CSE Program. And as I understand the testimony, it was adopted largely because the EU had taken the position

I think in 2002, actually, that our investment banks, our largest investment banks, needed to demonstrate that they were receiving consolidated supervision in a meaningful way, either here at home or they would be subject to regulation in the EU as a condition of their doing business there.

And I wondered what the motivation of the EU was in taking this position. Because of course at that time the United States did not have any requirement that investment banks, or other financial institutions other than banks and their holding companies, had to have consolidated regulation.

WITNESS DONALDSON: Well it's hard to get in the head of the EU.

COMMISSIONER BORN: Did they explain it at all, what their intentions were?

WITNESS DONALDSON: On the other hand, I think there was a competitive situation going on where the EU wanted to become much more of a financial center, if you will, and wanted to outdo the regulatory excellence that was emanating from this country.

So I think it was a movement on their part to try and bring control to this new entity, the EU financial markets. But that's just supposition.

COMMISSIONER BORN: So as I understand it, most of the impetus for this came from the industry itself who wanted to be able to continue their role in the EU. And did they come to the SEC with a proposal about consolidated regulation?

WITNESS DONALDSON: I think it was a chicken and egg thing. In other words--

COMMISSIONER BORN: Right.

WITNESS DONALDSON: --the EU was saying you better get yourself regulated, and our firms saying well if we have to be regulated we'd rather be regulated by the SEC than we would by a foreign regulator.

COMMISSIONER BORN: As I understand the program, it was one similar to what the banking regulators do, or banking supervisors do, in that it was really designed to be prudential regulation with an eye to the safety and soundness of the institution, rather than the traditional role that the SEC and the CFTC, for that matter, had played, which focused on investor protection.

Is that right?

WITNESS DONALDSON: I think that's right.

COMMISSIONER BORN: And was this a role that the SEC had had any experience with before? That is, prudential regulation?

WITNESS DONALDSON: No. Obviously the focus of the SEC was on investor protection and not prudential regulation.

COMMISSIONER BORN: So this was something new that the SEC was taking on essentially in terms of the approach to the purpose of the regulation?

WITNESS DONALDSON: Yes. I would say so. Although to go back to, we--even in terms of just strictly investor protection, we needed to know more about what was going on in this market that we had no jurisdiction over, which could have investor protection implications to it. That was much more important than the prudential aspect.

COMMISSIONER BORN: Mr. Cox, do you agree?

WITNESS COX: Yes. In fact, I think we have agreement even beyond this table with the current Chairman of the SEC who has testified about this as well.

This was an unusual step for the SEC, outside what normally was considered to be its core competency, certainly outside its tradition.

Prudential regulation is just different than rule-based regulation. To be very broad-brush about it, the biggest difference is that in rule-based regulation there is a positive standard. You can look at it. And you can conform your conduct to it. And if you don't do it, somebody comes in and checks the box and writes you up.

On the other hand, if you're being supervised, you have a conversation about it, you might be required to do something a lot more than the rule. You might find the rule doesn't really have any application to your circumstance. You're not paying attention to it. And you might have an ongoing dialogue where you revisit it regularly.

There are other important differences. The main one that I can point out is that supervisors tend not to be enforcers. There's a good reason for that. If you're going to have this dialogue, and that's going to be the nature of the supervision, you need to learn a lot. You need people to open up to you and tell you everything you need to know.

But if you're going to be an enforcer, then people are going to have their lawyers with them when you talk to them.

So when I negotiated at great length and some detail, which was very instructive and useful, the memorandum of understanding between the SEC and the Federal Reserve, one of the sticking points about sharing information was, well, if we give it to you, you might give it to enforcement.

And we said, well, if we see something that might be violative of law, of course we will. And they said, but if you do that, and the supervised people know it, they won't tell you in the first place.

And both of those are useful commentaries, but they tell you, you know, how it's very difficult to square the circle. So this was an interesting experiment for that reason. Ultimately, I think, however, you've got to decide which you're going to be.

And I noticed when Chairman Greenspan testified before this Commission he took special care to point out that the Fed doesn't even have an enforcement division. That's not what they do. And so supervision is very different.

If I may parse this even more finely, safety and soundness is something that is a term of art for bank regulators, and I don't believe that that's in the charter of the SEC's CSE Program.

And the reason that that matters somewhat is that, while it was a prudential supervisory program, it had specific aims. And preventing the failure of an institution wasn't one of them for the obvious reason that, unlike the Federal Reserve, there are no fiscal levers at the SEC. There's no money to rescue them with.

COMMISSIONER BORN: Well you did testify that the purpose of the program is to monitor for, and act quickly in response to financial or operational weakness in a CSE operating--CSE holding company, or its unregulated affiliates that might place regulated entities, or the broader financial system, at risk.

WITNESS COX: Yes, I think that's exactly right.

I just want to distinguish between that and, not to use a pejorative term, bailout, but the liquidity backstops that the banking system provides are a big distinction between this program which was in other ways parallel and the federal regulatory system; indeed, some of the state regulatory systems for banking.

CHAIRMAN ANGELIDES: Three minutes?

COMMISSIONER BORN: Please.

Did you feel--and I can ask either of you this--did you feel that you had the resources, the personnel, the experience to institute this kind of a new regulatory program?

WITNESS DONALDSON: Well, back when this was first being formed, the SEC was tremendously understaffed, and we got, concurrent with my selection as Chairman, we got a new budget. And we took our employment from 3,000 to close to 4,000.

So all of a sudden overnight we had not only more bodies but we had more well-trained bodies. So we felt we had a lot of adequate resources to get this thing going.

COMMISSIONER BORN: But obviously, in the end in 2008, all the investment, all the Consolidated Supervised Entities that were in the program, either failed or became something other than investment banks.

And I think, Mr. Cox, that you've said that the program was an utter failure and therefore you were terminating the project. Right?

WITNESS COX: I certainly terminated the project. I don't believe I ever used those words to describe the program, nor would I think even now that that's an accurate assessment.

I think, rather, as the Inspector General put it, the program failed to achieve one of its architectural objectives, which was to serve as an early-warning system.

But with respect to the staff that worked on this, something has been said about this in other fora so I just want to point out that the staff that was there when Chairman Donaldson was there, that was there when I was there, were highly expert people.

Director Sirri was an addition to this team, but Director Sirri had been the Chief Economist at the SEC under Chairman Levitt and, like the other people in this program, a distinguished Ph.D. in economics who taught at Harvard.

In terms of understanding mathematical models, it probably helps that he also--do you have a Ph.D. in astrophysics? A Cal Tech Degree in Astronomy--must have come in handy in understanding some of those econometric models.

Bob Colby, the Deputy who was there both under Bill and under me, a 30-year veteran, a Harvard lawyer of this area, understands it very, very well. Matt Eichner, who was the head of the program, two Harvard degrees and an MIT Ph.D. in economics, hired away by the Federal Reserve in the wake of all of this.

These are good people, and very smart people. One of the things that's always impressed me about the SEC is how sharp the resources there are, and how the agency is able to attract the very, very best people.

So I think that that's something of a canard. What I do think is correct, and this is something the Inspector General has pointed out, in other areas if not in this one, is that the skill sets at the SEC overweight lawyers. And that's probably something that's going to be a continuing priority for the agency to try and diversify.

Because even if it's going to be rule-based and not prudential, it still needs to have a variety of skill sets.

COMMISSIONER BORN: Well perhaps--

CHAIRMAN ANGELIDES: Would you like additional time?

COMMISSIONER BORN: Just one minute.

CHAIRMAN ANGELIDES: Okay, sure.

COMMISSIONER BORN: Perhaps this demonstrates, as well as anything could, how institutions that are too big and interconnected to fail may be too big to supervise, as well. Thank you.

WITNESS COX: That is an outstanding observation with which I completely concur, and I haven't heard it said at all, frankly, I'm sure it must have been said by you or others somewhere. But one of the lessons we've got to infer from all of this is that if the market is going to be moving as fast as it is, if people are going to be developing new financial products in the future, as surely they will be, then a system of regulation that tells everybody to slow down and wait until we catch up isn't going to work.

Instead, you've got to make sure that the subject of regulation is comprehensible to the regulator. And that means perhaps rather dramatically changing the scope of what it is that comes under regulation.

COMMISSIONER BORN: Thank you.

CHAIRMAN ANGELIDES: Just for the record, though, I want to, before we move on to Mr. Holtz-Eakin, I think Mr. Donaldson you were talking about staffing. It's my understanding, just for the record, that the staffing levels kind of pre-your tenure, Mr. Donaldson, at the SEC were about 3,000 employees, give or take. During your tenure, it moved up to about 4,000. During Mr. Cox, it moved down to 3,500.

But even in that context, the CSE staff in 2004 had 12 to 15 folks dedicated to it. In 2007, 24. So it was a pretty thin slice of folks. I just thought I'd make that observation.

WITNESS DONALDSON: At the beginning.

CHAIRMAN ANGELIDES: Well even in 2007, it had 24 folks dedicated to it.

WITNESS DONALDSON: Yes.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman, and thank you everyone for joining us today.

It seems to me there are really four areas that are worth pursuing. One is the structure and conduct of the CSE Program in isolation.

The second would be the experience of Bear and other investment banks underneath that program.

The third would be how the CSE looked relative to other regulators, where all regulated entities suffered some distress during this period.

And then the fourth would be the traditional role of the SEC in investor protection.

I wanted to pick up on what you just talked about, Mr. Cox, with the traditional role of investor protection. Because one of the striking things to me in all of this is that the U.S. ended up with trillions and trillions of dollars of toxic securities, and investors did not appear greatly protected when it all fell apart.

I am an economist. Recently that appears to be a good thing--it's not always. I didn't understand this, but it looks like that the bulk of this was issued under these particular regulations, Regulation D for qualified institutional buyers; Rule 144A; and that traditional SEC oversight essentially was waived for large amounts of these.

