

S. HRG. 112-3

**AN OVERALL ASSESSMENT OF TARP AND  
FINANCIAL STABILITY**

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**HEARING**  
BEFORE THE  
**CONGRESSIONAL OVERSIGHT PANEL**

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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MARCH 4, 2011  
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Printed for the use of the Congressional Oversight Panel



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CONGRESSIONAL OVERSIGHT PANEL

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THE HONORABLE TED KAUFMAN, *Chair*

KENNETH TROSKE

J. MARK MCWATTERS

RICHARD H. NEIMAN

DAMON SILVERS

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# AN OVERALL ASSESSMENT OF TARP AND FINANCIAL STABILITY

FRIDAY, MARCH 4, 2011

U.S. CONGRESS,  
CONGRESSIONAL OVERSIGHT PANEL,  
*Washington, DC.*

The panel met, pursuant to notice, at 10:00 a.m., in room D-538, Dirksen Senate Office Building, Senator Ted Kaufman, chairman of the panel, presiding.

Present: Senator Ted Kaufman (presiding), Richard H. Neiman, Damon Silvers, J. Mark McWatters, and Kenneth R. Troske.

## **OPENING STATEMENT OF HON. TED KAUFMAN, U.S. SENATOR FROM DELAWARE**

The CHAIRMAN. Good morning. As you can tell, this is our last hearing and we took the ceremonial picture.

Good morning, Mr. Secretary. We appreciate your willingness to join the final hearing of the Troubled Asset Relief Program.

There's no question our economy faces real challenges today, but let's take a moment at the start of today's hearing to imagine that those challenges could be far, far worse and were far, far worse. Let's imagine that the S&P 500, which is risen by nearly 20 percent in the last year, had instead fallen by 30 percent in the last month. Let's imagine that our economy, which has added over a million jobs in the last year, had instead lost that many jobs in just two months. Let's imagine that America's oldest and most highly regarded financial institutions were beginning to topple literally like dominos.

I think it's fair to describe this scenario as dire, even apocalyptic. And yet that is precisely the scenario that faced our economy in late 2008 around the time Congress passed the TARP into law.

Today the panic of 2008 is a slowly fading memory and the TARP played a role in turning the page on that grim chapter in American history. It did not rescue our economy on its own, nor were all of its programs successful, not by a long shot. Even so, I believe that any hearing on the TARP should begin by recognize its greatest success, that in a moment of financial panic, panic, it helped to pull our markets back from the abyss.

Despite this accomplishment the TARP remains deeply despised among the Americans public. Most of the anger is eminently understandable, as the program is viewed as having done far more for Wall Street than for every day Americans. It is only fair to note that some of the TARP's unpopularity is due to misunderstandings about its track record. Disraeli said, "There's three kinds of lies,

lies, damn lies and statistics” and polls are the third kind, statistics. But a recent Bloomberg poll I think hits the point in terms of anecdotal evidence, is exactly what I’ve found. It revealed that 60 percent of the Americans believe that most of the TARP money provided to banks will be lost and we will not get that back. Only 33 percent believe that most of the money will be recovered.

Many of TARP’s greatest skeptics, I am sure, recall the frightening price tag first associated with the program, \$700 billion, the amount the Treasury requested and Congress approved to bail out the financial system. What they may not know today is that the Congressional Budget Office estimates that the TARP will lose \$25 billion. Let me clear, \$25 billion is a vast sum of money, yet it is far less than anyone expected the TARP to cost when it was created.

Yet the news, unfortunately, is not all good. Most starkly, the TARP has fallen far short in its effort to help owner—homeowners stay in their homes. The President first announced the goal of leveraging the TARP to prevent 3 to 4 million foreclosures. Today the panel estimates it will prevent fewer than 800,000. It is no wonder then that many Americans view the TARP as a program designed and executed for the benefit of Wall Street CEOs rather than Main Street homeowners.

Further, it would be grossly mistaken to account for the TARP solely by the number of taxpayer dollars lost. The program has a far greater and more noxious cost. Moral hazard. That lingering belief that America’s biggest banks are Too Big to Fail and the rules that apply to everyone else in America do not apply to them. This belief continues to distort our financial markets, advantaging the largest banks on Wall Street, while disadvantaging every other bank in the country. The cost of moral hazard is not easily quantifiable, but is real and it’s reprehensible.

Today’s hearing will consist of three panels of distinguished witnesses. First we are joined by Acting Assistant Secretary Timothy Massad who currently manages all the TARP programs for the Department of the Treasury. Mr. Secretary, Mr. Massad, I particularly hope that you will share with us your lessons learned from more than two years at work on the TARP.

If you were creating the TARP today what would you have done differently? That’s what we’re focusing on, what would we have done differently. What can our nation learn from this ugly experience and how can we prevent it from ever happening again?

Our second panel includes witnesses from FDIC, the FHFA and the Federal Reserve. These offices played critical roles in responding to the financial crisis, often acting in coordination with addition to TARP programs. I hope these witnesses will help us place the TARP in its proper context among the full range of crisis response programs.

Finally, we’ll be joined by four of this country’s leading economists who will bring decades of experience and exceptional credentials to the task of scrutinizing TARP and its effects. I look forward to hearing their expert views on the financial crisis and its enduring impact.



All of our witnesses' testimony will provide material and support for the panels 30th and final Oversight Hearing Report which will be issued to Congress and the public later this month.

Before we proceed I'd like to hear from my colleagues. Mr. McWatters.

SEN. TED KAUFMAN, CHAIRMAN  
ROBERT H. REIDMAN  
DANNY DREHER  
JAMES BURGATOS  
KENNETH PROKOP

332 North Capitol Street, NW  
Room C-225  
Washington, DC 20543

Congress of the United States  
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Ted Kaufman  
Congressional Oversight Panel Hearing  
on the TARP's Impact on Financial Stability

March 4, 2011

Good morning, Mr. Secretary. We appreciate your willingness to join the Congressional Oversight Panel for our final hearing on the Troubled Asset Relief Program.

There's no question that our economy faces real challenges today – but let's take a moment, at the start of today's hearing, to imagine that these challenges were far, far worse. Let's imagine that the S&P 500, which has risen by nearly 20 percent in the last year, had instead fallen by 30 percent in the last month. Let's imagine that our economy, which has added over a million jobs in the last year, had instead lost nearly that many jobs in just two months. Let's imagine that America's oldest and most highly regarded financial institutions were beginning to topple like dominoes.

