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Statement of the Shadow Financial Regulatory Committee

Transparency in Federal Reserve Emergency Financial Rescue Programs

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In Statement No. 268 (February 9, 2009), *The Need for More Transparency in Discretionary Financial Rescue Programs*, the Shadow Financial Regulatory Committee commented specifically on the kinds of disclosures the Federal Reserve should make about its operations if it is to be truly accountable for its actions and maintain its credibility and political independence. In the case of the asset backed securities portfolio that the Fed acquired in support of the Bear Stearns acquisition by JPMorgan Chase the Shadow Financial Regulatory Committee suggested that the Fed disclose the names of counterparties to transactions, how transactions were priced, the quality and extent of collateralization and the current market-to-market values on those assets. This information is important to assure the public that resources are being used efficiently and responsibly. With the passage of time, much more disclosure can be provided, even if the potential market impact might have posed a problem at the time the emergency actions were taken.

Since that time, two events have occurred that illustrate the need for and value of improved transparency. The first was release of the voluminous forensic analysis of the problems in Lehman Brothers by the Examiner appointed by the trustee in bankruptcy. The second was the release by the Federal Reserve of a list of the assets it acquired as part of the Bear Stearns acquisition.

The Lehman Brothers report was detailed, thorough and extremely illuminating. It raises critical questions about what management knew and didn't know as well as the actions and behaviors of Lehman's auditors. It details regulatory avoidance activities using an accounting device known as REPO 105 to get assets off the firm's books temporarily, thereby improving its reported capital ratios. The report suggests that the reasons for Lehman's failure were not all that different from the typical reasons that financial institutions have historically tended to get into financial difficulties. These include rapid and largely uncontrolled growth, excessive risk taking, reaching for earnings, and overriding of internal credit standards and limits on lending by the firm's executive committee. All of these actions should have been of concern to senior management as well as the responsible regulators including both the SEC and Office of Thrift Supervision. The Examiner also analyzed the firm's over 900,000 derivatives positions and documented that the Federal Reserve Bank of New York had detailed information on Lehman's counterparties. Unfortunately, the forensics were provided through the bankruptcy process rather than reported by the responsible regulators, the Financial Crisis Inquiry Commission or in the course of the current Congressional debate over financial reform. Otherwise, the information may not have come to light.

In the case of the Federal Reserve Bank of New York's Maiden Lane portfolio acquired in assisting JPMorgan Chase's acquisition of Bear Stearns, only the names and CUSIPs of some of the assets were provided. Relevant detail necessary to assess the transaction and that would constitute true transparency should have included information on the valuation of those assets, when those values were established, and when the assets and other positions were acquired; similar details on short positions would also contribute to true transparency. Consequently, the data released only created a treasure hunt for analysts who were forced to search for available information on those assets and their current values.

The Committee recommends that the regulators and/or their respective Inspector Generals be required to conduct forensic investigations of the failures of all large complex financial institutions, modeled after that provided by the Examiner for Lehman Brothers failure and that that analysis be made publicly available in a timely fashion. Additionally, the Federal Reserve should be urged to provide much more detail on all emergency assistance provided under Section 13 (c) of the Federal Reserve Act. Data should be made available to encourage outside experts to help the public understand objectively what truly happened in the crisis.