Representative Anna G. Eshoo (D-CA)
Committee on Financial Services
United States House of Representatives
2128 Rayburn House Office Building
April 20, 2010

"Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner"

Mr. Chairman and Members of the Committee, thank you for inviting me to testify today. I particularly want to thank you for your extraordinary leadership in helping to steer our nation out of the worst financial crisis since the Great Depression.

This hearing on the public policy issues raised by the report of the Lehman bankruptcy Examiner continues to demonstrate your vigilance on behalf of the American people.

Up until days before its declaration of bankruptcy, Lehman Brothers was considered one of the most trusted, reliable, and safest of firms to invest in. The Examiner's report clarifies just how risky the practices and lack of transparency that sank Lehman really were. This behavior exemplifies Wall Street's reckless behavior which brought our economy to the brink of ruin. When we look at the case of Lehman, we are really examining the root causes of the crisis.

We learned in the Examiner's report that:

PAGE 732 - "Lehman employed off-balance sheet devices, known within Lehman as "Repo105" and "Repo 108" transactions, to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days, and to create a materially misleading picture of the firm's financial condition in late 2007 and 2008." "Lehman accounted for Repo 105 transactions as "sales" as opposed to financing transactions….By recharacterizing the Repo 105 transaction as a "sale," Lehman removed the inventory from its balance sheet."

PAGE 733 - "Lehman regularly increased its use of Repo 105 transactions in the days prior to reporting periods to reduce its publicly reported net leverage and balance sheet. Lehman's periodic reports did not disclose the cash borrowing from the Repo 105 transaction – *i.e.*, although Lehman had in effect borrowed tens of billions of dollars in these transactions, Lehman did not disclose the known obligation to repay the debt."

Why did Lehman do this? Let me quote the Examiner's report again:

PAGE 735 - "Starting in mid-2007, Lehman faced a crisis: market observers began demanding that investment banks reduce their leverage. The inability to reduce leverage could lead to a ratings downgrade, which would have had an immediate, tangible monetary impact on Lehman."

PAGE 738 - "By engaging in Repo 105 transactions and using the cash borrowings, Lehman reduced its reported leverage ratios."

PAGE 739 - "In this way, unbeknownst to the investing public, rating agencies, Government regulators, and Lehman's Board of Directors, Lehman reverse engineered the firm's net leverage ratio for public consumption."

Senior executives at Lehman were fully aware of this. The Examiner's report further states:

PAGES 742-743 - "A senior member of Lehman's Finance Group considered Lehman's Repo 105 program to be balance sheet "window-dressing" that was "based on legal technicalities." Other former Lehman employees characterized Repo 105 transactions as an "accounting gimmick" and a "lazy way of managing the balance sheet."

The bottom line is that despite senior management knowing full well the perilous situation they were getting themselves and their investors into, they kept moving forward. The Examiner concludes:

PAGE 746 - "Repo 105 transactions were not used for a business purpose, but instead for an accounting purpose: to reduce Lehman's publicly reported net leverage and net balance sheet."

PAGE 853 - "In order for this off-balance sheet device to benefit Lehman, the firm had to conceal information regarding its Repo 105 practice from the public."

With Lehman Brothers engaged in such risky behavior, this begs the question: Where were the SEC, the Treasury, and the Federal Reserve? The Examiner's report concludes that these three agencies were monitoring the situation since early 2007. They were aware that Lehman was in trouble given their highly-leveraged balance sheets. The agencies warned the firm about the risk of collapse if they did not move to more conservative investments. However, the leadership at Lehman Brother's continued to maintain their pattern of deception. The Examiner's report goes on to say:

PAGES 1482-1483 - "At the highest levels, each of these agencies recognized – as early as 2007 but certainly by mid-March 2008, after the Bear Stearns near collapse

- that Lehman could fail. Treasury Secretary Paulson, Fed Chairman Bernanke, FRBNY President Geithner and SEC Chairman Cox all had direct communication with (former Lehman CEO) Fuld. The day after Bear Stearns Weekend, teams of Government monitors from the SEC and FRBNY were dispatched to, and took up residence at Lehman to review and monitor its financial condition."