So I guess I would like to hear the views of you, Mr. Donaldson, and you, Mr. Cox, about whether the SEC had the power to tighten protection rules for large, sophisticated investors who ended up with these poorly understood, complex products during the crisis.

WITNESS DONALDSON: Well I think there was a hole in the regulation of derivatives as a result of the law that was passed, which took authority away from the--

COMMISSIONER HOLTZ-EAKIN: What about securitized mortgage assets, CDO-squared, things like that? Not just derivatives.

WITNESS DONALDSON: It was a the Commodities--

COMMISSIONER HOLTZ-EAKIN: Futures Modernization Act, yes.

WITNESS DONALDSON: Which in effect opened up a gate in the derivatives market and took authority from the CFTC and away from the SEC. It's through that hole that the credit default swaps and all these exotic instruments went. Nobody had jurisdiction over them.

COMMISSIONER HOLTZ-EAKIN: How about the CDO-squareds? Mortgage-backed securities, and various tranches repackaged? Those aren't all through that. Aren't some of those through your particular rules which allowed sort of very sophisticated investors to have products which were not going through the usual SEC registration process?

WITNESS DONALDSON: I'm talking about derivatives now.

COMMISSIONER HOLTZ-EAKIN: I'm not.

WITNESS DONALDSON: Oh, okay.

COMMISSIONER HOLTZ-EAKIN: So aren't there large amounts of securities which turned out in the end to be quite problematic, which were never in any way put through the traditional SEC scrutiny? But because of the existence of these exceptions for sophisticated investors and qualified institutional buyers?

WITNESS DONALDSON: Instruments? Or securities?

COMMISSIONER HOLTZ-EAKIN: Securities. My question is: Was there at any point in this, did the SEC have the power to increase its scrutiny of these instruments?

WITNESS DONALDSON: To increase its jurisdiction over these instruments, you're talking about?

COMMISSIONER HOLTZ-EAKIN: Yes.

WITNESS DONALDSON: Um, I suspect that it did, unless we were prohibited by law from having jurisdiction, which is what I was referring to on the derivatives issue.

COMMISSIONER HOLTZ-EAKIN: Right. I understand that. And did you ever contemplate that?

WITNESS DONALDSON: I'm not exactly sure what instruments you're talking about that we didn't have jurisdiction over.

CHAIRMAN ANGELIDES: Let me try to clarify. Not that I need to clarify Mr. Holtz-Eakin, but just as a listener I think he's talking about a whole series of instruments that grew up in the marketplace such as CDOs, which were taking BBB tranches of RMBS, Residential-Mortgage-Backed Securities, and creating new tranches, CDOs. Then taking those--

COMMISSIONER HOLTZ-EAKIN: Didn't I say that?

CHAIRMAN ANGELIDES: --and doing CDO-squareds, which is CDOs made of CDOs. And then taking those and creating synthetic CDOs.

COMMISSIONER HOLTZ-EAKIN: I'm sorry, I thought--

CHAIRMAN ANGELIDES: He's talking about this whole generation of products that developed of exotic instruments. Correct?

COMMISSIONER HOLTZ-EAKIN: I thought I said that.

WITNESS DONALDSON: I understand.

CHAIRMAN ANGELIDES: And by the way, that was on my time.

COMMISSIONER HOLTZ-EAKIN: We'll balance out at the end of the Commission.

Mr. Cox?

WITNESS COX: Yes. I think I understand your question, and you're asking in part about private placements as well as public offerings of securities, right?

COMMISSIONER HOLTZ-EAKIN: Yes. Absolutely.

WITNESS COX: I think the short answer is that these securities were issued both ways. So it's not really a characteristic of the security that it operates under an exception; it's rather a means--it's a question of the way that it's sold.

So that there are some statutory exceptions that would override everything--commercial paper for example, an exempt security, and what have you--so it depends on how people were structuring them.

But the fact that some of these were large, private placements under Reg D or otherwise, is really much more an incident of, you know, how that particular transaction was structured than the issuance of the securities themselves.

The largest issuer of these kinds of securities was of course the GSEs, and they were very active in the public markets. So there was a lot of requirement to come under the SEC's disclosure regime. You know, to the extent that securities were sold in public markets, in terms of their own reporting Fannie and Freddie of course did not volunteer to be covered by the 33 Act.

I actually asked Congress to do that. It hasn't been done even now.

COMMISSIONER HOLTZ-EAKIN: They said no.

WITNESS COX: But even now it hasn't been done. They did do the 34 Act in the Fall of 2008.

COMMISSIONER HOLTZ-EAKIN: So in retrospect, on the part of either of you, I mean should the SEC have required some examination of these market innovations?

WITNESS COX: Well certainly the SEC was all over this in many ways, both during Chairman Donaldson's tenure and mine, and I think still, to the extent that we are focused on securitizations and the use of the public markets for this sort of thing.

The second thing that I would say is that one of the big sources of private placement activity, or unregistered activity, is hedge funds. And there was a great deal focused on hedge fund regulation, right at the time that Bill was Chairman, and when I was Chairman.

The SEC enacted rules. I supported those rules and put them into effect. We now have to put them into effect by statute because the court said that the SEC didn't have that power.

COMMISSIONER HOLTZ-EAKIN: Okay. Thank you.

The other questions really do refer to the CSE. Commissioner Born has talked about the degree to which you had adequate staffing, and the degree to which this really was a safety and soundness regime. I think that's pretty clear.

I guess I am very much interested in sort of how effective you were able to be in understanding the risk profiles that especially the investment banks ended up with.

So in 2004 when the SEC adopted the Alternative Net Capital rule, it did obtain the power to examine the practice of the holding company, right, the risk management practices? Chairman Donaldson?

WITNESS DONALDSON: Is your question did we have the sophistication and the knowledge?

COMMISSIONER HOLTZ-EAKIN: Did you have the authority to?

WITNESS DONALDSON: The authority?

COMMISSIONER HOLTZ-EAKIN: Yes.

WITNESS DONALDSON: Well, we did not have the-- going forward, after I was there we did not have the authority in these CDOs, CMAs, et cetera, et cetera, these pool vehicles, particularly the mortgage pool vehicles, which again fell in between regulatory responsibility.

COMMISSIONER HOLTZ-EAKIN: So I guess my question is, my understanding is that when the broker-dealers adopted the Alternative Net Capital Rule, you had the authority to examine their risk practices and methodologies. And what did you do to get comfortable with their practices?

WITNESS DONALDSON: I think we did have the authority, and I think we--

COMMISSIONER HOLTZ-EAKIN: And how did you use it?

WITNESS DONALDSON: If I understand--I'm not sure I understand your question again.

COMMISSIONER HOLTZ-EAKIN: So the stress test that an investment bank might use, you examined them, became comfortable with them, signed off on them? Merrill Lynch, for example, first into the CSE Program, ultimately fails and has to have a forced marriage. You're comfortable with their risk management practices?

WITNESS DONALDSON: You're talking about the capital structure of the investment firms and stress testing--

COMMISSIONER HOLTZ-EAKIN: --their risk management, broadly defined: the capital they held; the portfolios the invested in; the concentrations of risk; their hedging practices.

WITNESS DONALDSON: Well I think again with the eventuality that came down the pike, we did not, nor did anybody I think, realize what effect would have of a, basically a run on the system, and a refusal to finance these firms by their traditional suppliers of capital, a withdrawal of capital.

I think that was a circumstance that was not anticipated. It was a crisis, and it was not anticipated. It was unexpected and unpredicted, at least by our agency, that that could happen.

COMMISSIONER HOLTZ-EAKIN: Mr. Cox, under your tenure, the other three investment banks entered the CSE Program. You took advantage of your authority to examine the risk management practices and became comfortable with them?

WITNESS COX: I think the answer is that the agency did. The way that this works inside the agency of course is that the [SEC] Commission, comprising five members who have broad policy-making responsibility for all division and offices and so on, receive a recommendation at a meeting in a room something like this where the staff presents documentation for that recommendation, and makes a recommendation.

And so literally the vote is on whether to accept or reject that recommendation. And the means of, you know, pushing back on that, or understanding it, is, you know, dialogue with the staff, you know, prior to the meeting, and so on.

And each of the Commissioners has counsels that help them do this. And so by the time one comes to a vote on this, those questions have been answered. The source of the information of course is the program itself, and the professional staff who run it.

And, you know, to the extent that they miss something, or to the extent that there is a mistake inherent in that system, then it probably wouldn't be uncovered in that way.

COMMISSIONER HOLTZ-EAKIN: Mr. Sirri, the Inspector General has reported that the SEC was aware of some deficiencies in the risk management practices of Bear Stearns, concentrations of mortgages, things like that. Do you think there are things the SEC could have done to prevent the failure of Bear?

WITNESS SIRRI: I think the distinction to be made here is the distinction between understanding concentration and understanding what that means for the risk of the firm.

We certainly were aware of concentrations of mortgage securities. Bear Stearns is a securities firm. Within that, they had a substantial fixed-income business.

And nested within the fixed-income business they had a substantial mortgage business.

So in that sense it was a business decision by the firm to be a very concentrated mortgage entity.

The thing that we missed, and that I think most of the industry missed, and most regulators missed, is the question of how volatile, or what kind of price or underlying value changes you could see in those mortgage instruments.

We didn't miss the concentration. The mistake was we felt that, given that they were concentrated, given the rating of the paper that they were holding, we thought they could withstand the kind of shock we might reasonably expect for mortgage instruments. It's in that sense that we misjudged.

COMMISSIONER HOLTZ-EAKIN: So one of the reasons I was curious about this is that what we heard from the Bear Stearns panels this morning was essentially a story that said: Well, yes, we know there was a large decline in housing prices, and there was going to be a great risk out there somewhere in mortgage finance, but we could not tell who held that risk.

We all looked around at each other, at the counterparties, the five investment banks, and couldn't tell who had the risk. So we decided we were all safe. The market looked around and said, yep, we decided you're all the same, too, but they decided none of them were safe, and we don't have them anymore.

