

Financial Crisis Inquiry Commission Hearing – January 13, 2010

Testimony of Peter J. Solomon

Thank you for asking me to appear before the Commission. Before I begin, I want to commend the leadership of the House and Senate for creating this bi-partisan Commission to examine the causes of the current financial and economic crisis in the United States.

When I entered Wall Street in the early 1960s, securities firms and commercial banks had not changed much since the 1930s. Stock ownership was not widespread. Public pension funds and endowments did not invest broadly. The average daily volume on the NYSE was about the same as 40 years earlier. There wasn't a large public bond market. The business of commercial banks was lending. The securities firms were usually private partnerships. Investment funds and trading were separate from banks and securities firms.

I have been afforded the opportunity over 50 years to observe the dramatic changes in the financial world from a number of perspectives. My career at Lehman Brothers spanned 29 years. I rose to Vice Chairman of the firm in the 1980s and was the Co-Chairman of the Investment Banking and Chairman of the Merchant Banking divisions. I have held financial positions in the public sector as Deputy Mayor of the

City of New York during the financial crisis of the late 1970s and as Counselor to the Secretary of the Treasury in the Carter Administration. I have been active on corporate, not-for-profit and foundation boards where I have been involved in investment decisions.

For the past 21 years, I have been the Chairman of the Peter J. Solomon Company, a private independent investment bank and member of the FINRA. Our firm is a throw-back to the era of the early 1960s when investment banks functioned as agents and fiduciaries advising their corporate clients on strategic and financial matters such as mergers and the raising of debt and equity capital. Unlike today's diversified banks, we do not act as principals or take proprietary positions. We do not trade and we do not lend.

For a moment, let me set the scene of the 1960s investment bank. The important partners of Lehman Brothers sat in one large room on the 3rd floor of Number One William Street – the Firm's headquarters. The partners congregated there, not because they were eager to socialize. An open room enabled the partners to overhear, interact and monitor the activities and particularly the commitments of their partners. Each partner could commit the entire assets of the partnership.

Lehman's capital at the time of incorporation in 1970 was about \$10 million. The wealth and, thus the liability, of the partners like Robert Lehman exceeded the Firm's stated capital by multiples. Since they were personally liable as partners, they took risk very seriously.

The financial community changed dramatically beginning in the 1980s. Incorporation and public ownership by securities firms enabled them to compete with commercial banks. Innovations like junk bonds, for example, allowed securities firms to

lend to non-investment-grade companies. All the firms accelerated the push into global markets, far-flung operations, mathematical modeling, proprietary dealings in debt and equity, the growing use of leverage and derivatives to hedge risk.

As the Commission investigates the causes of the 2007-2009 crisis, it is important to remember that market crises occur periodically. To name a few, in the last 20 years the markets have been roiled by Asian, Russian and Mexican crises; the crash of '87; the collapse of Long-Term Capital; the 2000 dot-com bubble collapse and Enron's bankruptcy.

The question before the Commission is: What events or actions occurred within the capital markets or the environment which allowed this crisis to become a debacle?

First, every legislative and regulatory move in the last 20 years has been towards obliterating the distinctions between providers of financial services and freeing the capital markets. The shining example, of course, is the Gramm-Leach-Bliley Act of 1999 which removed the last vestiges of the Glass-Steagall barriers.

Second, financial institutions used the more lenient regulatory environment to build scale and to extend scope. Citigroup, Bank of America, JP Morgan and Lehman Brothers, for instance, acquired competitors and expanded their operations into new fields. Concentration created institutions "too big to fail". Government regulation, in terms of oversight and coherence, did not keep pace with innovation, leverage and the expanded scope of the banks.

Third, access to new capital permitted the banks and securities firms to shift the nature of their businesses away from agency transactions and more towards proprietary

trading that took positions in marketable and less liquid securities and assets such as commercial real estate. Combined with greater leverage, earnings volatility increased.

Fourth, scale, scope and innovation created an inter-dependency, most noticeably in Credit Default Swaps, disproportionate to the equity capital of all banks. Managements misjudged the capabilities of their elaborate risk management systems, like VAR, to keep their institutions solvent. Even for insiders, transparency diminished so much that firms were not prepared for the extraordinary – so-called BLACK SWAN – event.

Given these changes affecting the banking system, what fundamental issues might the Commission probe?

1. The lack of coherent regulation by agencies where the application of existing regulation could have provided more transparency and forestalled a meltdown. The Commission might examine the role of campaign contributions as they relate to Federal Government's regulatory structure. The financial community has become increasingly active in Washington and is now one of the largest contributors to Federal political campaigns. Even today, one can see the detrimental effects of its lobbying on Government action to create transparent, accountable and efficient markets.

2. The Commission might consider whether the legal structure of banks contributed to undertaking excessive risk. The mixture of unlimited capital, limited liability and incentive compensation inevitably led to testing the levels of risk. It might be argued that public ownership and the compulsion to increase earnings per share propels employees towards greater risk. The experience of Lehman Brothers and Bear

Stearns indicates that large stock ownership by employees was not by itself a barrier to imprudent risk.

3. It is time to examine whether it is appropriate to have proprietary trading and investments, essentially hedge fund activities, within the same bank as lending and other agency transactions. The Commission might explore how these proprietary activities affect the stability of the markets and whether Congress should limit the scope of banks.

Paul Volcker has suggested that financial firms might be categorized between activities with ongoing relationship businesses such as lending, and transactional interactions such as trading. He has proposed that these functions be separated.

A corollary question is whether it would be preferable from a public policy perspective and adequate from a capital markets point of view to require proprietary investing to be in private partnerships. Until it went public, Goldman Sachs, for example, remained a private partnership and was able to attract sufficient capital and weather a series of large losses.

In closing, my hope is that the Commission will determine whether the 21st Century model is consistent with the need for stable banks and capital markets sufficient to finance the world economy. The Commission has an opportunity to approach this challenge in a bi-partisan manner and produce unanimous recommendations. These conclusions can have a profound effect on legislation as did the recommendations of the 911 Commission. In doing so, the Commission will make a major contribution to the stability of the financial markets and we will have a chance to mitigate future crises.

Thank you.