Testimony by Henry M. Paulson, Jr.
Before the House Committee on
Financial Services
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Chairman Frank, Ranking Member Bachus, and distinguished Members of the Committee, thank you for inviting me to provide written testimony to the Committee in connection with today's hearing on "Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner."

I was Secretary of the Treasury in 2008 when our nation suffered one of the most profound economic crises in history. No analysis of the crisis, no review of the government's response, and no planning for future financial reform can omit a study of one of the most significant events of that crisis—the failure of Lehman Brothers. That pivotal event highlighted the problems that plagued our financial system, demonstrated the inadequacies of our regulatory structure, and pointed the way to long term financial reform. This Committee's study of the public policy issues raised by the events surrounding Lehman's failure is, therefore, quite important and should substantially aid reform efforts.

The details of Lehman's collapse have been set forth at length in several places, including the bankruptcy examiner's report, and I will not attempt to repeat them here. Instead, I will set forth the difficulties that Treasury faced in dealing with Lehman's failure, and the policy lessons I think we learned from those circumstances. I hope this perspective will assist the Committee's examination.

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As Bear Stearns faced collapse in March of 2008, I and others in government discovered what little authority the federal government had to prevent the failure of a non-FDIC insured bank or to limit the effect of such a failure on the broader financial system. Indeed, if J.P. Morgan had not been willing to enter into an agreement to buy Bear Stearns with the assistance of the Federal Reserve and to guarantee Bear Stearn's trading book pending the shareholder vote, the firm would have failed. Realizing this, we immediately began to worry about the other investment banks, over which our authorities were similarly limited. I focused particular attention on Lehman, as the markets were losing confidence that Lehman had enough capital and liquidity to manage potentially significant embedded losses. The possibility of a Lehman failure especially concerned me because I knew it would have significant negative systemic consequences given how deeply interconnected the firm was with various other parts of our financial system. Among other things, Lehman's derivative contracts, secured funding, and triparty repo transactions touched numerous financial institutions across the country and around the globe. As we examined the potential problem presented by Lehman, however, we again realized just how limited our options were.

One option—an option I exercised early on—was to encourage Lehman to take preemptive action on its own to stave off collapse. Specifically, I strongly encouraged the firm's management to raise capital and increase its liquidity positions. In response, Lehman raised approximately $6 billion in new capital in the second quarter. As the situation deteriorated further, I also encouraged Lehman to seek a buyer or strategic partner. Lehman pursued this option as well and approached numerous financial firms and other investors about a potential acquisition or equity investment. None of these efforts were ultimately successful.

In addition to encouraging Lehman to take action on its own, I had my staff at Treasury—along with personnel from the Federal Reserve and SEC—evaluate our legal options for preventing, or mitigating the fallout from, a possible failure. The result of this analysis was disheartening. There were some limited powers that could be brought to bear in the event of the failure of a non-bank institution like Lehman. For example, the SEC might be able to ring-fence certain broker-dealer transactions to ensure that collateral was returned to customers, and the Fed might be able to take over certain triparty repo obligations. But, on the whole, there were significant shortcomings in our regulatory authorities. We had no ability to wind-down Lehman because it was not a bank. We had no sure mechanism for resolving Lehman's outstanding derivative contracts. And we had no authority to inject capital into the institution and thus had no way to resolve its balance sheet problems without a buyer. In short, the only mechanism for handling failure was the bankruptcy system, a process that was designed to resolve creditor claims, not reduce systemic risk, and was therefore inadequate to address all our concerns.

Ultimately, the only possibility for averting Lehman's collapse was to try to find a buyer. To increase the likelihood of doing so, we tried to affect a private industry-based solution to finance enough of the bad assets on Lehman's books to make an acquisition of the firm a possibility. In the days before Lehman's collapse, members of the government and private sector aggressively pursued this potential solution, but, in the end, were simply not able to arrive at a resolution that would prevent the firm's failure. On September 15, 2008, Lehman filed for Chapter 11 bankruptcy, and many of the consequences we had feared began to unfold.

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The difficulties we faced in trying to protect the financial system from the result of a Lehman failure underscore the reforms that our financial regulatory system badly needs. In my view the Lehman failure highlighted three particular types of reform that are critical.

First, capital and liquidity requirements for financial institutions must be increased to reduce the chances of financial institutions operating with the high leverage and low liquidity that we saw at Lehman and others. Of these two requirements, I think it is now generally understood that financial firms need more capital than they have held historically. Less well understood, but in my view more important, is the need for bigger liquidity cushions for those institutions which are more dependent on short term credit, which, as we have seen, can be quite unstable. There is no easy way to set these liquidity thresholds—they will vary institution by institution depending on the nature of their business and their liquidity demands under adverse conditions—but it is critical that regulators set them sufficiently high.

Second, we need a government regulator with responsibility for evaluating systemic risk. With access to all necessary information to monitor the markets, this regulator would have a better chance of identifying and limiting the impact of future speculative bubbles. Such a regulator would have the authority to design and implement appropriate systemic risk metrics, monitor the stability of the markets, and restrain activity at any financial firm that threatens the system. This authority is critical to reducing the chances of having an institution that is interconnected with the financial system to an extent that it cannot fail without harming the greater economy.

Third, no regulator can foresee all areas of potential systemic risk, and consequently the government must have the authority to wind-down, and eventually liquidate, nonbank financial institutions in a manner that prevents harm to the system as a whole. We sorely felt the need for this authority at the time of Lehman's failure, and, had we had it, I think the situation would have ended quite differently. This authority should include a number of tools, including the ability to provide emergency loans to enable an orderly liquidation. In addition, to facilitate these wind-downs all large firms should be required to develop a road map for their liquidation well ahead of any failure. These wind-down powers will ensure that future administrations do not find themselves hampered by the constraints we faced in 2008. Moreover, the existence of such authority will address the concerns of "moral hazard," by sending a clear signal to market participants that the government will not bail out failing firms—it will liquidate them.

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My time in government convinced me that reform is difficult unless prompted by a crisis. As it turns out, even a crisis does not make the path to reform simple. We must not lose our sense of urgency to make the necessary reforms to ensure our long-term prosperity. I look forward to seeing this Committee's work move us along the road to such reform.