And my question for you is: Could the SEC distinguish among the five entities under the CSE their relative exposure and, in the end, their exposure to the risk of a decline in housing markets, which is at the heart of what went on?

WITNESS SIRRI: The answer is, yes, we could certainly distinguish their relative exposures, just as we could judge their risk management capability and the degree to which they had hedged or otherwise managed their position.

So that is a judgment we could make.

COMMISSIONER HOLTZ-EAKIN: And, just to push that a little bit, one of the seminal moments that most people point to in the recovery was Treasury's stress test which distinguished relative financial health among entities within the TARP.

If you had the capacity to reveal relative financial health, why was there no information of that type available in the crisis?

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the gentleman an additional five minutes.

COMMISSIONER HOLTZ-EAKIN: I would ask that of

Mr. Cox, as well.

WITNESS SIRRI: As I understand those stress tests, they were substantially--they were more rigorous, more substantial than the types of tests that we performed. Notably, they were performed to a uniform benchmark across all firms.

So there were scenarios that were selected. They were run across all firms. It was a large undertaking.

The types of work we did with respect to stress tests of the firms, for example, did not impose a uniform standard on all of them. And it's something we discussed. The reason was that, while we certainly could have done that, we elected not to because we wanted to let the firms manage risk the way they thought it was best managed, given their business model; and then we needed to develop comfort with that.

In some cases we were comfortable. In other cases, we weren't comfortable and we required change.

COMMISSIONER HOLTZ-EAKIN: Which cases were those?

WITNESS SIRRI: That would have happened, we had a discussion earlier about, you--I think you asked questions like this about Bear Stearns. As I understand it, and Bear Stearns came into the program before I was there so I came in September of '06, so this is going to be before I got there, but let me relate to you what my staff related to me.

When Bear Stearns entered the program, they did not at the holding company level have a value-at-risk set of procedures or protocols. That was not the way they looked at risk at the bank.

Coming into the CSE Program they were required to develop those types of quantitative models, and to have those meet our--we had to approve them. We had to say that these met our standards.

So they, because they wanted to come into the program, developed those, got those going, came into the program. That would be one concrete example. And that's, if you will, a quantitative type example.

There are other examples that I think are important but have a different character that relate to risk governance. Risk governance is very important in these firms. The way that information flows and the way that authority flows within an integrated financial firm is very important if you're to resolve disputes and if appropriate decision--you want to have appropriate decision makers get information.

So for example the internal audit function at Bear Stearns did their work, but we found that information wasn't coming up to the audit committee appropriately. The quality of the information, and the nature of the process wasn't good. It wasn't transparent. And we expressed that view. We interposed ourselves, and we made sure that the quality of that interaction, the nature of it, changed, explicitly getting a more transparent flow of information from internal audit to the audit committee.

COMMISSIONER HOLTZ-EAKIN: All right. Thank you. Mr. Cox, I'd just close with the following question, which is: There's been a lot of discussion about the staffing of this, and to probe a little bit on how the different entities were treated underneath the CSE, but in the end all of these investment banks are now gone, failed in one way or another, but that's not unique to the crisis.

Many institutions failed who were bank holding companies, who were FDIC regulated, state regulated, there's a lot of failures. So do you feel it's inappropriate to single out the CSE, or you in particular, for the failures of the investment banks?

WITNESS COX: Well I think you are right to observe that this was something that affected all of the large banks, and ultimately all of the large banks increasingly similar as they are faced the same fate or the same bailout.

And the large money-center banks with their investment bank subsidiaries, or the stand-alone investment banks all fared essentially the same way.

I think the reason that so much focus came on the SEC in the midst of all of this was the sequence. Bear Stearns, which is the focus of this hearing, happened in March of 2008. And that put a lot of attention on first that institution; second, that space in financial services.

As we now look back on it, we can see that Bear Stearns quantitatively at least was a very modest complement to what ultimately required $16 trillion in order to restore confidence to the markets. That is how much the Federal Government committed in various forms.

COMMISSIONER HOLTZ-EAKIN: Thank you.

CHAIRMAN ANGELIDES: Okay--oh, Senator Graham. I had a senior moment there. Go ahead, Senator.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman. Thank you so much for being here with us today.

I would like to continue the line of questioning that Doug had started, Mr. Sirri, relative to the information that's available. And I'm particularly asking it from the perspective of that investor who is trying to make sense of what the risks are in the options that he or she has to invest in.

Much of our system is built upon informing the investor and assuming that they will then use their good judgment to make decisions that are best for them and best for the system.

In our last panel, Mr. Schwartz, the last CEO of Bear Stearns, made the statement that from the outside you could not tell the exposure to the housing mortgage risk with the kind of information that was being made available to the investor community.

My question is: Is that just an inherent limitation of the accounting and literary professions to properly explain to the lay person what it is that is going on? Or is the structure of the information that we make available inadequate but susceptible to being made more informative so that that prudent lay person can make better judgments?

WITNESS DONALDSON: I think that there is a-- these are complicated instruments, not designed to be understood by people who don't understand mathematical finance.

As a result of that, I think there was an over-reliance on ratings. I think the individual investor looked at the ratings before they bought. And that is one of the great weaknesses out there, was the weakness of the ratings system.

COMMISSIONER GRAHAM: But my question, you think that the instruments and the processes are inherently so complex that they're not susceptible to more informative presentation to the prudent lay person who is looking to that information to make judgments?

WITNESS DONALDSON: I think it can probably be better done, but I don't think it will ever be completely done, would be my judgment.

COMMISSIONER GRAHAM: Mr. Sirri?

WITNESS SIRRI: Let me answer your question in two ways. One with respect to the CSE Program, and then more generally.

Just to make clear, the CSE Program was not about disclosure. It was about risk and financial controls of the firms. So I just wanted to make sure to clarify that, if there was any misunderstanding.

The question you asked is one that is often asked. It's a very good question, and it goes to the opaqueness or transparency of financial intermediaries.

I would say that financial intermediaries are by their nature very opaque entities, by which I mean it is hard to tell what they're doing. And in the case of intermediaries, what securities they hold. You don't have to go to an investment bank to get this result.

You can think about a commercial bank that says it holds loans of various types. Well, there are loans, and then there are loans. Yet when you think about the disclosure, it's not generally sufficient to let you finally parse at the granular level you might like to distinguish on a loan by loan basis what is going on.

And that is just not a theoretical construct. That's reflected in the capital markets as well. If you take a financial intermediary and a corporate firm and you look at say, hypothetically, they're both AAs, if you look at the yields of their senior debt, the financial will trade at a wider spread, in part reflecting its opacity.

So this is a way of saying that I think it's very difficult to get sufficiently granular exposure to these firms. General Motors makes cars. They're going to make cars today, tomorrow, and a year from now. That's the nature of the firm.

But the financial intermediary today that has exposure long the yen, tomorrow could have an exposure short gold substantially. It can just make that kind of change because it's dealing in financial claims.

It happens very quickly, and the capital markets recognize that and discount their debt because of it. It's very hard to get periodic disclosure to reflect that.

COMMISSIONER GRAHAM: Do you think maybe the disclosure forms ought to contain something similar to what we require now on a package of cigarettes that this, you know, is dangerous to your health, and don't depend on what you're about to read for any salvation?

I wonder, Mr. Kotz, would you have any comments on that?

WITNESS KOTZ: I don't know about that specific disclosure. I mean, one thing we did look at in our audit was there was this issue that was discussed previously about what was the information for. And so there were certain situations within the SEC where other divisions, perhaps Corporation Finance, could have had access to some information from the trading and markets about what they were finding, what they were learning, through their supervision that might have been then used in a more disclosure process.

Also there were 10K filings by Corporation Finance which in this case we found the process took too long, and by the time the process was finished Bear Stearns had already collapsed.

So the investors weren't able to have that information because of the way the process worked. But part of the potential flaw of the program I think was that it was meant to provide information to the folks in trading and markets, and not necessarily to be disclosed outside of trading and markets so that they would feel comfortable in talking to them, and then that would go against the other divisions within the SEC--Chairman Cox said Enforcement, as an example, having that information which then could be used to provide information to investors.

COMMISSIONER GRAHAM: My last question relates to this room in which we're meeting, which is normally the house of the Senate Banking Committee.

To Mr. Donaldson and Mr. Cox, are there recommendations that were made during your leadership of the SEC to the Congress that were not adopted which would relate to the crisis that we're now discussing, not just narrowly to the shadow banking but to the broader financial industry that you think now the Congress should reconsider as it moves forward in its reform efforts?

WITNESS DONALDSON: Well one that I think Congress should definitely move forward on is the regulation of so-called hedge funds. I think these are large pools of capital totally unregulated, and we need legislation to regulate it. We tried to regulate them and it didn't get through the legal process. That would be number one I think on my mind.

COMMISSIONER GRAHAM: Mr. Cox, what would be your priorities for what Congress should do in terms of reforming the financial services system?

WITNESS COX: Well I have a longer list even now, but you asked what I recommended when I was Chairman that Congress didn't adopt, so let me begin there.

One of the things that I recommended when we lost this authority in court was what Chairman Donaldson just described, and that was restoring to the SEC, or giving the SEC for the first time the opportunity to regulate hedge funds, and register specifically their advisors.

The second thing is that I recommended urgently to the Congress is I discussed with Commissioner Born the closing of the regulatory gap for credit default swaps specifically, and that category more generally of derivatives, and I think you heard me explain the ways in which I thought that that should be done.

CHAIRMAN ANGELIDES: I'm going to yield two minutes, if you can try to squeeze it in there, so we can go to the next Commissioner. Thank you.

WITNESS COX: Sure. Third, I recommended to the Congress repeatedly in many ways that the SEC be given the authority to regulate municipal securities to the same extent that we regulate corporate securities from a disclosure standpoint. Not in exactly the same way, because they are different animals, but because this multi-trillion dollar market presents all the same risks to investors, two-thirds of whom are individual investors in that market, as does the corporate market.