PAGE 1482 - "When the Examiner questioned Lehman executives and other witnesses about Lehman's financial health and reporting, a recurrent theme in their responses was that Lehman gave full and complete financial information to Government agencies, and that the Government never raised significant objections or directed that Lehman take any corrective action."

So, we had one of the largest banks in our nation teetering on the brink of bankruptcy. The executives of that bank were masking accounting gimmicks that inflated their quarterly earnings. The agencies responsible for monitoring these banks, specifically the SEC, were taking a hands-off approach when it came to regulation.

The rest of the story we know all too well.

Lehman Brothers was forced to declare bankruptcy, and left a trail of devastation in its wake.

In my Congressional District, San Mateo County and its public institutions were severe victims and still are of the Lehman Brothers bankruptcy.

San Mateo County is required by California State law to hold operating funds, reserves and bond proceeds in an investment pool. Their investment pool which held funds on behalf of the county and local cities, school districts, transit agencies and the community college district, were invested in the most highly-rated, conservative Lehman securities.

When Lehman collapsed, San Mateo County lost $155 million.

As a result, the County and its 735,000 residents are now reeling financially. Teachers are being laid off. Schools are not being built or renovated. Roads are not being improved. Transportation plans are being scrapped, and critical upgrades in public safety have ceased.

The financial plight of San Mateo County was recently profiled in detail in a February 24, 2010, Wall Street Journal article entitled. "Lehman's Ghost Haunts California." Mr. Chairman, I respectfully request that this article be included in the record.

The San Mateo County leaders did nothing wrong. They were not playing the market. They were not rolling the dice to optimize their dollars. They invested in the safest, most conservative instruments. And yet when Lehman Brothers went down, their funds were lost.

It's not only San Mateo County who made the mistake of trusting this institution. More than 40 other municipalities from around the country lost close to $1.7 billion when Lehman collapsed.

Mr. Chairman, we've worked for well over a year now to find a solution for San Mateo County and the other affected counties throughout the country. This work resulted in explicit language in the *Emergency Economic Stabilization Act of 2008,* which gave the Secretary of the Treasury the authority to purchase the troubled assets held by local governments. In that legislation, Section 103(7) states:

"In exercising the authorities granted in this Act, the Secretary shall take into consideration …the need to ensure stability for United States public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil..."

I communicated this to Secretary Geithner on multiple occasions. Each time I called to his attention the economic crisis that still exists in San Mateo County and other counties around the nation. Each time I asked him to use his statutory authority to provide them relief. Each time, the Secretary has refused to use TARP funds to assist these localities.

The amount of TARP funds that could be used to assist the municipalities affected by the Lehman collapse is miniscule compared to the hundreds of billions of dollars the Treasury Department has provided to banks. The $1.7 billion these municipalities lost represents one-quarter of 1% of TARP funds.

In his most recent letter to me on March 11th the Secretary said, "I appreciate your concern. However, Treasury does not intend to make purchases of Lehman Brothers securities from public instrumentalities."

This is where I must reference the Examiner's report again. On page 1504, when referring to an interview with Federal Reserve Chairman Bernanke, the Examiner says:

PAGE 1504 - "Bernanke noted that, after passage of the TARP legislation, the Treasury had authority to inject capital directly into institutions: "If we had that [TARP] authority on September 14, we would have been able to save [Lehman], no question about it."

Congress has since vested the Secretary with the authority to correct the harm done, but he has chosen not to exercise it.

Let's fast forward to today. We now know that the federal government is earning billions of dollars in profits from the sale of the troubled assets. In a March 29, 2010, AP article I also request be submitted for the record, it was reported that the federal government will receive $7.5 billion from the sale of the 27 percent stake in Citi they now have. To date, the federal government has already earned $15.4 billion from dividends, interest, and the sale of bank stock.

These transactions will total more than <u>TEN</u> times the amount of money that all the counties in the country lost with the Lehman collapse.