I think it's fair to describe this scenario as dire, even apocalyptic. And yet that is precisely the scenario that faced our economy in late 2008, around the time Congress passed the TARP into law.

Today the panic of 2008 is a slowly fading memory, and the TARP played a role in turning the page on that grim chapter in American history. It did not rescue our economy on its own, nor were all of its programs successful – not by a long shot. Even so, I believe that any hearing on the TARP should begin by recognizing its greatest success: that in a moment of financial panic, it helped to pull our markets back from the abyss.

Despite this accomplishment, the TARP remains deeply despised among the American public. Much of that anger is eminently understandable, as the program is viewed as having done far more for Wall Street than for everyday Americans. Yet it is only fair to note that some of the TARP's unpopularity is due to misunderstandings about its track record. A recent Bloomberg poll revealed that 60 percent of Americans believe that most of the TARP money provided to banks will be lost. Only 33 percent believe that most of the money will be recovered.

Many of the TARP's greatest skeptics, I am sure, recall the frightening price tag first associated with the program: \$700 billion, the amount that Treasury requested and Congress approved to bail out the financial system. What they might not know is that, today, the Congressional Budget Office estimates that the TARP will lose \$25 billion. Let me be clear: \$25 billion is a vast sum of money – yet it is far less than anyone expected the TARP to cost when it was created.

**Congressional Oversight Panel**

Yet the news, unfortunately, is not all good. Most starkly, the TARP has fallen far short in its efforts to help homeowners stay in their homes. The president first announced a goal of leveraging the TARP to prevent three to four million foreclosures; today, the Panel estimates that it will prevent fewer than 800,000. It is no wonder, then, that many Americans view the TARP as a program designed and executed for the benefit of Wall Street CEOs rather than Main Street homeowners.

Further, it would be grossly mistaken to account for the TARP solely by the number of taxpayer dollars lost. The program has a far greater and more noxious cost: moral hazard, that lingering belief that America's biggest banks are "too big to fail" – that the rules that apply to everyone else in America do not apply to them. This belief continues to distort our financial markets, advantaging the largest banks on Wall Street while disadvantaging every other bank in the country. The cost of moral hazard is not easily quantifiable, but it is real, and it is reprehensible.

Today's hearing will consist of three panels of distinguished witnesses. First, we are joined by Acting Assistant Secretary Timothy Massad, who currently manages all TARP programs for the Department of Treasury. Mr. Secretary, I particularly hope that you will share with us your "lessons learned" from more than two years of work on the TARP. If you were creating the TARP today, what would you have done differently? What can our nation learn from this ugly experience, and how can we prevent it from ever happening again?

Our second panel includes witnesses from the FDIC, the FHFA, and the Federal Reserve. These offices played critical roles in responding to the financial crisis, often acting in coordination with or in addition to TARP programs. I hope these witnesses will help us place the TARP in its proper context among the full range of crisis response programs.

Finally, we will be joined by four of this country's leading economists, who bring decades of experience and exceptional credentials to the task of scrutinizing the TARP and its effects. I look forward to hearing their expert views on the financial crisis and its enduring impact.

All of our witnesses' testimony will provide material and support for the Panel's 30<sup>th</sup> and final oversight report, which we will issue to Congress and the public later this month.

Before we proceed to the testimony, I would like to offer my fellow panelists the opportunity to deliver their own opening remarks.

**STATEMENT OF J. MARK McWATTERS, ATTORNEY AND  
CERTIFIED PUBLIC ACCOUNTANT**

Mr. McWATTERS. Thank you, Senator Kaufman.

And welcome to our distinguished witnesses.

Although the Congressional Budget Office has recently estimated that the subsidy cost of the TARP downward to only, only \$25 billion, such metrics should not serve as the sole determinant of the success or failure of the program. We should remain mindful that the TARP's overall contribution to the rescue of the U.S. economy was relatively modest, when considered along with the multi-hundred billion dollar bailout of Fannie Mae and Freddie Mac, the multi-hundred trillion dollar intervention of the Federal Reserve and FDIC as well as the incalculable efforts of private sector capital market participants.

It is particularly difficult to label the TARP, or any other government sponsored program aimed at securing financial stability, an unqualified successful when the unemployment rate hovers around 9 percent, the combined unemployment and under-employment rate equals 16 percent and millions of American families are struggling to escape foreclosure. It is of cold comfort to these families that the two big to fail financial institutions, aided by the TARP and other generous, below market rate, government sponsored programs are recording near record earnings. That is, to this day that TARP carries a substantial stigma with the residents of Main Street should come as little surprise.

Professor Troske and I noted in our additional views of the Panel's 2010 Oversight Report that the repayment by the TARP recipients of advances received under the program is a misleading measure of the effectiveness of the TARP and therefore should serve—should not serve as the standard by which the TARP is judged.

The unlimited bailout of Fannie Mae and Freddie Mac, by Treasury, in the purchase of \$1.25 trillion of GSE, guaranteed mortgage backed securities, in the secondary market by the Federal Reserve, under its quantitative—first quantitative easing program no doubt materially benefited the TARP recipients and other financial institutions. These institutions were not required, however, to share the costs incurred in the bailout of the GSEs.

In effect, the bailout of Fannie Mae and Freddie Mac permitted the TARP recipients to monetize their GSE guaranteed MBS at prices above what they would have received without the GSE guarantees and use the proceeds to repay their obligations outstanding under the TARP, thereby, arguably shifting a greater portion of the TARP from the TARP recipients themselves to the taxpayers. Costs such as this should be thoughtfully considered when evaluating the TARP.

After reflecting upon the analysis conducted by the panel, its individual members and panel staff over the past two years, it is all but clear that the success or failure of the TARP remains an open question in that neither a favorable adjustment to the CBO subsidy rate, nor the repayment of the TARP funds by some recipients tells the entire story. It is critical to note that although the TARP played a meaningful role in the rescue of the U.S. economy during the closing days of 2008, its enduring legacy may have been to all

but codify the implicit guarantee of the “Too Big to Fails” notwithstanding the profound moral hazard risks arising from such action.