And as we've seen, the economy has only put those stresses more seriously on municipal finance. California is now in a similar position to Greece, nearly, and this is going to be an enormous issue. And disclosure, transparency, sunlight, is the best anecdote. There are all sorts of other fancy things you might do with regulation, but letting the markets understand what's going on will let investors protect themselves.

I also urged that we have legislation around the infrastructure for credit default swaps, which I think is very, very important. I think we need to merge the CFTC and the SEC jurisdiction over futures and options. We're the only market on earth that does it this way. It's very stove piped. And the reason we don't do it, as you know, since we're sitting in this room, is there's a different jurisdiction--Ag on the one hand, and Banking on the other.

We also need to rationalize more broadly the jurisdiction of the Judiciary Committees with the Banking Committee because now we need to resolve these institutions. And I made recommendations and have recommendations to make on that, but the bankruptcy system needs to be tailored in order to resolve these large financial institutions, and you can't do it if you've got to do it through the Banking Committee and the House Financial Services Committee. But you can't do it, either, if you do it only through the Judiciary Committee.

So I know my two minutes to answer this question are up. Please come back to me if you'd like on that.

CHAIRMAN ANGELIDES: All right. Thank you.

VICE CHAIRMAN THOMAS: Or come back to us in writing.

CHAIRMAN ANGELIDES: Yes.

Mr. Wallison?

COMMISSIONER WALLISON: Thank you, Mr. Chairman.

Chairman Donaldson, let me start with you, because you had something in your prepared remarks that I thought was quite wise. One of the things that is unique about you on this panel is that you have actually been in the investment banking business. You ran a business in that area. And so you have quite a lot of experience in how investment banks actually operate.

And what you said was a simplistic comparison of CSE leverage ratios to leverage ratios at bank holding companies is misleading. The product mix of securities firms typically differs significantly from that of banks, with relatively more extensive holdings of highly liquid assets in market-making books, and more limited exposure to off-balance sheet funding vehicles.

In other words, investment banks are a different business model entirely from commercial banks.

In light of this comment, do you think that there is anything inherently wrong, or inherently inapposite in the investment banking model? Or can we expect that investment banks will return at one point as fully functioning members of the financial system?

WITNESS DONALDSON: Well the investment banks have started from a base quite different than the commercial banking system. There are a lot of different businesses. I don't think there's anything inherently wrong with that model, except I think as things have developed now I think it's questionable whether the investment banks can continue to basically trade for their own account, proprietary trading, when they have the backstop now--all the investment banks are bank holding companies now where they have the backstop of the Federal Reserve--and I question some of the businesses that are in the investment bank mold right now.

Top on that list would be proprietary trading.

COMMISSIONER WALLISON: Okay, but assuming that they are not bank holding companies, or they have not submitted themselves to regulation by the Fed as bank holding companies, a stand-alone investment bank is not a business model that we ought to consider unsuitable for our economy?

WITNESS DONALDSON: No. I don't think it is. I mean, I think it is one that has to be regulated both in terms of leverage and liquidity and all the things that we've been talking about here, but I don't think the model itself is outmoded.

COMMISSIONER WALLISON: I'm going to ask your successor about the regulation issue, because I'm interested in this. I've asked the preceding groups about the same thing.

And that is, we have a strong system of regulation for banks. We have I guess what we would call a much less robust system of regulation for investment banks. At least you have all made a very strong presentation about how suitable and how effective in some respects investment bank regulation was, although we know that it's not as robust as the regulation of commercial banks.

Yet, as you pointed out, Chairman Cox, both regulated commercial banks and investment banks failed under their respective regulatory regimes at the same time during, or preceding, or however we define the financial crisis.

So are we looking at something--and I'm asking you to speculate a little bit here--are we looking at something that happened in the market during the financial crisis that no regulatory structure could cope with?

Or are you saying that there is a way to make regulation so robust that it can withstand the kinds of pressures that occurred in the financial crisis?

WITNESS COX: Let me answer the last part first and work backwards in that question.

We now can quantify. We know exactly how strong that gale force wind was. And we know that it took $16 trillion to restore market confidence once that approach was decided upon, once you decided you wanted to backstop that system as opposed to letting things fail.

As a result, it's easy to see that no amount of liquidity was going to be enough to withstand a run on the bank because at some point cash runs out. If everybody-- these are fractional reserve systems. The investment banks were more levered. The commercial banks were nonetheless very levered themselves, you know, just at a distance from investment banks, but if people pull out their money, they collapse. That's what happens to banks. That's why there can be a run on the bank.

So once you're in the run on the bank space where fear is driving it and people are pulling out their money, then capital and liquidity standards cannot be enough. That's the first part of the question.

But the next part of your question is: Is this system that we've got, the market such as it is today, susceptible of some form of regulation that will stand between us and what happened? Or is this inherently out of control?

And what I would say is that, as long as you're willing to let institutions fail, then you really don't have to worry too much about how much it's going to cost the taxpayers, because the losses fall on the people who take the risks.

The problem that we have had that got us to this discussion is that the government decided, the people's representatives ultimately decided, that these institutions could not fail. And that makes it a very direct intersection with the system of taxation and representation that goes with it.

If the federal government is going to be involved, if the taxpayers are going to be involved, in paying for these things, then it seems to me you cannot have--Commissioner Born or whoever it was that said this earlier had the right label--which is too big to manage--

COMMISSIONER WALLISON: All right, but let me stop you there, because--

WITNESS COX: --what a lot of these holding companies are.

COMMISSIONER WALLISON: Let me stop you there, because this is the fundamental question and you've touched on it. And that is, Bear, as we have been told, and you've said it, had 10 percent capital. The officials of Bear when they were here told us they were expecting in fact to be profitable in the first quarter of the new year before they were taken over, yet Bear was rescued.

In other words, it was treated as though it was too big to fail. Now in the past, in the securities business as you've mentioned, Drexel, Kidder, Solomon, all failed, no particular disaster in the market as a result of all of those failures, and people learned lessons from that. Bear was the first time that the U.S. Government has ever stepped in to rescue a securities firm, as distinguished from a bank.

So in your view, and let me add one more point, and that is the officials of Bear who were here before us, just before you, said they didn't think that Bear was too big to fail.

Do you think Bear was too big to fail? Did you participate in a recommendation concerning Bear's disposition that week? And if--I don't want to ask you what your recommendation was because of executive privilege, but if you choose to imply what you said and what you thought, we would like to hear it.

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the Commissioner an additional five minutes.

COMMISSIONER WALLISON: Thank you.

WITNESS COX: Yes. I heard the testimony earlier today on that subject. I thought it was very illuminating to learn that there was not an expectancy at Bear Stearns of a government rescue.

That contrasts with what we heard from Richard Fuld testifying recently before the House of Representatives who said that he expected a liquidity bridge. So I do think something changed in March.

COMMISSIONER WALLISON: That was moral hazard, wasn't it?

WITNESS COX: Well moral hazard certainly, but I think that understates it, given the scope of what was going on. Moral hazard is sort of a vague thing. This is very specific. I mean, I think beginning in March everyone, first of all in the investment banking space, but, you know, possibly throughout the shadow banking system as we've been loosely referring to it here, came to the view that they too would be too big to fail.

I mean, certainly if you were a larger investment bank, how could you not be?

COMMISSIONER WALLISON: Right. And so what I'm asking is: What is your view about the policy of rescuing Bear in light of the moral hazard, as vague as that might be, that it created? And clearly Fuld's remarks suggested very certainly that moral hazard was operating here. Because he expected that his firm would be protected in some way. And so probably they didn't take many of the actions that they would otherwise take to protect themselves, and many others probably didn't take actions with respect to Lehman that were necessary to protect themselves.

So what is your view on the policy of that? Was it a good idea to rescue Bear, or not?

WITNESS COX: Well this is, as I said, the ultimate bell that can't be un-rung. The way to answer this question to everyone's satisfaction would be to rewind the tape and do it the other way.

Since we cannot do that, there are two explanations for what happened. One is that the world would have been a lot worse if we hadn't done these things.

The other is that these runs on the bank are driven by panic and fear, and what the government did made that worse.

We've heard all of this before, and I honestly don't know how to sort that out. To go back and real time, which is what you inquired about, I was of course natively skeptical--as Commissioner Thomas mentioned, I am natively skeptical, period, about all of these things--and so I was skeptical about the long-term consequences of a bailout.

I thought that the short-run effects were clear enough. And the purpose of this was to restore confidence to the system. But not only what's called moral hazard but the precedential effect of where do you go from here needed to be thoroughly considered.

I was very satisfied that these questions were thoroughly considered by both Tim Geithner and Hank Paulson, with whom I was in conversation in those days. And so after discussing moral hazard problems and all the other questions, I remember Secretary Paulson saying he never thought he would ever see the day when Bear Stearns would be deemed too big to fail.

But once that decision was made by the Federal Reserve about what they needed to do to protect the system for which they are responsible, with the money for which they are responsible, the SEC and I personally acquiesced in the decision and agreed to do everything possible to help facilitate the--

COMMISSIONER WALLISON: May I interrupt, because I think I'm running out time. And I think that I understand the ruminations that went through your mind.

What I'm asking you is, knowing now what you know about what happened in the market after Bear Stearns, do you believe that it was a good policy to rescue Bear Stearns?

Was there any indication that you had as Chairman of the SEC that the failure of Bear Stearns would have affected other institutions?

WITNESS COX: As Chairman I didn't have any--and Director Sirri is here, and I certainly was, you know, constantly in contact with him throughout this time, he knows what resources the SEC had available for this purpose. We have an Office of Economic Analysis and so on.

The SEC did not in 2008 have a body of data on which to draw to say you can't do that, that's wrong. And so, you know, playing my role as Chairman of the SEC institutionally it would have been impossible for me to say the SEC has a completely different view as--I would have to answer this question more as a 17-year veteran of Congress and say, you know, would I have voted for it? And that's a lot easier.

COMMISSIONER WALLISON: Okay, would you have voted for it?

