

# U.S. DEPARTMENT OF THE TREASURY

## Press Center

### Treasury Secretary Tim Geithner Written Testimony before the House Financial Services Committee

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Chairman Frank, Ranking Member Bachus, Members of the Committee, thank you for the opportunity to testify before you today.

The failure of Lehman Brothers in September 2008 was a key inflection point during the most critical phase of the recent financial crisis. Lehman's bankruptcy accelerated a classic "run" on our financial system--a phenomenon not witnessed in this country since the 1930s. In the face of this run, the U.S. government, together with governments from around the world, had no choice but to intervene aggressively, on an unprecedented scale, to prevent an economic catastrophe.

The Lehman episode was not just a disaster for Lehman. It was a disaster for our country. And like any calamity, it should be subjected to careful, independent scrutiny. Whenever an airline tragedy occurs, our National Transportation Safety Board conducts a detailed examination of the causes of the accident. Financial disasters should receive similar examinations.

The Valukas Report is a great example of such an inquiry. The authors of that report have done an important service not only to the Lehman bankruptcy proceedings, but also to current and future students of the recent financial crisis.

As this Committee knows, detailed, independent inquiries are a part of what makes our system strong and resilient. Today's hearings are an important part of this process. I welcome the opportunity to participate.

While the causes of the financial crisis extend far beyond any single firm, Lehman Brothers illustrates many of the failures that brought our financial system to the edge of the abyss. The financial reforms proposed by the Administration, and passed by this Committee, are designed to address these failures in a comprehensive fashion.

No regulatory regime will be able to prevent major financial firms from reaching the point of insolvency. But a well-designed regulatory framework must put in place shock absorbers to contain the damage caused by a major firm's default. And it must provide the government with tools to manage the orderly dismantling and liquidation of firms that mismanage themselves into insolvency.

#### Lehman Brothers: A Case Study in Our System's Failures

Lehman caused Lehman's insolvency. But in many ways, Lehman Brothers serves as an iconic example of what went wrong with our financial system in the years leading up to the crisis. These deficiencies were not limited to Lehman. Rather, they were widespread and far-reaching problems in the basic structure of our financial system. I want to begin by briefly reviewing several of these critical failures.

*The Shadow Banking System*. Lehman Brothers operated with very high levels of leverage, and it financed itself to a large extent through the issuance of short-term debt. These factors, combined with a high-risk business model, made Lehman vulnerable to collapse.

Of course, leverage and maturity transformation (the use of short-term liabilities to finance longer-duration assets) are inherent in banking. But unlike regulated banking institutions, Lehman conducted its activities largely free from the important prudential constraints that come with banking regulation. In this regard, Lehman Brothers was part of a broader pattern.

In the run-up to the recent crisis, we witnessed a period of explosive growth in leverage and maturity transformation *outside* the perimeter of prudential banking regulation. This parallel, lightly regulated system has come to be known as the "shadow banking system." Large dealer firms like Lehman were a key part of this system--but they were just one part. At its peak, the shadow banking system financed about \$8 trillion in assets with short-term obligations, making it almost as large as the real banking system.

The rapid growth of this system was fueled by light regulation and weak or nonexistent capital requirements. It was also driven by cheap funding from large institutional investors, such as money market mutual funds and securities lenders, which furnished a ready supply of short-term financing.

Financing long-term, risky assets with short-term debt was a reliable formula for rapid growth and robust earnings during the boom. But these activities were vulnerable to fragility and rapid deleveraging when conditions deteriorated, as they inevitably did.

The emergence of shadow banking represented a failure of regulation to keep pace with developments in the financial sector. As much as any other factor, this fundamental regulatory failure set the stage for the crisis.

Market Structures: Tri-Party Repo and Money Market Mutual Funds. Like other dealer firms, Lehman Brothers relied heavily on a critical funding market called the repurchase agreement, or "repo," market. This market proved to be a major source of liquidity risk and instability in the crisis—for Lehman as well as other firms. This portion of the shadow banking system merits particular attention.

Repos are essentially loans that financial institutions use to finance securities inventories—typically on an overnight basis. Repos are collateralized by assets on dealers' balance sheets, in the same way that a mortgage is secured by a home.