The TARP, in essence, reinforced the bubble/bailout cycle as the government’s preferred business model. Along these lines, the panel offered the following observations in its June, 2010 report on the AIG bailout. And I quote, “The government’s actions in rescuing AIG continue to have a poisonous effect on the marketplace. By providing a complete rescue that called for no shared sacrifice among AIG’s creditors, the Federal Reserve and Treasury fundamentally changed the relationship between the government and the country’s most sophisticated financial players. The AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America’s largest financial institutions and to ensure repayment to the creditors doing business with them. So long as this remains the worst effects of AIG’s rescue on the marketplace will linger.”

Likewise, in its January, 2011 report on the rescue of General Motors and Chrysler, the panel noted, and again I quote, “Treasury is now on course to recover the majority of its automotive investments within the—within the next few years. But the impact of the actions will reverberate for much longer. Treasury’s rescue suggested that any sufficiently large American corporation, even if not a bank, may be considered Too Big to Fail creating a risk that moral hazard will infect the economy far beyond the financial system. Further, the fact that the government helped absorb the consequences of GM’s and Chrysler’s failure, has put more competently managed institutions at a disadvantage. For these reasons, the effects of Treasury’s interventions will linger long after the taxpayers have sold their last shares of stock of the automotive industry.”

In closing, it is important to consider the reasons underlying the distinct unpopularity of and the stigma associated with the TARP, that the TARP helped to rescue the United States economy from financial collapse in the closing days of 2008 should not have served as a basis for the public outrage and scorn that shadows the program to this day. From my perspective the public rejected the program because hundreds of often profligate and ill-managed financial and other institutions, and their shareholders and officers receive taxpayer funded bailouts as well as other subsidies from the Treasury, the Federal Reserve and the FDIC on remarkably favorable terms. Many senior officers of these institutions retained their lucrative employment and although they generally suffered meaningful dilution, the shareholders and those TARP recipients were not wiped out.

The publicly—public intuitively recognized that such policies were an anathema in a market economy when entrepreneurs and passive investors alike, retained their business investment profits without question, but are accordingly expected to bear their full losses with transparency and accountability and without subsidy.

Main Street quickly realized that the TARP was heavily tilted in favor of Wall Street, while Main Street was stuck with dramatic rates of unemployment, neighborhoods decimated by foreclosure,

banks that refused to lend and the general sense that the residents were left on their own.

Thank you. And I look forward to our discussion.

The CHAIRMAN. Mr. Silvers.

Congress of the United States  
CONGRESSIONAL OVERSIGHT PANEL

## Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing  
on the TARP's Impact on Financial Stability

March 4, 2011

Thank you, Senator Kaufman, and welcome to our distinguished witnesses.

Although the Congressional Budget Office (CBO) has recently revised its estimated subsidy cost of the TARP downward to “only” \$25 billion,<sup>1</sup> such metric should not serve as the sole determinate of the success or failure of the program. We should remain mindful that the TARP’s overall contribution to the rescue of the U.S. economy was relatively modest when considered along with the multi-hundred billion dollar bailout of Fannie Mae and Freddie Mac, the multi-trillion dollar interventions of the Federal Reserve<sup>2</sup> and FDIC as well as the incalculable efforts of private sector capital market participants. It is particularly difficult to label the TARP or any other government-sponsored program aimed at securing financial stability an unqualified success when the unemployment rate hovers around 9 percent, the combined unemployment and underemployment rate equals 16 percent,<sup>3</sup> and millions of American families are entering foreclosure. It is of cold comfort to these families that the “too-big-to-fail” financial and other institutions aided by the TARP and other generous below market rate government-sponsored programs are recording near-record earnings. That to this day the TARP carries a substantial stigma with the residents of Main Street should come as little surprise.<sup>4</sup>

<sup>1</sup> See Congressional Budget Office, Report on the Troubled Asset Relief Program—November 2010 (online at <http://www.cbo.gov/doc.cfm?index=11980>).

<sup>2</sup> Pursuant to the requirements of Dodd-Frank, on December 1, 2010, the Federal Reserve released data on the amount and frequency of use of the Primary Dealers Credit Facility, an emergency short-term lending facility which was created in March 2008 and expired in February 2010. For the first time since the Great Depression, the central bank’s credit was extended to firms other than banks. The facility provided, cumulatively, \$8.95 trillion to primary dealers. It was utilized aggressively by every major investment bank. Among the data disclosed was that Goldman Sachs borrowed money from the facility 85 times between March 18, 2008 and November 26, 2008, with the largest transaction amounting to \$18 billion. Merrill Lynch used the facility 226 times with its largest transaction being \$33.2 billion. The largest single loan was a \$47.9 billion loan to Barclays, a foreign bank. For transaction data, see Board of Governors of the Federal Reserve System, *Regulatory Reform: Usage of the Federal Reserve Credit and Liquidity Facilities – Primary Dealer Credit Facility* (online at [www.federalreserve.gov/newsevents/reform\\_pdf.htm](http://www.federalreserve.gov/newsevents/reform_pdf.htm)).

<sup>3</sup> See Bureau of Labor Statistics, Economic News Release (February 4, 2011) (online at <http://www.bls.gov/news.release/empsit.t15.htm> and <http://www.bls.gov/news.release/empsit.nr0.htm>).

<sup>4</sup> In assessing the TARP it is important to consider the reasons underlying the distinct unpopularity of and the “stigma” associated with the program. That the TARP helped to rescue the United States economy from financial collapse in the closing days of 2008 should not have served as the basis for the public outrage and scorn that

## Congressional Oversight Panel

In order to better assess the TARP, I offer the following recap of certain issues raised by the Panel and its individual members over the past year.

Quantitative Easing One and the Bailout of Fannie Mae and Freddie Mac

Professor Troske and I noted in our Additional Views to the Panel's September 2010 Oversight Report that the repayment by TARP recipients of advances received under the program is a misleading measure of the effectiveness of the TARP and therefore should not serve as *the* standard by which the TARP is judged.<sup>5</sup> The unlimited bailout of Fannie Mae and Freddie Mac by Treasury and the purchase of \$1.25 trillion of GSE-guaranteed mortgage-backed securities (MBS) in the secondary market by the Federal Reserve under its first quantitative easing program no doubt materially benefitted TARP recipients and other financial institutions. These institutions were not required, however, to share any of the costs incurred in the bailout of the

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shadows the program to this day. From my perspective, the public rejected the program because hundreds of often profligate and ill-managed financial and other institutions and their shareholders and officers received taxpayer funded bailouts as well as other subsidies from the Treasury, the Federal Reserve and the FDIC on remarkably favorable terms. Many senior officers of these institutions retained their lucrative employment and, although they generally suffered meaningful dilution, the shareholders of most TARP recipients were not wiped out. The public intuitively recognized that such policies were an anathema in a market economy where entrepreneurs and passive investors alike retain their business and investment profits without question but are accordingly expected to bear their full losses with transparency and accountability and without subsidy. Main Street quickly realized that the TARP was heavily tilted in favor of Wall Street while Main Street was stuck with dramatic rates of unemployment and underemployment, neighborhoods decimated by foreclosures, banks that refused to lend and the general sense that its residents were left on their own.