WITNESS COX: I would not have, as a member of Congress, voted for a policy of bailing out financial institutions outside the traditional banking system.

COMMISSIONER WALLISON: Thank you.

CHAIRMAN ANGELIDES: All right. Mr. Georgiou.

COMMISSIONER GEORGIOU: Thank you, Mr. Chairman. And thank you, gentlemen, for joining us this afternoon.

Mr. Cox, at page 13 of your written testimony you state that, and I quote, "Above all, the SEC is a law enforcement agency."

And our role on the Commission here is to determine whether the performance or failure of the SEC in this law enforcement function played a role as a cause of the global financial crisis.

As the top cop at the U.S. SEC, you were for almost four years the most important person in the world responsible for policing the global securities markets. And as we look back on your tenure, everyone knows of the two large ponzi schemes that were missed by the SEC--Bernie Madoff and Stanford. And of course although these con men cost investors tens of billions of dollars, few would argue that they were causes of the global financial crisis, and neither would I.

But at page 3 of your testimony, if I could direct you to it, you stated that the MBS devaluation was itself the result of an asset bubble in the residential mortgage market exacerbated by the rise in the use of high-risk mortgage products, including the notorious, quote, "liar loans," and no-money-down financing. It is abundantly clear as the SEC's former chief accountant, Len Turner, testified in Congress on the failure of AIG, that, quote, "if honest lending practices had been followed, much of this crisis quite simply would not have occurred. The nearly complete collapse of lending standards by banks and other mortgage originators led to the creation of so much worthless or near worthless mortgage paper that as of September 2008 banks had reported over one-half trillion dollars in losses on U.S. subprime mortgages and related exposures."

And again we've heard at other hearings about an FBI report in 2004 issuing a warning about the extraordinary amount of fraud in the mortgage origination market.

Now I guess I would ask you, in light of the fact that these underlying mortgages became part of these residential mortgage-backed securities, which as you stated, you know, became worthless or near worthless mortgage paper, and then of course they in turn were sliced and diced into collateralized debt obligations and a whole variety of other securities, what did the SEC do to investigate the underwriting of these so-called AAA securities that were created from this, quote, "worthless or near worthless mortgage paper?"

WITNESS COX: Well one of the reasons that I pointed this out in my written testimony is to knit together what is a rather long narrative of all of the things that went wrong in the financial crisis.

And certainly the failure of underwriting standards in the mortgage business is one of them. The SEC obviously is not the regulator of mortgage lending, nor the enforcer of those standards.

But if it is not the case that the collapse of those standards was the cause of the financial crisis, it certainly is much closer to the beginning. And I think it is very, very important that we keep our eye on that ball because, even today, albeit the GSEs are now under government management, the standards that seemed to be extant are very loose, and that hazard is still being created.

The SEC's enforcement role is focused, as you pointed out, in the securities markets. And there the SEC has been very active. In 2007, we formed a Subprime Task Force. At the time that I left, the following year, we had over 50 active subprime investigations going.

Some of those have resulted in actions in the last year that are quite well known. Some of them were announced while I was Chairman. I think it is very, very important that the SEC continue in this vein because, as we all know, market confidence is in some ways very closely connected to law enforcement.

Furthermore, as the SEC has over half of its people devoted to law enforcement, I think you can expect--

CHAIRMAN ANGELIDES: Mr. Georgiou, on my time can I just follow up, and then return to you on my time?

COMMISSIONER GEORGIOU: Sure. That would be fine.

CHAIRMAN ANGELIDES: Were those enforcement actions against subprime lenders, originators, for deceptive practices? Against whom were those?

WITNESS COX: They wouldn't be against lenders for lending. They would be against people for committing securities fraud in some wise or another.

CHAIRMAN ANGELIDES: Yes, but by any measure, let me just be blunt to kind of cut through it. Did the SEC succeed in this regard, or not?

WITNESS COX: I think so. I think that--

CHAIRMAN ANGELIDES: You think the SEC succeeded? This securitization market went hog wild, and it was underpinned by mortgages, as you said in your testimony, that were inherently flawed. This became a business of hundreds of billions of dollars, trillions of dollars. And to suggest that the SEC was effective in those enforcement actions frankly is ludicrous, and I'm sorry to buy into your time, Mr. Georgiou, but I just at a certain point long answers do not suffice for direct and effective action.

WITNESS COX: Well I think I answered a different question than the one that you put, because I wouldn't disagree with your assessment that law enforcement generally was not effective to stop the abuses in mortgage lending and the lack of underwriting standards. I simply meant to separate the SEC's role, which is to go after securities fraud, and all the rest of law enforcement which includes in some cases banking regulators that are responsible for mortgage lending and enforcing those underwriting standards.

When people are--the liar loans, and all that sort of thing, are obviously--

COMMISSIONER GEORGIOU: But let me take back--

CHAIRMAN ANGELIDES: Back on your time, Mr. Georgiou.

COMMISSIONER GEORGIOU: Let me take it back, though. But you also had a law enforcement function. As you said, your responsibility was to ascertain whether the securities that were created from these flawed mortgage products were--you know, met the standards of the Securities and Exchange Commission, and to the extent that they were floated in the public marketplace or, you know, whatever other authorities you had as a regulator.

And it seems to me that that was a complete failure during those years. I mean, the fact that you may have started in '06 and '07 and maybe something came out in '08, by that time everything was all over. I mean, Bear had already collapsed and, you know, Lehman was about to go out the door, and everything else was in trouble.

WITNESS COX: Well if I may, just to disagree rather strongly with that, in real time, as you remember the credit markets froze up, and that affected the municipal markets, and in particular auction rate securities.

COMMISSIONER GEORGIOU: Indeed.

WITNESS COX: And in the fastest action that I've ever seen the SEC bring, we also got the largest settlements by far in the SEC's history. Normally those are measured in millions. These settlements in the auction rate securities cases were over $55 billion of money returned to investors in the form of settlements. And that is, to this day, the record for the SEC.

And it was a very significant real-time action that the SEC took for the protection of investors.

COMMISSIONER GEORGIOU: Well the undoing of the auction rate--I mean, the taking back of those securities by the underwriters. I understand that. And that was good. But the mortgages themselves, the residential mortgage-backed securities that were created from these loans, which you characterized as becoming later worthless or near-worthless, it seems to me those proliferated during many years without anybody effectively acting against them.

And I'm not going to just point to you. I mean, I think the private-sector people who originated them also had responsibility for them, and of course ultimately--

WITNESS COX: I think we're coming to agreement here on the theory of the case, because it wasn't obviously technically securities fraud that caused all of this. And, to the extent that these were securitized, the disclosure system didn't work. It wasn't sufficiently transparent.

I think the SEC rules provided a whole lot of information about the securities, but the underlying instruments were so complex that the marketplace was unable effectively to appraise the risk and to price it.

COMMISSIONER GEORGIOU: Well they all appraised it at AAA.

WITNESS COX: And so they relied on broad-brush crutches such--

COMMISSIONER GEORGIOU: Yes, and basically they were rated at extraordinarily high levels, and of course everybody now knows that they didn't deserve anywhere near that perception in the marketplace. And we just heard from the people at Bear who learned that when they couldn't roll over their money, they couldn't finance them at anything approaching the par that they were holding them on their books, and ultimately that caused enormous liquidity problems for them and put them out of business, and put a number of other people out of business as well.

There was a discussion this morning about Bear in particular that had to do with naked short selling. And I hate to admit that I from time to time actually read Rolling Stone, but there was an article about a month ago now that called into question a particular trade that was placed on Bear in which Bear was, I think at that time, trading at something like $60 a share, and somebody bought a put for $1.7 million to put the shares at $25, or thereabouts, which was a very unusual trade.

And then of course there was quite a lot of short selling in the next 10 days, and there was enormous volume in the marketplace, and at least I'd say Mr. Cayne, if not Mr. Schwartz, suspected that there was some potential nefarious collusion on the part of a number of people to do a Bear raid, if you will on Bear Stearns.

And so we had a little discussion about that, and they really--and of course it turns out that apparently you testified before this committee here in this room regarding, that subject was raised to you at some point, and I wondered if you might comment on what the SEC did to look into that. Because so far at least it appears that it's not been resolved.

WITNESS COX: Yes. As I mentioned, we had many investigations, you know, well over 50 of them, at the time that I left, focused on these related areas. And one of the areas that was of great significance was market manipulation.

When I was Chairman we set the record for the highest number of market manipulation enforcement actions. It was a big area of focus. And one of the path-breaking actions that we brought involved the intentional spreading of false rumors.

In the market crisis, given the scale of it, it was so large, obviously that's an environment that's ripe for that kind of fraud and manipulation. You intentionally spread a false rumor, that's a climate in which somebody might believe it.

And so investigating all of the, or at least as many as was humanly possible, of those claims in real time was a very important focus for the SEC.

I know that the way that those investigations work, ultimately you have to prove your case in court. And so it takes a while to develop the evidence, and I can't, as a former Chairman, tell you what the inventory is of the SEC right now, but I would not be surprised if there are not ongoing investigations even now in those areas.

COMMISSIONER GEORGIOU: Well this was--

CHAIRMAN ANGELIDES: Do you need more time, Mr. Georgiou?

COMMISSIONER GEORGIOU: Just a moment or so.

CHAIRMAN ANGELIDES: All right. One minute.

COMMISSIONER GEORGIOU: Thank you. This was with regard to the particular allegation of naked short selling at Bear and Lehman.

Now I don't know whether you had any recollection of that, because I know that you gave assurances that that would be looked into.

WITNESS COX: Yes, and I can give you assurances that it immediately was set upon by the Enforcement Division at the Securities and Exchange Commission. Beyond that, it probably would not be appropriate for me to say if I did know. I don't know the answer to where this stands at the moment.

COMMISSIONER GEORGIOU: Right. Okay. I think that's fine.