One particularly large and important segment of the repo market is called "tri-party" repo. In this \$2 trillion market, repo lenders (usually money market mutual funds) extend loans overnight to dealers. During the trading day, credit is provided by big banks that act as repo "clearing banks." Through this process, individual dealer firms typically borrow hundreds of billions of dollars each day.

While tri-party repo has been effective in providing liquidity to securities markets during normal times, under stress conditions these arrangements proved to be a source of liquidity risk for important parts of the financial sector. During the recent crisis, there was significant uncertainty in the markets about whether money funds would maintain their investments and whether repo clearing banks might refuse to provide intraday credit. Uncertainty in this area contributed to "flight" risk in the tri-party repo market.

These structural issues were exacerbated by tri-party lenders' concerns around collateral quality. Traditionally, tri-party repo funding had been limited to the safest collateral classes, such as Treasury and agency securities. During the credit boom, however, tri-party repo lenders began to fund riskier collateral—most notably, various forms of complex structured mortgage products. Tri-party repo lenders extended this credit without requiring sufficient haircuts to reflect the risk of the underlying collateral. Not surprisingly, when the value of this lower-quality collateral became uncertain, tri-party lenders became less willing to continue funding.

As a consequence of these issues, the tri-party repo market was a critical source of liquidity strain on dealer firms during the financial crisis. And money market mutual funds, which provide a large portion of tri-party repo funding, made these liquidity problems even more acute. Money funds were themselves shown to be sources of instability during market stress. In a chaotic and uncertain financial environment, savers who parked cash in money funds became concerned that those assets might not have been as safe as they had anticipated. These concerns intensified after Lehman's bankruptcy, when one large money fund "broke the buck," meaning that its net asset value fell below \$1 per share. The money fund industry experienced a modern-day bank run in September 2008. This run accelerated dramatically following Lehman's collapse.

Aggressive policy action was required to stabilize the money funds, including a temporary government guarantee of this \$3 trillion industry. Although this program was successful and resulted in positive returns to taxpayers through guarantee fees, the money fund guarantee exposed taxpayers to substantial risks.

Tri-party repo and money funds are prominent examples of market structures and practices that were not robust enough to withstand a major disruption.

Derivatives. Lehman was a major participant in the over-the-counter (OTC) derivatives markets. As of August 2008, Lehman held over 900,000 derivatives positions worldwide. The market turmoil following Lehman's bankruptcy was in part attributable to uncertainty surrounding the exposure of Lehman's derivatives counterparties.

In this regard, Lehman's bankruptcy highlights another flaw in our financial infrastructure: the opacity and complexity of the OTC derivatives markets. These products grew exponentially in the run-up to the crisis. The notional amount of outstanding credit default swaps grew from about \$2 trillion in 2002 to over \$60 trillion at year-end 2007. Because these trades are conducted on a bilateral basis, the market has very little visibility into the magnitude of derivatives exposures between firms.

Before the crisis, regulatory efforts were underway to reduce the risks in this system. The New York Fed played a leading role in improving the OTC derivatives markets infrastructure from 2005 to 2008. Huge backlogs of unconfirmed trades were eliminated. A central repository for credit derivatives trades was established. And, in 2008, the notional amount of aggregate credit default swaps was reduced substantially through regulatory portfolio compression requirements, which caused dealers to collapse superfluous positions. These initiatives were necessary predicates to further reform in the OTC derivatives markets, including central clearing. As a result of these initiatives, the market uncertainty surrounding derivatives exposures in the crisis was substantially less than it might otherwise have been.

Despite this progress, the basic infrastructure of the OTC derivatives markets makes them a dangerous transmission vehicle for instability during periods of market turmoil. When a major derivatives market participant fails, uncertainty around derivatives exposures undermines confidence in other institutions. OTC derivatives markets, in their current form, significantly increase the risk of financial contagion.

Breakdown in Basic Checks and Balances. Lehman's plunge into high-risk businesses in the years before its bankruptcy has become a familiar story. During this period of aggressive growth, Lehman developed significant exposures to risky subprime lending, commercial

real estate, structured products, and high-risk lending for leveraged buyouts. Importantly, the Valukas Report indicates that Lehman repeatedly breached its own risk concentration limits in pursuit of higher earnings.

These types of risk management failures were widespread in the financial sector. Sound risk management practices were in many cases disregarded in favor of concentrated, directional bets. AIG, Bear Stearns, and Lehman Brothers, not to mention scores of mortgage lenders, all allowed fundamental breakdowns in risk management.