<sup>5</sup> See the Additional Views of J. Mark McWatters and Professor Kenneth R. Troske that accompany the September 2010 Oversight Report of the Congressional Oversight Panel, *Assessing the TARP on the Eve of Its Expiration* (online at <http://cop.senate.gov/documents/cop-091610-report-mcwatterstroske.pdf>).

Former Panelist Paul S. Atkins and I concluded in our Additional Views to the Panel's January 2010 Oversight Report as follows:

In order to expedite the swift metamorphosis of many TARP recipients from insolvent to investment grade, the institutions were arguably subsidized through government sponsored purchases of mortgage-backed securities and by the all but unlimited investment of (and commitment to invest) public funds in Fannie Mae, Freddie Mac and AIG. One may argue that the government has created without meaningful public debate or analysis a series of "bad banks" within the Federal Reserve, Treasury, Fannie Mae, Freddie Mac, and AIG to accomplish what TARP alone failed to achieve. These "bad banks" or, perhaps, "debt consolidation entities" operate by actually and virtually removing toxic assets from the books of TARP recipients and other holders and issuers. The Federal Reserve and Treasury have actually removed [over] \$1 trillion of troubled assets from the books of TARP recipients and other holders and issuers through outright purchases. The Federal Reserve and Treasury have also virtually removed additional troubled assets from the books of TARP recipients and other holders and issuers by propping up the market values of such assets and maintaining historically low mortgage rates.

See the Additional Views of J. Mark McWatters and Paul S. Atkins that accompany the January 2010 Oversight Report of the Congressional Oversight Panel, *Exiting TARP and Unwinding Its Impact on the Financial Markets*, at 145 (online at <http://cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf>).



**Congressional Oversight Panel**

GSEs.<sup>6</sup> In effect, the bailout of Fannie Mae and Freddie Mac permitted TARP recipients to monetize their GSE-guaranteed MBS at prices above what they would have received without the GSE guarantees and use the proceeds to repay their obligations outstanding under the TARP, thereby arguably shifting a greater portion of the cost of the TARP from the TARP recipients themselves to the taxpayers.<sup>7</sup> Costs such as this should be thoughtfully considered when evaluating the TARP.

Bailout of AIG

With respect to the bailout of AIG, the Panel offered the following observations in its June 2010 report:

The government's actions in rescuing AIG continue to have a poisonous effect on the marketplace. By providing a complete rescue that called for no shared sacrifice among AIG's creditors, the Federal Reserve and Treasury fundamentally changed the relationship between the government and the country's most sophisticated financial players. The AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America's largest financial institutions, and to assure repayment to the creditors doing business with them. So long as this remains the case, the worst effects of AIG's rescue on the marketplace will linger.<sup>8</sup>

Robo-signing and other Mortgage Loan Irregularities

With respect to the robo-signing and other mortgage loan irregularities, the Panel offered the following observations in its November 2010 report:

Treasury has claimed that based on evidence to date, mortgage-related problems currently pose no danger to the financial system, but in light of the extensive uncertainties in the market today, Treasury's assertions appear premature. Treasury should explain why it sees no danger.<sup>9</sup>

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<sup>6</sup> By contrast, TARP recipients (other than under the foreclosure mitigation programs) are required to repay all of their advances, together with interest or dividends thereon, and grant warrants to Treasury.

<sup>7</sup> A portion of this benefit may be offset by the successful exercise of "put-back" rights by RMBS investors and others against mortgage loan originators.

<sup>8</sup> See the June 2010 Oversight Report of the Congressional Oversight Panel, Congressional Oversight Panel Examines AIG Rescue and Its Impact on Markets, at 10 (online at <http://cop.senate.gov/documents/cop-061010-report.pdf>).

See also the Additional Views of J. Mark McWatters that accompany the June 2010 report (online at <http://cop.senate.gov/documents/cop-061010-report-mcwatters.pdf>).

<sup>9</sup> See the November 2010 Oversight Report of the Congressional Oversight Panel, Examining the Consequences of Mortgage Irregularities for Financial Stability and Foreclosure Mitigation, at 6 (online at <http://cop.senate.gov/documents/cop-111610-report.pdf>).

See also the Opening Statement of J. Mark McWatters at the hearing of the Congressional Oversight Panel on

*Opening Statement of J. Mark McWatters, March 4, 2011 – 3*

## Congressional Oversight Panel

Foreclosure Mitigation under the HAMP

With respect to HAMP and Treasury's other foreclosure mitigation programs, the Panel offered the following observations in its December 2010 report:

While HAMP's most dramatic shortcoming has been its poor results in preventing foreclosures, the program has other significant flaws. For example, despite repeated urgings from the Panel, Treasury has failed to collect and analyze data that would explain HAMP's shortcomings, and it does not even have a way to collect data for many of HAMP's add-on programs. Further, Treasury has refused to specify meaningful goals by which to measure HAMP's progress, while the program's sole initial goal – to prevent 3 to 4 million foreclosures – has been repeatedly redefined and watered down. Treasury has also failed to hold loan servicers accountable when they have repeatedly lost borrower paperwork or refused to perform loan modifications. Treasury has essentially outsourced the responsibility for overseeing servicers to Fannie Mae and Freddie Mac, but both companies have critical business relationships with the very same servicers, calling into question their willingness to conduct stringent oversight. Freddie Mac in particular has hesitated to enforce some of its contractual rights related to the foreclosure process, arguing that doing so “may negatively impact our relationships with these seller/servicers, some of which are among our largest sources of mortgage loans.” Treasury bears the ultimate responsibility for preventing such conflicts of interest, and it should ensure that loan servicers are penalized when they fail to complete loan modifications appropriately.<sup>10</sup>

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Foreclosure Mitigation held October 27, 2010 in Washington, DC (online at <http://cop.senate.gov/documents/statement-102710-mcwatters.pdf>).