I believe it's time for the federal government to do for local governments what we've done for big banks.

I'm introducing legislation <u>that will require portions of these profits</u> coming into the Treasury from the sale of their interests in financial institutions to be used to provide relief to counties affected by the Lehman collapse.

It will clarify a way for the federal government to assist local governments impacted by the Lehman collapse.

At a time when saving those institutions which were deemed "too big to fail," we shouldn't overlook those who are being treated as though they are too small to help.

It's time to serve the best interests of the American people. They lost their taxpayer dollars which they intended to be invested in their community for vital services.

Thank you, Mr. Chairman and Members of the Committee. I look forward to partnering with you and my good friend and colleague Congresswoman Speier in moving my legislation forward to assist the public agencies who trusted Lehman, invested hard-to-come-by tax dollars, only to see them evaporate. The Examiner's report describes in excruciating detail the shocking condition of Lehman Brothers, yet nothing was done. My abiding hope is that we will make this right by not only legislating reforms so it can never happen again, but also by assisting our public institutions who are required to carry out their responsibilities to our mutual constituents.

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Lehman's Ghost Haunts California

By JOHN CARREYROU

SAN MATEO, Calif.—Little more than a year after the worst of the financial panic, Wall Street is bouncing back. But in this county just south of San Francisco, pain from the financial system's near-collapse is still felt every day.

San Mateo, a scenic swath of peninsula between the Pacific Ocean and San Francisco Bay, saw $155 million evaporate when Lehman Brothers went bankrupt in September 2008. On top of deep budget cuts brought on by California's fiscal crisis, the loss on Lehman securities means San Mateo's 735,000 residents are taking a hit.

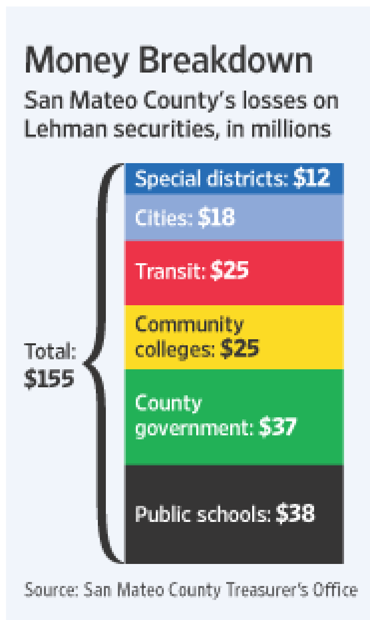
Public schools here have laid off dozens of teachers and delayed or canceled renovations. Local community colleges are slashing classes and scrapping new facilities, even as enrollment surges because of the bad economy. The county trimmed its commuter rail service and shelved plans to build a new women's jail to alleviate overcrowding.

The biggest factor behind San Mateo's trouble is California's spending cuts. But its Lehman losses make a bad situation worse. The problem underscores the diverging fortunes of Wall Street and Main Street and helps explain the populist anger still simmering in many parts of the country. Last week, Barclays PLC reported that its 2009 profit more than doubled to $14.7 billion thanks in part to its acquisition of Lehman's North American operations.

Lehman Brothers' collapse is "old news for most of America," says Richard Gordon, a member of the county's board of supervisors. But in San Mateo County, he says, "It's a continuing story that continues to unfold."

A report by Beacon Economics, commissioned by the county, estimates that the Lehman losses reduced local government spending, especially on construction projects, by $148 million over two years. The consulting firm says this resulted in 1,648 jobs lost or not created. County unemployment now hovers around 9%, double what it was 18 months ago.

Dozens of cities and counties around the country, from Sarasota, Fla., to Boulder, Colo., lost a total of $1.7 billion when Lehman went under, because they held Lehman bonds or other securities. The two worst hit states are Florida and California. Florida public agencies lost a total of more than $400 million, mostly from a state investment pool. California municipalities lost a total of $250 million across some 28 cities and counties.



San Mateo County's loss was the biggest of any municipality. Under state rules, the county government, city governments and area school districts hold their operating funds, reserves and bond proceeds together in an investment pool that lost about 6% of its value when Lehman went under.