Our financial system relies on a set of complementary institutional controls to prevent such unsound practices from emerging. Boards of directors, ratings agencies, and audit and disclosure functions are essential checks and balances against risk management failures.

These mechanisms provide an important level of redundancy in oversight. When effective, they identify material business risks and act as independent referees on firms' internal risk management processes. Major risk management failures require multiple failures to take place within this system of checks and balances.

Before and during the crisis, weaknesses in these checks and balances were prevalent. Boards of directors failed to exercise critical judgment and address critical weaknesses in risk management. Ratings agencies failed to do an adequate job of assessing the risks in structured credit products and disclosing their ratings methodologies. Auditors failed to identify practices that may have crossed the line from an accounting perspective. And the existing accounting and disclosure regime did not adequately apprise investors of material risks in a timely fashion.

*Pervasive Opportunities for Regulatory and Accounting Arbitrage.* Lehman provides a stark example of how gaps in our system have allowed financial firms to maneuver their operations to "optimize" regulatory and accounting treatment.

Our regulatory system has given firms too much leeway to structure their activities for favorable tax, accounting, and regulatory treatment.

For internationally active firms, differences between U.S. and foreign tax, accounting, and capital regimes have prompted firms to structure their activities to minimize these constraints.

Our system in many cases allowed risks to migrate to where regulation was weakest. As the SEC has acknowledged, its voluntary oversight regime allowed Lehman and other investment banks to operate with too much leverage and risk.

Accounting arbitrage has also been widespread. The Valukas Report describes how Lehman appears to have moved certain assets off-balance sheet through repo transactions executed in its London broker-dealer subsidiary. According to the Report, these transactions were designed to reduce the firm's reported leverage at quarter-end.

Importantly, regulatory and accounting arbitrage makes institutions far more complex than they need to be. Complexity poses serious challenges to an effective audit and disclosure regime. Readers of the financial reports of major financial institutions know that they are highly opaque and difficult to understand. Indeed, disclosure documents of complex financial firms are often indecipherable even to experienced analysts.

Without transparency and comparability, market discipline cannot operate effectively. The system we have is not tenable in this regard. Financial reporting must be simpler and easier to understand, and must facilitate meaningful comparisons across institutions.

Of course, none of our government's financial supervisors did an adequate job. But the most dangerous practices that precipitated the crisis were heavily concentrated in the most lightly regulated parts of the financial industry. Regulatory arbitrage is not a formula for financial stability.

*Flawed Compensation Practices.* Compensation structures at Lehman allowed top executives to realize substantial gains without suffering the downside if their business decisions proved unwise. Lehman's top executives received substantial cash compensation during the boom. And they were able to cash out significant amounts from stock compensation they received in the years prior to the crisis.

This phenomenon was not isolated to Lehman. At many financial firms, compensation structures were misaligned with the time horizons of risk: executives were rewarded for short-term performance, with little attention to the risk of future losses. These practices did not incentivize prudent risk-management and long-term value creation. Instead, they encouraged high-risk activities that were designed to achieve short-term profitability.

As I described earlier, our system has checks and balances that are meant to limit such practices. But, in many cases, these checks and balances did not work. Professionals whose jobs were to monitor and constrain risk-taking were generally paid substantially less than those who made investment decisions. Compensation committees gave little attention to the risk-taking implications of pay-setting decisions. And directors charged with making those decisions lacked the sophisticated, independent advice they needed to assess critically the complex relationship between compensation and risk-taking.

*No Tools to Wind Down Large Financial Firms.* Lehman's bankruptcy in September 2008 helped to turn an intensifying global financial crisis into a classic financial panic. Fearing further defaults, investors declined to renew funding to all types of financial institutions. Money fund investors redeemed their shares and redeployed funds from the private sector to Treasury securities, driving yields into

negative territory. Credit markets froze, and corporate America found itself unable to access short-term credit through the commercial paper markets. Without forceful government intervention, the financial system would have collapsed.

These circumstances demonstrated a critical shortcoming in our system. In that moment of historic stress, the government lacked any means to wind-down and liquidate a complex, interconnected financial firm in an orderly way.