<sup>10</sup> See the December 2010 Oversight Report of the Congressional Oversight Panel, *A Review of Treasury's Foreclosure Prevention Programs*, at 5 (online at <http://cop.senate.gov/documents/cop-121410-report.pdf>).

See also the Additional Views of J. Mark McWatters and Professor Kenneth R. Troske that accompany the December 2010 report, at 126-127 (online at <http://cop.senate.gov/documents/cop-121410-reportmcwatterstroske.pdf>), which provide:

It is regrettable that the HAMP creates disincentives for investors and servicers as well as homeowners by rewarding their dilatory and inefficient behavior with the expectation of enhanced taxpayer-funded subsidies. Since any intermediate to long-term resolution of the housing crisis must reside substantially with the private sector lenders and investors who hold the mortgage notes and liens, instead of spending an additional \$30 billion on a government sponsored foreclosure mitigation effort, we believe Treasury would be best served by strongly encouraging these participants to engage in good faith, market-based negotiations with their distressed borrowers. In our opinion, this is the best way to bring stability to the housing market so that the economy can start growing again.

As I have stated before, it is critical to note that my assessment of the TARP and HAMP is in no way intended to diminish the financial hardship that many Americans are suffering as they attempt to modify or refinance their underwater home mortgage loans, and I fully acknowledge and empathize with the stress and economic uncertainty created from the bursting of the housing bubble. As such, I strongly encourage each mortgage loan holder and RMBS investor and servicer to work with each of their borrowers in a professional, good-faith, transparent and accountable manner to reach an economically reasonable resolution prior to pursuing a foreclosure remedy. In my view, foreclosure should serve as the exception to the rule that follows only from the transparent and objective failure of the parties to modify or refinance a troubled mortgage loan pursuant to market-based terms.

*Opening Statement of J. Mark McWatters, March 4, 2011 – 4*

## Congressional Oversight Panel

Contracting Authority under the TARP

With respect to Treasury's contracting authority under the TARP, the Panel offered the following observations in its October 2010 Report:

The largest TARP financial agency agreements were those with Fannie Mae and Freddie Mac to provide administration and compliance services for Treasury's foreclosure mitigation programs. As described in detail in the case study accompanying this report, these agreements raise significant concerns. Both Fannie Mae and Freddie Mac have a history of profound corporate mismanagement, and both companies would have collapsed in 2008 were it not for government intervention. Further, both companies have fallen short in aspects of their performance, as Fannie Mae recently made a significant data error in reporting on mortgage redefaults and Freddie Mac has had difficulty meeting its assigned deadlines.<sup>11</sup>

General Motors, Chrysler and GMAC/Ally Bank<sup>12</sup>

With respect to the rescue of General Motors, Chrysler and GMAC/Ally Bank, the Panel offered the following observations in its January 2011 report:

Treasury is now on course to recover the majority of its automotive investments within the next few years, but the impact of its actions will reverberate for much longer.

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<sup>11</sup> See the October 2010 Oversight Report of the Congressional Oversight Panel, *Examining Treasury's Use of Financial Crisis Contracting Authority*, at 6 (online at <http://cop.senate.gov/documents/cop-101410-report.pdf>).

<sup>12</sup> With respect to the bailout of GMAC, the Panel offered the following observations in its March 2010 report:

Although the Panel takes no position on whether Treasury should have rescued GMAC, it finds that Treasury missed opportunities to increase accountability and better protect taxpayers' money. Treasury did not, for example, condition access to TARP money on the same sweeping changes that it required from GM and Chrysler: it did not wipe out GMAC's equity holders; nor did it require GMAC to create a viable plan for returning to profitability; nor did it require a detailed, public explanation of how the company would use taxpayer funds to increase consumer lending.

Moreover, the Panel remains unconvinced that bankruptcy was not a viable option in 2008. In connection with the Chrysler and GM bankruptcies, Treasury might have been able to orchestrate a strategic bankruptcy for GMAC. This bankruptcy could have preserved GMAC's automotive lending functions while winding down its other, less significant operations, dealing with the ongoing liabilities of the mortgage lending operations, and putting the company on sounder economic footing. The Panel is also concerned that Treasury has not given due consideration to the possibility of merging GMAC back into GM, a step which would restore GM's financing operations to the model generally shared by other automotive manufacturers, thus strengthening GM and eliminating other money-losing operations.

See the March 2010 Oversight Report of the Congressional Oversight Panel, *The Unique Treatment of GMAC Under the TARP*, at 4 (online at <http://cop.senate.gov/documents/cop-031110-report.pdf>). See also the Additional Views of J. Mark McWatters and Paul S. Atkins that accompany the March 2010 report (online at <http://cop.senate.gov/documents/cop-031110-report-atkinsmcwatters.pdf>).

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Treasury's rescue suggested that any sufficiently large American corporation – even if it is not a bank – may be considered “too big to fail,” creating a risk that moral hazard will infect areas of the economy far beyond the financial system. Further, the fact that the government helped absorb the consequences of GM's and Chrysler's failures has put more competently managed automotive companies at a disadvantage. For these reasons, the effects of Treasury's intervention will linger long after taxpayers have sold their last share of stock in the automotive industry.<sup>13</sup>

After reflecting upon the analysis conducted by the Panel and its individual members over the past two years, it is clear that the success or failure of the TARP remains an open question and that neither a favorable adjustment to the CBO subsidy rate nor the repayment of TARP funds by some recipients tells the entire story. In concluding, it is significant to note that although the TARP played a meaningful role in the rescue of the U.S. economy during the closing days of 2008, its enduring legacy may be to have all but codified the implicit guarantee of the “too-big-to-fails”<sup>14</sup> notwithstanding the profound moral hazard risks arising from such action.<sup>15</sup> The TARP, in essence, reinforced the “bubble-bailout cycle” as the government's preferred business model.<sup>16</sup>

<sup>13</sup> See the January 2011 Oversight Report of the Congressional Oversight Panel, *An Update on TARP Support for the Domestic Automotive Industry*, at 5-6 (online at <http://cop.senate.gov/documents/cop-011311-report.pdf>).