I guess I did want to ask one real quick question to Mr. Kotz, and that was, one of the things that struck me about your testimony is your pointing out that Bear was permitted to allow internal auditors to audit the risk management system rather than external auditors, which it struck me was a major deficiency in the process, and I wondered if you could elaborate just very briefly on that.

WITNESS KOTZ: Sure, sure. Yes, I mean we found in fact that the procedures of the CSE Program required that it be done by external auditors, but rather the decision was made to have internal auditors do it. And that there were some questions about how that work was performed.

And so we recommended that that matter be looked at, but also that it be ensured that if there was a decision like that that was made, to have internal auditors instead of external auditors do the work, that at least it be run by the [SEC] Commission, because strictly speaking under the rules we found that it was prohibited to do it that way.

COMMISSIONER GEORGIOU: Right. And of course that sort of follows on to the fact that the CSE permitted the supposedly regulated entities to essentially establish their own parameters for capital and liquidity associated with the risks that they perceived.

So if they were then also investigating the noncompliance with that--

CHAIRMAN ANGELIDES: Yes, Mr. Georgiou, let's wrap this up just because of time. Thank you.

COMMISSIONER GEORGIOU: Okay. Very good. Thank you.

CHAIRMAN ANGELIDES: And that's okay, if you'll request time we'll see if we can do it.

Mr. Hennessey.

COMMISSIONER HENNESSEY: Thank you. We heard this morning from the Bear executives that Bear failed basically because of an act of God or nature, and that the firm was both solvent and profitable; and that what brought the firm down was an unsubstantiated run, which was either a panic or maybe it was caused by nefarious actors out there.

Mr. Kotz, what I thought I heard from you in your testimony was that part of the reason why Bear failed was because the CSE Program was not effectively enough implemented, and that there actually were problems at Bear.

My question is not specifically about the CSE Program, but was the run on Bear unsubstantiated? Was everybody either irrational or nefarious in withdrawing either their money as customers from Bear, or their willingness to offer liquidity to Bear? Or were there actual substantive problems with Bear that justified some of the people pulling out?

Do you buy the executives' argument that there was no reason for their firm, no rational reason for their firm to experience runs?

Maybe, Mr. Kotz, we will start with you. And I have one other topic, so if you could keep your answers brief I'd appreciate it.

WITNESS KOTZ: We didn't look specifically at that issue, but I can say that we certainly looked at, you know, in hindsight, issues that arose that perhaps trading and markets could have seen there were deficiencies. And those deficiencies would go against the theory of the Bear Stearns executives that there was just this run by unsubstantiated rumors.

COMMISSIONER HENNESSEY: Chairman Cox?

WITNESS COX: I was picking up where David is leaving off. His report to the agency, which I was very grateful for and accepted all 26 recommendations from and put into effect immediately, was very clear that there was no evidence of any connection between the significant deficiencies that he found in his examination and the cause of Bear Stearns collapse.

So the question is a live one, just as you put it, whether or not this is some irrational manifestation of something, or, you know, why Bear? And I think there are several reasons.

First, it was the smallest of the investment banks, and so if there were going to be a run on one of these firms it would take place--and if the run were going to be occasioned not only by people withdrawing their funds but also marketplace activity that would incent that such as concerted attacks on the firm by people betting against it, it would be easiest to accomplish that in the marketplace with the smallest of the firms.

So I think that's why Bear was first. And I think everyone understood after Bear that you would just go next on the pecking order. So even in an efficient market where everything is rationally priced, you know, to the extent these firms had similar business models and so on, there was nonetheless a hornet's nest around, you know, one firm at a time.

And I think people understood by the time it all culminated in September that all of them in the end, given that momentum that was building up would be vulnerable in that same way.

COMMISSIONER HENNESSEY: Let me move on to the other topic. The title of this hearing has been about the shadow banking system, and there is an implication from that

that if only there were more sunlight, if only people had more information, and if only there were tougher regulations, none of these problems would have happened.

We've heard a lot of specific questions about the CSE Program, and arguments that in fact the CSE Program needed to be legislatively strengthened. I happen to believe that there should be leverage requirements that are imposed. So I buy some of those arguments.

But what I'm having a tough time with is a point that's been raised by some others, which is singling out the particular aspects of the CSE Program as being primary contributing factors to these failures, given that over 200 commercial banks also failed.

So I have no doubt that a stronger CSE Program or even a more effectively implemented CSE Program could have helped. What I'm trying to figure out is: How does the difference between the CSE Program and for instance the FDIC's greater amount of information and greater regulatory oversight of the commercial banks help us understand that two of the five investment banks failed, and 200 commercial banks failed?

It seems to me what we should be thinking about is not just why did Bear fail, why did Lehman fail, and what does that teach us about the CSE Program; but in addition, why did Washington Mutual, and Wachovia, and Indy Mac, and

200 other banks fail? And is there in fact some underlying common aspect here that is more important than differences between the FDIC regime and the CSE regime?

Maybe start with Dr. Sirri and then--

WITNESS DONALDSON: The permanency of the credit.

COMMISSIONER HENNESSEY: Sorry?

WITNESS DONALDSON: It's the lack of permanency of the operating capital that forced the investment banking firms to fail, the withdrawal of the funds they needed to operate the business. It had nothing to do with the CSE Program, in my view.

COMMISSIONER HENNESSEY: Okay. Dr. Sirri?

WITNESS SIRRI: I think the observation you make and the observation that Commissioner Wallison make are a good one, which is that it's hard to ascribe causality to the form of the regulation--you know, the implementation of the regulatory oversight.

I would just make the ancillary comment that it's hard to ascribe the problem to the institutional form. Because you saw investment banks, commercial banks, insurance companies, nonbank mortgage originators, all sorts of entities fail.

It seems what was common in this case are the instruments. The instruments were tied tightly to mortgages, and in some cases to commercial real estate.

So that seems to be what was common. I think especially in the regulated entities, the commercial banks and in the CSE firms in the sense that they were regulated, and maybe a couple of other places, people understood the exposures. They understood the concentrations--talking specifically about Bear Stearns. But what was harder to appreciate was justifying--reconciling what the market was telling you--and remember, markets aggregate information, and the market was sending a particular signal--with something that happened that was really outside the ken of what people expected. And in this case, the movement of those prices.

There were a number of things like that that happened. We spent a lot of time here talking about the disappearance of secured funding. These were scenarios that we just didn't plan for.

Had we gone back in time four years ago, and I said and directed my staff to say we need to run a one-week evaporation of secured funding scenario. We want to manage these firms to that. I think that would have been a very difficult thing to cause to happen. Ex post, it happened.

But to go back four years ago and say we want a risk scenario to be repo disappears in a week? You know, in all honesty, people would have come back and said, you know, what are you talking about? They wouldn't say that today.

COMMISSIONER HENNESSEY: Chairman Cox?

WITNESS COX: I think first, to answer the CSE part of your question, that Inspector General Kotz couldn't have been more clear that the significant deficiencies were--there was no evidence that--

VICE CHAIRMAN THOMAS: Mr. Chairman, I yield the Commissioner three additional minutes.

COMMISSIONER HENNESSEY: Just enough time to hear the answers is all I need. Thank you.

WITNESS COX: That there was no evidence that any of this caused the crisis.

So we are then left to answer your question, as you put it: What is it that all of these things have in common?

All of the commercial banks that you mentioned that had to be rescued, or that failed, and the investment banks. And the one thing that they all have in common is that they all used the same regulatory standards.

The Basel Standards in use, not only here in the United States, by the Fed and other bank regulators, but by bank regulators around the world, heavily discount mortgages from a risk standpoint. And they deeply discount Fannie Mae and Freddie Mac paper.

And so to the extent you're worried about mortgage concentration, concentration is baked into these standards. And those were the standards, not coincidentally, that the SEC decided to port into its CSE Program and put it at the center of it. It became the backbone of the CSE Program.

And so therein lies an explanation not only of what happened to the investment banks but also what happened to all these commercial banks.

COMMISSIONER HENNESSEY: Chairman Donaldson, anything else to add? Or Mr. Kotz?

WITNESS KOTZ: Yes, I would just add that, you know, there's been discussion today about how things looked right after Bear Stearns collapsed, and then how things look now. And of course we did our report right after Bear Stearns collapsed. But I think we were appropriately judicious in what we said, as Chairman Cox noted, that we didn't find a specific connection between the failure of the CSE Program and the collapse of Bear Stearns.

I would also echo what Chairman Cox said and add perhaps one other feature, which is that in addition to the standards being inappropriate and not useful, what we found in this case was the lack of exertion, the lack of influence, and the lack of regulatory effect, that it was not aggressive enough oversight that was conducted here.

And perhaps if one were to look at other situations, they might find that that same lack of aggressive oversight could have been a cause of perhaps more than just matters involving CSE and the SEC.

COMMISSIONER HENNESSEY: Thank you.

CHAIRMAN ANGELIDES: Ms. Murren.

COMMISSIONER MURREN: Thank you.

Thank you all for being here today. And I actually wanted to pursue that exact line of questioning, Mr. Kotz. And that is:

When you think about the CSE Program, do you think the voluntary nature of that program did not allow the SEC to pursue things as aggressively as they might have?

WITNESS KOTZ: Yes. I mean, I think that was a big factor. I mean, today we have heard a lot about how the program was described: dialogue, conversation, we're trying to learn a lot from them, the business decisions are up to them, let the firms manage risk the way they want to. Those are all qualities of a voluntary program.

And while in our report we did find that there were some instances when certainly the SEC could have been more aggressive in saying, as was suggested by the Chairman earlier, you're out of the program. Or to threaten to be out of the program.

Nevertheless, I do think that the voluntary nature of the program was something that was in the minds of all the oversight folks, that that had a great effect on how the program was implemented.

COMMISSIONER MURREN: Your comments and also your written testimony suggest that you felt that there might have been some culture of inaction at the SEC. And I'm not sure what time frame you were looking at when you suggest that.

Do you think that that's still present now, because Mr. Cox would describe a different picture? How would you assess it today?