After the near-failure of Bear Stearns, it was apparent to informed observers that Lehman Brothers was the weakest of the remaining independent investment banking firms. And we knew that a disorderly bankruptcy of Lehman Brothers, if it occurred, would have damaging consequences for the financial system. With the limited powers that we had, we worked diligently to avoid an outcome that would destabilize the financial system and damage the broader economy. But our tools were insufficient.

The stability of the U.S. financial system cannot be left vulnerable to the reckless choices of individual firms. Lehman's disorderly bankruptcy was profoundly disruptive. It magnified the dimensions of the financial crisis, requiring a greater commitment of government resources than might otherwise have been required. Without better tools to wind down firms in an orderly manner, we are left with no good options.

### **Actions Taken by the FRBNY**

Lehman Brothers was symptomatic of many of the deep structural flaws in our financial system. These flaws did not emerge overnight. Rather, they were a product of developments in the financial system that unfolded over the course of many years.

I was President of the Federal Reserve Bank of New York at the time of Lehman's bankruptcy filing and during the period leading up to it.

As an independent investment bank, Lehman was supervised not by the Federal Reserve, but by the SEC. The Federal Reserve had no regulatory authority over the firm--no authority over its capital, no authority over its liquidity, and no oversight over its audit and accounting control functions. The Federal Reserve was not engaged in supervision of Lehman Brothers. It did not have the legal authority to do so. These roles and responsibilities remained with the SEC. As I mentioned earlier, the failure to subject all large, interconnected financial firms to robust oversight was a major flaw in our system.

Although the New York Fed was not Lehman's supervisor, it did establish an onsite presence at Lehman in March 2008, after the fall of Bear Stearns.

On the day of the Bear Stearns sale in March 2008, the Federal Reserve announced the creation of the Primary Dealer Credit Facility ("PDCF")--a collateralized lending facility to provide liquidity to primary dealers. The creation of the PDCF meant that the Federal Reserve was a potential lender to the major dealer firms. To manage the risks associated with this facility, the New York Fed immediately installed a small number of analysts at each of the major independent dealer firms, including Lehman Brothers.

After creating the PDCF monitoring program, the Federal Reserve entered into a Memorandum of Understanding ("MOU") with the SEC, which was formalized in July. The MOU was designed to facilitate information-sharing and cooperation. It established a clear division of responsibilities between the SEC and the Federal Reserve. It explicitly affirmed the SEC's role as the supervisor of the independent investment banks.

The PDCF monitoring program did *not* establish the full panoply of supervisory oversight powers that the Federal Reserve exercises with respect to bank holding companies. That regime entails large examination teams, with oversight of the firm's audit and control functions.

In accordance with the MOU, the Federal Reserve worked closely with SEC on a number of important initiatives after the near-failure of Bear Stearns in March. The SEC and the Federal Reserve jointly worked to encourage improvements in the capital and liquidity positions of the investment banks. Simultaneously, the SEC and the Federal Reserve cooperated on a range of other priorities, including taking steps to address risks associated with the derivatives and repo markets.

With respect to Lehman Brothers, between March and September, the New York Fed worked closely with Treasury and the SEC to encourage the firm to raise capital, reduce balance sheet risk, find a strategic buyer, and take other actions to survive the storm. Lehman was unsuccessful in these efforts. The global financial crisis had escalated significantly by the fall of 2008, limiting the available options to stabilize the firm.

The Federal Reserve's powers were limited: it could lend on a short-term basis against good collateral, but it could not safely put a failing investment bank out of existence.

In the absence of a willing buyer, the U.S. government did not have the authority to take the steps that would have been necessary to prevent Lehman's disorderly failure. Lehman lacked sufficient high-quality collateral to permit the Federal Reserve to extend a loan large enough to prevent the firm from defaulting. Given the magnitude of the firm's liquidity issues, stabilizing Lehman would have required a buyer that was willing to guarantee its trading obligations during the period between the signing and closing of the acquisition transaction. No such buyer materialized.

Some have asked why Lehman went bankrupt, while AIG received extraordinary assistance that prevented default. The answer is that AIG presented a very different case. AIG had enough high-quality collateral to permit the Federal Reserve to extend a loan sufficient to

stabilize the firm--largely the profitable insurance businesses that were relatively insulated from the firm's losses on complex financial transactions.

In the end, in the absence of a willing buyer, bankruptcy was the only option for Lehman Brothers. The government had neither the authority nor the tools to prevent Lehman's failure from imperiling the financial system.