<sup>14</sup> Financial and other institutions may evolve into too-big-to-fail entities in a stealth-like manner during periods of rapid bubble expansion when market participants and, perhaps, their regulators are consumed with congratulating themselves on their financial, business and regulatory acumen and the tax coffers are growing with the oversized profits generated from a breathless array of paradigm shifting financially engineered transactions. By the time these institutions awaken from their stupor, the bubble has broken and the markets are in a flat spin.

As we now appreciate, the few contrarians who identified and spoke out against the inflating bubble of 2005-2008 were correct in their assessments, and the too-big-to-fail institutions with their vested interests in bubble economics were not. Regrettably, after the creation and implementation of the TARP there is all the more reason for the too-big-to-fail institutions to ignore the contrarians and conduct their affairs secure in the expectation, if not a sense of entitlement, that a TARP-like rescue will follow any future misadventures.

<sup>15</sup> It, perhaps, would have been preferable to have resolved the most insolvent of the TARP recipients in early to mid-2009 (but probably not in the last quarter of 2008 when confidence in the markets had shattered). While this approach may appear harsh, such action would have sent a clear message to corporate directors, officers and shareholders that in a market economy the right to fail will be respected by the government and that financial and other institutions should revise their internal control and risk management protocols accordingly.

Any regulatory response to this problem, however, may offer little practical comfort because bubbles don't necessarily develop simply because regulators are carelessly asleep at the switch or because existing regulation is inadequate, but instead, they inflate because regulators and business professionals often fail to appreciate in a timely and appropriate manner the inherent systemic risk embedded in the assembly-line propagation of historically profitable, yet otherwise pedestrian, business transactions such as the securitization of home mortgage loans. Otherwise, why did the regulators fail to identify and preemptively respond to the most recent bubble, and why did many financial institutions and other investors continue to drink their own home-brewed toxic mix of mortgaged-backed Kool-Aid well after the music had stopped? Some, no doubt negligently or even recklessly, chose to ignore the emerging risk, yet many others never saw it coming.

<sup>16</sup> The Additional Views issued by J. Mark McWatters and former Panel member Paul S. Atkins with respect to the Panel's January 2010 report on *Exiting TARP and Unwinding Its Impact on the Financial Markets* describes some of the challenges presented by the TARP:

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Thank you and I look forward to our discussion.

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The January report analyzes the difficulties that may arise when the United States government directly or indirectly undertakes to prevent certain systemically significant institutions from failing. Although the government does not generally guarantee the assets and obligations of private entities, its actions and policies may nevertheless send a clear message to the market that some institutions are simply too big or too interconnected to fail. Once the government adopts such a policy it is difficult to know how and where to draw the line. With little public debate, automobile manufacturers were recently transformed into financial institutions so they could be bailed out with TARP funds and an array of arguably nonsystemically significant institutions – such as GMAC – received many billions of dollars of taxpayer funded subsidies. In its haste to restructure favored institutions, the government may assume the role of king maker – as was surely the case in the Chrysler and GM bankruptcies – and dictate a reorganization structure that arguably contravenes years of well-established commercial and corporate law precedent. The unintended consequences of these actions linger in the financial markets and legal community long after the offending transactions have closed and adversely – yet subtly – affect subsequent transactions that carry any inherent risk of future governmental intervention. The uninitiated may question why two seemingly identical business transactions merit disparate risk-adjusted rates of return or why some transactions appear over-collateralized or inexplicably complicated. The costs of mitigating political risk in private sector business transactions are seldom quantified or even discussed outside the cadre of businesspersons and their advisors who structure, negotiate and close such transactions, yet such costs certainly exist and must be satisfied.

See the Additional Views of J. Mark McWatters and Paul S. Atkins that accompany the January 2010 report, at 157-158 (online at <http://cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf>).

*Opening Statement of J. Mark McWatters, March 4, 2011 – 7*

**STATEMENT OF DAMON SILVERS, DIRECTOR OF POLICY AND  
SPECIAL COUNSEL, AFL-CIO**

Mr. SILVERS. Thank you, Mr. Chairman.

Good morning. This is the last hearing of the Congressional Oversight Panel. I would like to begin by expressing my gratitude to Senate Majority Leader Harry Reid and to House Minority Leader Nancy Pelosi for giving me this opportunity to serve my country.

I would also like to express my profound gratitude to our chair and his predecessor, my dear friend, Elizabeth Warren, for their leadership of our panel.

And also our—my gratitude to our staff, in particular our staff director, Naomi Baum, for all they have done over the last two and a half years to make our panel a success.

Finally, I would like to thank my fellow panel members, Richard Neiman, Mark McWatters and Ken Troske. We have worked together as a team in a manner that is tragically rare in our national politics today and I'm honored to have been a part of that.

Now today we hear from Acting Assistant Secretary Timothy Massad, from representatives of the key independent agencies that work together with Treasury on restoring financial stability and from some of the world's leading economists and experts on financial crises. While I'm grateful to all of our witnesses for joining us today, I want to note that we have, in many ways over the past two and a half years, benefited from the advice and assistance of Secretary Massad, of Professor Stiglitz and Professor Johnson. And it is fitting that they should be with us today.

Before I conclude my opening remarks, I think it's appropriate for me to be clear what my final conclusions are about the TARP program. One, I believe TARP, through the initial investments in the large banks and in securitization markets primarily, was a substantial contributor to halting a global financial panic. It is, frankly, irresponsible, to suggest our nation would have been better off had we taken no action.

Two, I believe, and there is overwhelming evidence to support my position in our February, 2009 report, that at the time these initial TARP investments were made, the public did not receive anything like full value for our money. However, over time the management of these assets and the execution of further transactions, by the team at Treasury managing TARP, became systematically fairer to the taxpayer. And the team at Treasury, Secretary Massad, his predecessor, deserve a great deal of credit for that.

Three, the Paulson Treasury Department was not truthful with the public when it said that the Capital Purchase Program funds were only going to healthy institutions. And the Geithner Treasury Department has compounded this lack of candor by refusing to admit, in testimony before this panel, that Citigroup and Bank of America were on the verge of collapse when they received additional TARP funds in November, 2008 and January, 2009, respectively.

Four, the failure to replace bank management, to do a rigorous evaluation of the state of bank assets and to restructure bank balance sheets accordingly has left the United States with weak major banks and a damaged sense of trust between the American public and our nation's elected leaders.