WITNESS KOTZ: Well we were talking about it in terms of the CSE Program. We were limiting it to the CSE Program. So, you know, that lack of aggressive oversight may have been reflected in the fact that it was considered a voluntary program.

I don't think we would have that same view with respect to other aspects of the SEC that Chairman Cox described nor, when he was there, nor now under Chairman Shapiro.

COMMISSIONER MURREN: If I could--thank you. Mr. Sirri, could you talk a little bit about some technical aspects that I've heard a number of people have talked to me about a couple of things, and they relate to transparency and disclosure.

Are there differences in the disclosure requirements for long positions versus short positions, generally speaking? And then also maybe more specifically mutual funds versus hedge funds? And do you think that these--if there are differences--do you think that they play a role in some of what has been talked about today with regard to market activities and potential manipulation?

WITNESS SIRRI: Sure. Let me see if I can be helpful. So let's start with hedge funds versus mutual funds.

The regime for reporting for mutual funds is very particular because mutual funds are regulated investment companies. So there's a particular regime for disclosure about those. It's administered by the Division of Investment Management.

You can find out information about every security that they hold, a listing that they'll be provided periodically, concentrations; that kind of information is provided to you by the Division of Investment Management's regulatory regime.

And that is because mutual funds are consummately individual investor products. And so disclosure is aimed at that.

Hedge funds are different. Hedge funds are not regulated. They're exempt under particular portions of the Investment Company Act. The advisor could be registered, concededly; generally it's not. And so there's no regime for disclosure about those positions.

They are not required to periodically report a table saying, look, here's what we own; here's what we bought and sold. That just doesn't happen. So that's mutual funds versus hedge funds.

You also asked about long and short positions. I think it's a good question and one that we get asked--one that we were asked a lot, and during the time of the 2008 crisis something that the [SEC] Commission dealt with directly, disclosure around, especially short positions.

I think it depends what instruments you're talking about. Here I'm going to presume you were talking about equities. Your question may have been broader than that to other kinds of instruments. If you were asking about equities, then the dominant disclosure is disclosure about, during the time this crisis was building up, the disclosure was about long positions, a periodic reporting regime under Section 13.

When it came--short position disclosure is something the [SEC] Commission has dealt with. It's something that the UK is dealing with the FSSA is dealing with, and something that I think is still a topic of debate.

Then the last portion of your question, as I understood it, was did the disclosure regime figure importantly into what we saw happen?

I think with respect to in a sense equity disclosures for the mutual funds, or here, I'm going to say I don't think they were the key issues. That is, the disclosure of those equity positions. Because what we saw here were issues around fixed-income instruments, the mortgage instruments, or loans of various types that weren't even securities.

So I don't think they related to that type of a--those kinds of disclosure issues.

COMMISSIONER MURREN: If I could stop you there, because I want to follow up on that. There are a number of companies in a variety of different industries, whether it's energy, Constellation Energy would be one that comes to mind, if you look at what the executives from Bear Stearns just said about the financial sector, there are instances where it appears that, because of pressure on the equities securities and potentially on some of their debt instruments, too, that it puts companies in a position where they might go south perhaps not necessarily directly because of the fundamentals.

And I guess my question is: When you have mutual funds who are required to have a certain level of disclosure, but you have hedge funds who are not required to disclose at all, and then furthermore not required to disclose short positions the way you might long positions, doesn't it add to the desire to have a whisper or chatter or manipulation that you might not otherwise have if you were to have those disclosure requirements in place?

In other words, why would you not do it?

WITNESS SIRRI: I, I--it's an issue that we regularly discussed amongst ourselves, because it's something you have to think about. And I think it may be under consideration still by the [SEC] Commission. You know, I've been gone for a bit.

I think, look--

COMMISSIONER MURREN: Aren't the principles the same?

WITNESS SIRRI: Many of them are. But there's a slightly different side. When you have mutual fund disclosure, it's for the benefit of the shareholders who own the mutual funds.

The disclosure you're talking about, say for Constellation Energy, is for Constellation Energy's benefit. Right? So if they were a hedge fund holding long Constellation Energy, or short Constellation Energy, the concern you expressed was about Constellation Energy.

The disclosure regime with respect to mutual funds was for the benefit of the mutual fund shareholders.

COMMISSIONER MURREN: Well I think that when you look at--Constellation Energy was one example, but if I wished to invest in a stock, I could very easily go on Edgar and pull up who their ownership structure is to see what kind of company I'm keeping.

And so I do think that to the extent that part of the job and the mission of the SEC is to create a fair environment where people are able to easily assess the investments that they're going to make, knowing who's got a short position on would be an important part of making that investment decision, in the same manner that knowing who has a long position would be.

WITNESS SIRRI: I take your point. I think it's a good point. The only thing, the additional point I would observe about the short positions is at times they're not held long term.

COMMISSIONER MURREN: Um-hmm.

WITNESS SIRRI: So they may be very short term. But if your point is, look, there might be a well-known investor who has a short position on, that they've had it on for nine months or a year, that might be relevant information to you as an investor. You might like to know that when you made your purchase or sale decision about those shares. I take that point.

COMMISSIONER MURREN: And as a follow-on to the specific example, because it's come up several different times--

CHAIRMAN ANGELIDES: Do you need more time, Ms. Murren?

COMMISSIONER MURREN: Maybe a minute, please? Thank you.

--as it relates specifically to Bear, is that something that you yourself have had an opportunity to explore? Or is that something again that, you know, is still in discussions?

WITNESS SIRRI: I'm--

COMMISSIONER MURREN: Did you see the previous testimony? I'm sorry, the executives from Bear Stearns talked a lot about--

WITNESS SIRRI: I was coming over here, so I'm sorry I didn't see that, but I caught a sense of it, but I can't really--I mean, if you want to explain it to me I'm happy to answer.

COMMISSIONER MURREN: It's just their particular take on this was that there was in fact market manipulation that was at work, and that was they were in a good position except for the fact that they ended up with a liquidity run.

WITNESS SIRRI: So I'd answer it this way. You know, over the period of time we're talking about, 2008, a number of senior executives of Wall Street firms felt that there was manipulation in their securities often through short selling. They would say, the short sellers have ganged up on us.

And running a Division, my response to these people when they called was to say: Please get us some specificity. Get us a trade. Get us a name. Get us something that I can turn over to Enforcement, or whoever I would have turned it over to, so they can pursue it.

And I had countless conversations, and that was the information I relayed straightaway to those people. And I will tell you, not one single time did anything come back to me with enough specificity that I could pass it on to a colleague at the [SEC] Commission.

COMMISSIONER MURREN: That's helpful. Thank you.

CHAIRMAN ANGELIDES: Ms. Born, you had a follow-up question, and then Mr. Holtz-Eakin.

COMMISSIONER BORN: Yes. I wanted to ask about a slightly different topic. During the decade leading up to the financial crisis in 2008, securities firms broadly defined spent $1.1 billion in federal lobbying expenses and campaign contributions, according to data from the Center for Responsive Politics.

The financial sector as a whole reportedly spent more than $5 billion for lobbying and campaign contributions during the same period.

I wanted to ask Mr. Cox and Mr. Donaldson whether you were aware, while you were at the SEC, of these efforts to exert political influence in Washington? And whether the financial services industry was actively lobbying Congress concerning the regulatory powers of the SEC.

Mr. Donaldson?

WITNESS DONALDSON: Well certainly one is aware of lobbying going on. But in terms of lobbying--if your question is: Did it affect the operations of the SEC? Did it affect the decisions that were made? Did it affect any of the things that we were supposed to be doing in terms of protecting investors? No.

COMMISSIONER BORN: How about the laws applicable to you? Were there any changes in the law during your period there?

WITNESS DONALDSON: Well certainly a perfect example I guess would be the lobbying on hedge funds. I mean, there was a massive lobbying effort going on. And it basically didn't have any effect on the decision of the [SEC] Commission to vote to regulate hedge funds. And that was thrown out in a court decision.

But as far as influencing anybody within the [SEC] Commission or on the [SEC] Commission, I don't think there was any influence coming from that.

COMMISSIONER BORN: And there were no legislative changes resulting from industry lobbying that you were aware of relating to the SEC?

WITNESS DONALDSON: You mean in terms of the functioning inside the SEC?

COMMISSIONER BORN: Or your powers, or your Jurisdiction?

WITNESS DONALDSON: Not that I was aware of.

COMMISSIONER BORN: Mr. Cox?

WITNESS COX: Well I obviously have the unique opportunity to have seen this from three vantage points in Washington: from the White House first, then from Congress, and then from an independent agency.

My assessment first is that there is an enormous amount of lobbying that goes on. And because this is all about money, even more so.

Second, the lobbying almost always takes the form of stopping things from happening when it comes to the SEC rather than trying to reverse-engineer the whole system and make the SEC into something.

And so when I got to be the Chairman of the SEC and I was in a position to make legislative recommendations such as the ones that I'd outlined earlier concerning CDS, concerning the municipal market for example, there was immediate push-back. And, you know, a lot of it was from the industry that likes things the way it is.

I mentioned that the municipal market is a multi-trillion dollar market. There are firms that underwrite all of this debt that like things exactly the way they are now and they don't want to have prospectuses, and they don't want to disclose to retail investors the same things they'd find if they were buying a regular bond. And so they're going to try and stop it.

COMMISSIONER BORN: Thank you.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: I want to thank everyone on the panel for the time you spent helping us piece together this very complicated narrative that we're going to have to eventually agree on.

One of the things that really stands out about today is that, again, the Bear panels basically said, as we look around the investment bank world in particular, Wall Street in general, we all look the same. We couldn't tell risk differences, couldn't tell where the risks were, and so when Bear goes down for unfounded rumors they all went down because of unfounded rumors because they all were the same.

Whereas you, Mr. Sirri, you said you could very clearly identify the concentrations and risks, and that ex- post certainly independent of organizational form, regulatory environment, those exposed to residential and in some commercial instruments are the ones who failed. And that would suggest that markets really were disciplining Bear in particular when things started to happen.