## Financial Reform

Lehman Brothers illustrates many of the key deficiencies of our current regulatory regime--a regime that simply is not equipped to effectively monitor, constrain or respond to risks in our financial system.

The Administration's reform proposals--which are broadly consistent with the reform bill that passed the House in December and the bill currently working its way through the Senate--have been crafted to address precisely these failures.

If these reforms become law, we will be far better situated to avoid the abuses that led to the crisis. In particular:

- Any major financial firm whose failure could pose a risk to the financial system will be subject to robust, comprehensive supervision, with clear regulatory accountability. An insurance company like AIG that operates with massive derivatives exposure, or an investment bank like Lehman Brothers, will not be able to escape robust consolidated supervision by virtue of its corporate form. These regulatory loopholes will be closed, and opting out will not be an option.
- Major financial firms will be subject to *more stringent* prudential requirements than other financial firms--higher capital, higher liquidity, and more exacting oversight. These higher requirements will reflect the fact that major firms pose greater risks to the financial system. So not only would firms like Lehman, Bear Stearns, and AIG be subject to consolidated supervision, but they also would be subject to substantially higher standards than other firms, due to their size and interconnectedness.
- Better disclosure and transparency will reduce opportunities for accounting arbitrage. We have committed to improving accounting standards and moving forward with international accounting convergence. At the Pittsburgh summit last year, the G-20 leaders called on international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards. These initiatives are currently underway, and they will greatly improve the transparency and comparability of financial statements.
- Regulators are taking action to address the unstable aspects of the repo and money fund industries. Under the auspices of the Federal Reserve, an industry-led task force has been working to develop enhancements to the policies, procedures and systems supporting the tri-party repo market. This initiative is designed to ensure that the structure of the tri-party repo market will not amplify systemic risk during future periods of market stress. And the SEC recently enacted new rules to strengthen liquidity and disclosure in the money fund industry. More work remains to be done in this area, and the President's Working Group on Financial Markets is preparing a report setting forth options to address systemic risk and to reduce the susceptibility of money funds to runs.
- Reform will bring comprehensive oversight and transparency to the OTC derivatives markets. These markets have proved to be a major source of uncertainty and risk during periods of financial disruption. The proposed reforms will bring the bulk of these trades into central clearing arrangements, ensuring full transparency and reducing the degree to which financial contagion can spread due to real or perceived counterparty credit exposures. All dealers and major market participants will be subject to tough prudential standards, including margin and capital requirements. And the SEC and CFTC will have full enforcement authority to set position limits and address fraud, manipulation, and abuse. These reforms will make the system far more resistant to the types of disruption we saw when Lehman failed.
- Important standards will be put in place regarding disclosure and accountability for executive compensation. In particular, companies will be required to hold an annual, non-binding shareholder vote to approve executive compensation. And compensation committees will be given the independence and tools they need to drive a harder bargain over executive pay. These reforms will help to ensure that compensation practices are aligned with the long-term interests of shareholders. They will complement other initiatives relating to compensation in the United States and abroad, including the compensation standards agreed upon by the G-20 for financial institutions around the world; new SEC disclosure rules that will give shareholders critical information on the relationship between pay practices and risk-taking; and recent Federal Reserve guidance on compensation principles that will be incorporated into the supervisory process.
- Finally, we will have a resolution regime that will give the government the necessary tools to safely put failing financial institutions out of existence. The pending bills would establish a bankruptcy-like regime for large financial institutions that mismanage themselves into failure. Under the proposed resolution authority, major financial firms facing insolvency will be dismantled, sold, or liquidated in an orderly fashion. Culpable management will be replaced, equity will be extinguished, and creditors will be exposed to losses. Any costs incurred through this wind-down process will be recouped from large financial institutions--not covered by taxpayers. Resolution authority was the critical tool we needed to deal with Lehman, Bear, and AIG. We must have it when the next big financial firm gets into trouble.

## Conclusion

There are few better examples of why we need comprehensive financial reform than Lehman Brothers. No financial regulatory system will ever be perfect. Financial firms will always overreach and get into trouble. But it is clear that good financial regulation can mean the difference between a fundamentally sound and resilient financial system, and one that is built on an unstable foundation.

The path we choose will have significant implications for the future of our economy. Like the President, I am confident that our country will once again choose to tackle these tough problems and enact meaningful reform.

Thank you.