Five, although more than half a million families have been helped by tarps foreclosure prevention programs, foreclosure prevention has been subordinated to the needs of the banks. The truth is that continued mass foreclosures of homeowners are a powerful source of systemic risk and downward pressure on our economy and on jobs.

In December, 2008 this panel held its first hearing in Clark County, Nevada. We did so to make the point that the American people would judge TARP based not on the wealth of bankers but on the health of our communities. In December of 2008 unemployment in Southern Nevada was 9.1 percent. Today it is 14.9 percent. In December, 2008, 6.58 percent of all home mortgages in Nevada were delinquent. Today 10.06 percent are.

The most recent statement of the Federal Reserve's Open Market Committee states that quote, "The economic recovery is continuing, though at a rate that has been insufficient to bring about a significant improvement in labor market conditions. Growth in household spending picked up late last year but remains constrained by high unemployment, modest income growth, lower housing wealth and tight credit." That is precisely the scenario that the majority of this panel warned in our April, 2009 report, would be the likely consequence of failing to restructure the major banks.

Although this panel is going out of business, the task of managing TARP's remaining programs, of regulating the banks, of overseeing systemic risk goes on. The mass foreclosures tragically continue, but it is never too late to act to make change.

Thank you.

The CHAIRMAN. Dr. Troske.

SEN. PETER ROBINSON, CHAIRMAN  
 EDWARD H. NEWMAN  
 DAMON SILVERS  
 J. AMAR SHUKATTAJI  
 KENNETH R. TROSKE

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Congress of the United States  
 CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Damon Silvers  
 Congressional Oversight Panel Hearing  
 on the TARP's Impact on Financial Stability

March 4, 2011

Good morning. This is the last hearing of the Congressional Oversight Panel. I would like to begin by expressing my gratitude to Senate Majority Leader Harry Reid and House Minority Leader Nancy Pelosi for giving me this opportunity to serve my country. I would also like to express my profound gratitude to our chair and his predecessor my dear friend Elizabeth Warren for their leadership of our panel, and to our staff, in particular our staff director Naomi Baum, for all they have done over the last two and a half years to make our Panel a success. And finally, I would like to thank my fellow Panel members, Richard Nieman, Mark McWaters and Ken Troske. We have worked together as a team in a manner that is tragically rare in our national politics today—and the fruits of that collaboration can be found in our numerous unanimous reports and in the teamwork that has characterized these hearings.

Over the last two and a quarter years, this Panel has tried to provide the Congress of the United States and the American people with clear, comprehensive answers to the questions we posed in our very first report about TARP. We have priced the major TARP transactions, evaluated the Treasury Department's approach to large banks and small banks, tried to understand TARP's impact on both the credit markets and the broader economy, and focused in particular on TARP's impact on the housing market and the foreclosure crisis.

Today, we hear from Timothy Massad, the Director of the Office of Financial Stability, from representatives of the key independent agencies that worked together with Treasury on restoring financial stability, and from some of the world's leading economists and experts on financial crises. While I am grateful to all of our witnesses for joining us today, I want to note that we have in many ways over the last two and a half years benefited from the advice and assistance of Mr. Massad, of Professor Stiglitz and Professor Johnson, and it is fitting they should be with us today.

Before I conclude my opening remarks I think it is appropriate to be clear what my final conclusions are about the TARP program.

One, I believe TARP—through the initial investments in the large banks—was a substantial contributor to halting a global financial panic. It is irresponsible to suggest our nation would have been better off had we taken no action.

Two, I believe, and there is overwhelming evidence to support my position in our February, 2009 report, that at the time these initial investments were made, the public did not receive anything



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like full value for our money. However, over time TARP's transactions have become fairer to the public.

Three, the Paulsen Treasury Department was not truthful with the public when it said that Capital Purchase Program funds were only going to healthy institutions, and the Geithner Treasury Department has compounded this lack of candor by refusing to admit in testimony before this Panel that Citigroup and Bank of America were on the verge of collapse when they received additional TARP funds in November, 2008 and January 2009 respectively.

Four, the failure to replace bank management, to do a rigorous evaluation of the state of bank assets, and to restructure bank balance sheets accordingly has left the United States with weak banks and a damaged sense of trust between the American public and our nation's elected leaders.

Five, although more than half a million families have been helped by TARP's foreclosure prevention programs, foreclosure prevention has been subordinated to the needs of the banks. But the truth is that continued mass foreclosures of homeowners are a powerful source of systemic risk and downward pressure on our economy and on jobs.

The most recent statement of Federal Open Market Committee states "the economic recovery is continuing, though at a rate that has been insufficient to bring about a significant improvement in labor market conditions. Growth in household spending picked up late last year, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit." That is the scenario the majority of the Panel warned in our April, 2009 report would be the consequence of failing to restructure the major banks.

In December, 2008, this Panel held its first hearing in Clark County, Nevada. We did so to make the point that the American people would judge TARP based not on the wealth of bankers but on the health of our communities. In December of 2008, unemployment in southern Nevada was 9.1%. Today it is 14.9%. In December, 2008, 6.58% of all home mortgages in Nevada were delinquent, today 10.06% are.

Although this Panel is going out of business, the task of managing TARP's remaining programs, of regulating the banks, of overseeing systemic risk, goes on. The mass foreclosures continue. But it is never too late to act, to make change. Thank you.

**STATEMENT OF KENNETH TROSKE, WILLIAM B. STURGILL  
PROFESSOR OF ECONOMICS, UNIVERSITY OF KENTUCKY**

Dr. TROSKE. Thank you, Senator Kaufman.

I would like to start by thanking the witnesses for appearing before the panel today. I recognize that all of you are very busy people with a number of other responsibilities, so I appreciate you taking time to come here and help us with our oversight responsibilities.

Given the focus of this, our last Oversight Panel Hearing, it seems appropriate to comment on the overall impact of TARP and the financial rescue efforts in general. I was recently asked by a reporter whether my assessment of TARP would be different if TARP had ended up costing \$356 billion, as was originally estimated, instead of the current estimate of \$25 billion, one of the more creative questions I've gotten from a reporter. I answered that any complete assessment of the success of TARP needed to take into account a number of factors, such as the role TARP played in preventing a financial collapse, the risk taxpayers were exposed to at the time TARP was enacted, the long run impact TARP had—has—will have on the market and TARP's effect on the likelihood of future financial crises.