The investment pool owned highly rated Lehman bonds and notes, which currently trade around 20 cents on the dollar. Any recovery from the bankruptcy process will take at least another year. A recovery of 20 cents on the dollar would leave the pool with a loss of roughly $125 million.

Much of the anger in San Mateo is directed at the Obama administration and, specifically, at Timothy Geithner, the Treasury secretary. Mr. Geithner has declined to use funds from the government's Troubled Asset Relief Program, or TARP, to bail out municipalities.

"There's too big to fail, and we're too small for them to care," says Mary McMillan, the county's deputy manager.

Before Wall Street's crash in late 2008, San Mateo County was on track to balance its $1.7 billion annual budget within five years. California's cutbacks and the Lehman collapse torpedoed that.

The county government lost $37 million when Lehman Brothers went under. That's on top of a $100 million deficit due in part to state cutbacks. San Mateo County has limited power to increase taxes: Boosting sales taxes requires two-thirds voter approval, and two efforts have failed in recent years.

The schools were hit hard, too. In one typical case, Lehman-related losses at the Sequoia Union High School district, one of 25 in the county, totaled $6.2 million, an amount equivalent to 7% of the district's annual budget. Meanwhile, the state cut its funding to the Sequoia district this school year by $1.9 million and is cutting it again next school year by another $3.4 million.

San Mateo ranks among California's most diverse counties. Home to software giant Oracle Corp. and biotechnology pioneer Genentech, it encompasses both wealthy enclaves and working-class, immigrant cities such as Daly City and East Palo Alto that depend heavily on county services. In East Palo Alto, unemployment is 20%.

When Lehman Brothers filed for bankruptcy-court protection on Sept. 15, 2008, the news was met with a mix of panic and disbelief by local officials. The county's schools took the worst hit, losing $38 million overnight. Two county school districts, the Sequoia

district and the Menlo Park City Elementary School District, had just sold more than $90 million worth of bonds to fund renovations and expansions and deposited the proceeds in the county investment fund. The lost bond proceeds totaled nearly $8 million, a debt local taxpayers will be paying off for the next 30 years.

Jean Holbrook, the county's superintendent of schools, says the Lehman losses came on the heels of deep funding cuts from the state that had already cost the jobs of 91 of the school's 681 employees, including 21 teachers. In the ensuing year, 60 more school employees would have to be let go, resulting in larger class sizes and fewer elective courses.

San Mateo's board of supervisors ordered an independent review of the way the county investment fund was run, but found no wrongdoing. In keeping with rules California passed in the mid-1990s (following Orange County's disastrous experiment with derivatives), San Mateo's treasurer had invested in highly rated securities and put no more than 10% of the fund in any single issuer.

With Lehman bonds trading at pennies on the dollar, county officials held little hope of recovering their investment through bankruptcy proceedings. So they opted for a two-pronged strategy: They sued former Lehman Brothers executives for fraud, and they lobbied their state congressional representatives to insert language in TARP legislation that would let municipalities tap the federal rescue program.

Though such language was included in the final bill, bailing out municipalities was low on the list of the federal government's priorities in late 2008 as the financial system flirted with collapse.

To rally support and keep the issue alive in Washington, Ms. McMillan, the deputy county manager, began reaching out to other counties and cities ensnared in the Lehman bankruptcy.

In May 2009, as financial institutions began to stabilize and the specter of a depression subsided, the House Committee on Financial Services agreed to hold a hearing on the matter.

In their testimony before the committee, Democratic Reps. Anna Eshoo and Jackie Speier, whose districts span parts of San Mateo County, argued that the $1.7 billion municipalities were asking for amounted to just one-quarter of 1% of TARP funds and paled in comparison with the hundreds of billions of dollars the Treasury Department had provided to banks.

Ron Galatolo, chancellor of San Mateo's community colleges, told the assembled congressmen that he felt it was "highly inequitable to use TARP funding to shore up banks and to bail out failing corporations but fail to protect agencies' taxpayer dollars, such as ours."