But there's one more piece of interference with market discipline that came up this morning that I wanted to get your reaction to--yours, Mr. Sirri, and Mr. Cox as well. Because in the moment, Mr. Schwartz suggested that there was an indirect lender of last resort that would appear for the investment banks, and that was commercial banks borrowing from the Discount Window at the Fed and then handing the funds over; that this was a traditional role commercial banks had played. And he even suggested the Fed tried to engineer this in the midst of the crisis.

And I was wondering if you would comment on whether you felt that was an expectation on the part of the investment banks, or whether there was indeed an effort of that type?

WITNESS SIRRI: Well to take your second question first, I have no knowledge that there was such an effort in place. So I absolutely can't comment on that.

To the first part of your question, I think there have been times in the past where commercial banks were used as conduits to, you know, address certain parts of the financial system that had gotten in trouble.

I think for instance in the stock market crash of 1987 that was a mechanism that was used to assist portions of the financial system.

COMMISSIONER HOLTZ-EAKIN: And in your oversight of their liquidity risk management in particular, was there an expectation that this would be a part of managing liquidity risk, because these guys would show up?

WITNESS SIRRI: Absolutely not. The mechanism you mentioned, which I acknowledge is a mechanism, I never once had that discussion with my staff as being part of the liquidity management scenario.

CHAIRMAN ANGELIDES: Mr. Thomas?

VICE CHAIRMAN THOMAS: No, thank you.

CHAIRMAN ANGELIDES: All right. Just one quick wrap-up question to bring us back home at least to the discussion about the CSE Program.

In picking up on something Mr. Hennessey said, I do think one of the things we're going to have to consider is the relative performance of different kinds of institutions engaged in either similar or diverse practices.

But at the end of the day, the CSE Program on an objective basis failed because all five institutions either were gobbled up, converted to bank holding companies, or failed.

I think I want to task a very specific question, because it really does go to the nature of what it was constructed to be; whether it was constructed to be an accommodation to the EU and the financial institutions, or a true regulatory program.

When the program was adopted in the open session, Mr. Donaldson, you said if anything goes wrong it's going to be a big mess. Annette Nazareth, who I think, yes, she was then Director of Trading and markets, assured the [SEC] Commission: We have broad discretion and the ability to constrict activity we believe is problematic.

And I guess this is probably for you, Mr. Sirri, as head of that department. And I have had the opportunity to review, as have other Commissioners, the Monthly Monitoring Reports, which I believe went to you, correct?

WITNESS SIRRI: Yes, they did.

CHAIRMAN ANGELIDES: And obviously they identify, per the discussions, a number of risk areas that are occurring at these institutions, and particularly Bear.

I guess the simple question is: It's all hindsight, but thinking of this program should there have been certain activities of Bear that you should have constrained?

WITNESS SIRRI: So let me start. I will directly answer your question. One thing that I want to make sure has come out that hasn't come out that much to date is something that you asked about: why was the program there?

An important part of the program was the regulated entity, the broker-dealer. In the Drexel Burnham world, what happened was the regulated entity, that broker, was sound but capital was downstream from the holding company to the broker-dealer.

When the holding company and other parts got in trouble, it took down--or impaired and took down the broker-dealer.

So the point there is that, given that we're charged with watching the broker-dealer, comprehensive information about the broker-dealer was not enough. You're not going to do it that way.

So we needed other information to watch the broker-dealer.

CHAIRMAN ANGELIDES: Very basically, looking at the holding company, looking at the whole elephant, were there activities that should have been constrained?

WITNESS SIRRI: So to have done that would have meant--so let's take concentration of mortgages as an example because it seems to be the key issue here.

CHAIRMAN ANGELIDES: Sure.

WITNESS SIRRI: I think what you're asking me is: Should we have looked at that mortgage concentration and said it's too much. You, Bear Stearns, need to ratchet that back?

CHAIRMAN ANGELIDES: Right.

WITNESS SIRRI: I think the answer is, when you ask the question what we would do, if you ask the question in August of 2007, or in that kind of time frame when it just starts to bubble up, or maybe a little earlier, at that point it's probably too late.

The reason it's too late is the markets had started to seize up by then. So when you start to see the problem, slightly after the--or at the time of the fall of the Bear Stearns hedge funds, it's probably too late to shed those positions wholly without taking a pretty serious capital hit.

So you then have to move back in time to ask the question. So let's suppose we move back in time to 2005, perhaps, and you say--

CHAIRMAN ANGELIDES: 2006.

WITNESS SIRRI: Fine.

CHAIRMAN ANGELIDES: Whatever time period, was there a point along the way where you saw serious enough problems that, if you identified them you should have pushed them?

WITNESS SIRRI: Well the October 2006 report that came to me about that highlighted the concentrations. The point is, though, the thing you would have to deal with is, you would have to have a view that was contrary to the view of the entire market.

That is, a small group of folks who were smart people doing diligent work, you would have had to take a position that was contrary to the firm, the street, the market. We did not have that level of confidence that we were right.

If we did have the level of confidence that we were right, that we knew the mortgage market was going to go down, then we would have taken a position. We would have run it up the flag pole within the building.

But what I'm telling you is that, as a staff who identified the concentration, who saw what happened, we didn't sit there and say, oh, my gosh, these markets are going to head down; it's a bubble. Therefore, we should do something.

We didn't have--we didn't believe that that was the case.

CHAIRMAN ANGELIDES: Yes, but this raises a very significant--actually, the corollary to that, and then I'm going to go to the Vice Chair, is that it raises a very significant issue. Which is, that what we have heard in a series of hearings, and in our investigative work, is that, quote/unquote, "this is what everyone believed."

And of course it's not really what everyone believed because there were many voices out there saying there's a bubble underway. There's tremendous amounts of subprime lending going on. There are risks to the system. But it does seem to me that the people in the system itself didn't have critical eyes.

There weren't many iconoclasts around either at the investment banks or at the regulatory agencies. There weren't many outside critical voices saying, “Hey, wait a minute.” And this is a structural issue that everyone who, quote/unquote, "knew," all the people of knowledge, were very insular. They were all part of a system in which they shared values and information, and it turned out to be very limited.

WITNESS SIRRI: I think I would answer that in two parts.

The first is to say at that moment, as at any moment, there are people on both sides of the mean. There are people who--there's no question there are people who had the view at that time that you were in a bubble and that these were going to decline.

At the same time, you had people who said this was still a strong market. The signs were good. You should invest heavily and concentrate in mortgages.

The market brings those two people together at a particular price. What I take away from this is actually that when you're a regulator and you sit in the middle and you look at that, it is very hard to second-guess the market at that instance. It is a tough judgment to make.

And if you design a regulatory system that hinges critically upon that, that hinges on the regulator second-guessing market prices, that's a very tough thing to do.

CHAIRMAN ANGELIDES: I don't think I was suggesting that so much as calibrating the level of risk posed to the overall system by certain activities.

I agree. I'm in real estate. It's very hard to call the top, it's very hard to call the bottom, and I'm generally not good at it.

Having said all that, you can also decide that you need to put parameters around certain activities because of the consequences of not doing so.

Mr. Thomas?

VICE CHAIRMAN THOMAS: Yes, but haven't we just now come full circle? That is, there's a brown bag on the table. You know, is it worth something? How much is it worth? And you've got people who are going to be all over the lot.

I love it when people say that someone predicted something and they got it right. What about the 872 times they predicted and they didn't get it right? I mean, at some point the concept of markets is a collective wisdom.

But how can you have wisdom about what's in a brown bag when you can't look in the brown bag to make the decision? Which is the whole business about the way in which you handled these new instruments, CDO and the rest, and you have to have a structure and an exchange so that you have some concept so that at least other people can look at what is in the brown bag and come to a conclusion.

I just would like to get it out of the brown bag and on the table so people can make those assumptions. To say that there were some people who said that it was going to be bad is not going to be enough people lined up to offset that they said it was going to be good.

So how can you expect a referee to make that kind of a decision? I think it was a lot of people who thought they were smarter than they were dealing with products they had no idea what they were, created by folks--back to Mr. Wallison's position--who didn't fully understand what they were doing, except that this was something that was very useful for their particular purposes.

And there was another agency pushing it for the societal betterment, in terms of making sure that everybody was able to possess something which was a mortgage, regardless of how much they made and under what conditions they lived.

WITNESS DONALDSON: Can I just--

VICE CHAIRMAN THOMAS: And so we're completely around to beginning again at the circle.

WITNESS DONALDSON: Can I just make one comment?

VICE CHAIRMAN THOMAS: I'm through raving. I'm done.

CHAIRMAN ANGELIDES: Super quick, and then we want to adjourn this session. Yes.

WITNESS DONALDSON: It seems to me that what you are saying is absolutely correct. It seems to me that one solution to that, which has been tossed around, is an independent systemic risk oversight, somebody who is not in the channels of looking at things from the point of view of their agency and a normal way of looking at it, somebody that has a right to go anywhere, an agency that has the right to go anywhere and can put two and two together.

VICE CHAIRMAN THOMAS: But why do you need someone above the fray? Why don't you just get it out of the brown bag and set it there and say what it's worth? If you can't look at it and examine it, to me it's the failure of transparency and the ability to communicate in a market that prices it based upon what other people think it's worth.

That has been my biggest problem. How in the world could people figure out what they had when they didn't know what it was?

WITNESS DONALDSON: Right.

CHAIRMAN ANGELIDES: Thank you very much.

Anything else from Commissioners? Thank you all very much for your time this afternoon. Thank you, Commissioners, for a very hard day of work. We will be back in this room at 9:00 a.m. tomorrow with Former Secretary Paulson. Thank you all very much.

VICE CHAIRMAN THOMAS: And current Secretary Geithner.

CHAIRMAN ANGELIDES: And current Secretary Geithner, to follow.

(Whereupon, at 5:41 p.m., Wednesday, May 5, 2010, the hearing was recessed, to reconvene at 9:00 a.m., Thursday, May 6, 2010.)