After the hearing, Rep. Eshoo sought a meeting with Mr. Geithner, but says the Treasury secretary didn't respond to her letters and phone calls for months.

Rep. Eshoo finally met with him on Oct. 28, followed by a second meeting on Dec. 2. She says Mr. Geithner told her that TARP was intended only for financial institutions and that rescuing municipalities would open a Pandora's box of claims from other investors.

Rep. Eshoo invoked the passage inserted a year earlier in the TARP bill, which refers to "the need to ensure stability for U.S. public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil."

She says Mr. Geithner said the passage fell short of mandating use of TARP funds to bail out municipalities.

While declining to comment on the meetings, a Treasury spokeswoman says: "There are countless well-intentioned ideas for deploying TARP funds, but we determined that making Lehman Brothers' creditors whole is not consistent with what Congress intended for TARP funding."

In San Mateo, reverberations from the Lehman losses were on display on the campus of Cañada College, one of the county's three community colleges, earlier this month.

Students held a two-day teach-in to protest faculty layoffs, course cancellations and fees that jumped 30% this year.

Lilliam Castellanos, a 35-year-old student majoring in Latin America studies to become an interpreter, said she could no longer afford textbooks because the funding for a program that handed out book vouchers to Hispanic students had been cut sharply. Other students complained about long wait lists to get into courses and a reduction in the number of counselors.

Mr. Galatolo, the chancellor, says the colleges' $25 million Lehman loss compounded funding cuts made by the state, forcing him to slash the colleges' annual budget by one-fifth, to $100 million from $125 million.

Of the $25 million loss, $20 million had been earmarked for new buildings and classrooms that he says now won't be built. The remaining $5 million came directly out of the colleges' operating fund.

Mr. Galatolo says he's angered by the return of multimillion-dollar bonuses on Wall Street "while we can't make ends meet for our students." As for Mr. Geithner, he says, "He had the ability to help us, and he chose not to."

On the other side of the peninsula, in the wind-swept, rural community of Half Moon Bay, Robert Gaskill, superintendent of the Cabrillo Unified School District, says his

district's share of the Lehman loss was $1.4 million, out of an annual budget of $28 million.

Mr. Gaskill says he had to lay off five teachers and projects that 20 more will be let go in the 2010-11 school year, out of 177, because of state funding cuts. The district is also paring back summer school.

Michael Bachicha, former director of the schools' special programs, sat through the school-board meeting at which his job was eliminated in April 2009. Because he had tenure, Mr. Bachicha was able to land another job teaching at the district's "continuation" high school for students who are falling behind. But his salary dropped from $105,000 to $72,000. Around the same time, his wife lost her job as a kindergarten teacher at a local private school.

Mr. Gaskill, the district superintendent, says the teaching job that Mr. Bachicha took bumped someone else less senior off the payroll, resulting in one of the five teacher layoffs.

Ms. McMillan, the deputy county manager, hasn't given up on getting the Lehman money back. She holds conference calls every two weeks with officials from other affected counties and cities to plot strategy. On last week's call, 35 people dialed in from across the country.

In the meantime, the county is gearing up to dismiss hundreds of employees this spring, the first time it has had to resort to mass layoffs, according to Mr. Gordon, the member of the board of supervisors.

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Associated Press

Gov't will sell Citi stock, reap bailout profits

By STEVENSON JACOBS, AP Business Writer Stevenson Jacobs, Ap Business Writer Mon Mar 29, 6:10 pm ET

NEW YORK – Bank bailouts are turning out to be great business for the government. Unfortunately for taxpayers, other federal rescues will almost certainly wind up in the red.

The Treasury Department said Monday it will begin selling its stake in Citigroup Inc. at a potential profit of about $7.5 billion — not a bad haul for an 18-month investment.

The move is a major step in the government's effort to unravel investments it made in banks under the $700 billion Troubled Asset Relief Program at the height of the financial crisis.

Yet a year and a half after Congress passed the big bailout, other parts of it — particularly troubled automakers General Motors and Chrysler and insurer American International Group — show no signs of being profitable.

Despite the returns from Citi and other banks, analysts and even the Treasury Department predict the bailout will wind up costing taxpayers at least $100 billion. The bailouts of mortgage giants Fannie Mae and Freddie Mac, which were not included in TARP, will add billions more.

But the money the government makes off banks helps offset the damage. With the sale of the Citi shares, the eight major banks that got bailout money funds will have repaid the government in full. Those investments have netted the government $15.4 billion from dividends, interest and the sale of bank stock warrants, which gave the government the right to buy stock in the future at a fixed price.

Based on Monday's share price, selling its 27 percent stake in Citi would add about $7.5 billion in profits. The stock fell 3 percent to $4.18 a share Monday after news of the planned Treasury sales. But that still puts it well above the $3.25 a share the government paid. The government also still holds Citi stock warrants, which will add to its profits down the road.

Overall, it's a 14 percent rate of return on the $165 billion invested in the biggest banks. Hundreds of smaller banks also received money and have been paying the government a steady stream of dividends and interest.

By comparison, someone who invested money in the Standard & Poor's stock index in early October 2008, when the bailout was passed, would actually have lost about 3 percent.

"Overall, TARP may cost taxpayers money. But the banking part of it is going to be a moneymaker," banking analyst Bert Ely said. "When you strip away all that emotion," he added, "this has turned out to be a good bet."

The government's bank profits can be misleading. The banks benefited heavily from other subsidies, including the $182 billion bailout of AIG. Tens of billions of that money went to banks that had suffered losses with AIG, and the banks didn't have to repay a penny.

"It's baloney to say we've made money off the bank bailouts," said Simon Johnson, a professor at the Massachusetts Institute of Technology and a former chief economist at the International

Monetary Fund. "You have to add up all the money we've put into the economy and other firms" related to banks.

Douglas Elliott, a fellow at Brookings Institution and former investment banker at J.P. Morgan, predicted the government will lose about $100 billion on the overall bailout program. That's slightly less than Treasury's own estimate of $117 billion.

Most of those losses are for the bailouts of AIG, General Motors and Chrysler, and automaker financing arms GMAC and Chrysler Financial.

And those estimates don't include losses expected from the takeover of Fannie Mae and Freddie Mac. In September 2008, the government seized the mortgage companies and has since pumped $126 billion into them to keep the housing market from plummeting further. That number is only expected to grow, and the Obama administration has not detailed any exit strategy.

The banks have been the one bright spot in the government's portfolio. And few benefited as much from taxpayer help as Citigroup.

Citi, one of the hardest-hit banks during the credit crisis and the recession, received a total of $45 billion in bailout money, one of the largest rescues in the TARP program.

Of the $45 billion, $25 billion was converted to the government's ownership stake in the bank. Citi repaid the other $20 billion in December.

The government received 7.7 billion shares of Citigroup in exchange for the $25 billion. It said it will sell the shares over the course of this year, depending on market conditions.

Understandably, the government will probably hold on to its shares if prices fall steeply. But Citi stock has been steadily rising with the broader market in recent months, which means the Treasury Department stands to pocket a hefty profit.

The Treasury had been planning to sell 20 percent of its stock at the time Citi was issuing new shares late last year. At a price of $3.15 a share, the government would have lost $158.7 million on the sale, so it opted to wait.

Selling at today's prices would give the government an 18 percent return on its $45 billion investment in Citigroup, according to Linus Wilson, a finance professor at the University of Louisiana at Lafayette.

But he said taxpayers could have done even better if the government had paid market value when it bought the bank's preferred shares. Instead, it paid a hefty premium to help boost the bank's capital.

"Citigroup stands to be our most profitable bank investment, bar none," Wilson said. "But we also took the most risk with Citi."

Others say that even if the government were to lose money on the deal, it was worth it.

"It kept the recession from getting considerably worse," Brookings' Elliot said. "That's worth whatever amount we end up losing."

AP Business Writers Daniel Wagner and Marcy Gordon in Washington and Stephen Bernard in New York contributed to this report