So while the actual cost of TARP is an important component, it is only one factor affecting ones evaluation of the success or failure of TARP. So my answer to the reporter was, "Yes, I could still view TARP as a success even if the program had cost taxpayers \$356 billion."

Throughout the financial crisis the government's actions were circumscribed by the expectations of the market that in the event of a financial crisis the government would bail out firms whose bankruptcy threatened to increase systemic risk. These expectations, of course, were based on past government bailouts of large financial firms. In fact, as I have argued previously, these expectations affected the severity of the financial crisis, since the market responded to these expectations by encouraging firms to grow until they became Too Big to Fail, thereby increasing the number and size of systemically risky firms in the economy and in turn increasing the amount of money needed to stem the financial crisis. Also, once they'd attained Too Big to Fail status, the bailout guarantee provided these firms gave them the incentive to increase their risky behavior, thus increasing the likelihood of a financial crisis.

Ultimately, in my mind, the success or failure of TARP in particular and the overall financial rescue in general will hinge on whether we are able to eliminate the problem that caused the crisis, Too Big to Fail firms. Unfortunately, at least so far, it does not appear that we have taken the necessary steps to end Too Big to Fail.

In my opinion, the first step in fixing the problem of Too Big to Fail firms is defining exactly what we mean by "systemically important firms" or "systemically important risks." That way the market has a clear understanding of which firms will receive support in the next financial crisis and which will not.

Then the government needs to start charging market based fees to these firms for insurance provided to them, through substantially higher reserve requirements, which has been advocated by

Professor Meltzer among others, by requiring firms to hold additional alternative reserves against their systemically risky holdings, as has been proposed by Professor Zingales, by charging firms by the bailout insurance along the lines proposed by the president of the Federal Reserve Bank of Minneapolis, or through some alternative mechanism which forces these firms to pay the cost of the insurance that is currently being paid for by the American taxpayers.

Only by ending the taxpayer funded survival guarantee for large firms, both domestic and foreign, will we return basic market discipline to Wall Street and ensure that large financial firms face the same competitive pressures faced by firms operating on Main Street. In turn, this will ensure that future financial crises will be much less severe and the fixes to these crises will not involve putting trillions of taxpayer dollars at risk.

Since this is our last hearing, there are some people I would like to note and thank for their work with the panel. First I would like to thank the panel staff and especially our executive director, Naomi Baum, for their work. Looking over the totality of the panel's reports, one realizes this work will become one of the definitive sources of information about the financial crisis and this is largely due to the hard work, patience and dedication of our staff.

I would also like to thank my fellow panel member, Mark McWatters for help—for the help he has provided me in becoming familiar what the issues facing the panel. Mark was always available when I needed someone to bounce ideas off of, which helped me develop and formulate my ideas about TARP.

I would like to thank Senator Kaufman for the leadership he has provided over the last several months. Senator Kaufman's guidance was important in helping the panel continue to build on the bipartisan spirit of cooperation we first developed under the leadership of former chair, Elizabeth Warren.

Finally, I would like to offer a special thanks to the longest serving panel members, Richard Neiman and Damon Silvers. Richard has been part of 30 reports issued by the panel, while Damon has participated in 27. As someone who is exhausted after having participated in a mere 10, I can honestly say I don't know how they've done it reading over and offering comments on three drafts of each one of these reports. Based on my observations, both Richard and Damon have performed these tasks while recognizing the important responsibility they had to represent and protect the interests of the American taxpayers. So as one of these taxpayers, I would like to say thank you.

And the—and I would also like, in conclusion, to thank the witnesses once again for joining us and helping us with our discussion today.

The CHAIRMAN. Thank you.  
Superintendent Neiman.

Congress of the United States  
 CONGRESSIONAL OVERSIGHT PANEL

## Opening Statement of Kenneth Troske

### Congressional Oversight Panel Hearing on the TARP's Impact on Financial Stability

March 4, 2011

Thank you, Senator Kaufman.

I would like to start by thanking the witnesses for appearing before the panel today. I recognize that all of you are very busy people with a number of other responsibilities, so I appreciate you taking time to come here and help us with our oversight responsibilities.

Given the focus of this, our last Oversight Panel hearing, it seems appropriate to comment on the overall impact of TARP and the financial rescue in general. I was recently asked by a reporter whether my assessment of TARP would be different if TARP had ended up costing \$356 billion, as was originally estimated, instead of the current estimate of \$25 billion. I answered that any complete assessment of the success of TARP needed to take into account a number of factors, such as the role TARP played in preventing a financial collapse, the risk taxpayers were exposed to at the time TARP was enacted, the long-run impact TARP had on the market, and TARP's effect on the likelihood of future financial crises. So while the actual cost of TARP is an important component, it is only one factor that affects one's evaluation of the success or failure of TARP. So my answer to the reporter was, yes, I could still view TARP as a success even if the program had cost taxpayers \$356 billion.

Throughout the financial crisis, the government's actions were circumscribed by the expectations of the market that, in the event of a financial crisis, the government would bail out firms whose bankruptcy threatened to increase systemic risk—expectations that were based on past government bailouts of large financial firms. In fact, as I have argued before, these expectations affected the severity of the financial crisis since the market responded to these expectations by encouraging firms to grow until they became too big to fail, thereby increasing the number of large firms, and in turn increasing the amount of money needed to stem the financial crisis. Also, once they'd attained too-big-to-fail status, the bailout guarantee provided these firms gave them the incentive to increase their risky behavior, thus increasing the likelihood of a financial crisis. Ultimately, the success or failure of TARP in particular, and the overall financial rescue in general, will hinge on whether we are able to eliminate the problem that caused this crisis:—too-big-to-fail firms. Unfortunately, at least so far, it does not appear that we have taken the necessary steps to end too big to fail.

In my opinion, the first step in fixing the problem of too-big-to-fail firms is defining exactly what we mean by systemically important firms or systemically important risks. That way the

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market has a clear understanding of which firms will receive support in the next financial crisis and which will not. Then the government needs to start charging market-based fees to these firms for the insurance provided to them, through substantially higher reserve requirements, which have been advocated by Professor Meltzer among others; by requiring firms to hold additional alternative reserves against their systemically risky holdings, as has been proposed by Professor Zingales; by charging firms for the bailout insurance along the lines proposed by the President of the Federal Reserve Bank of Minneapolis; or through some alternative mechanism which forces these firms to pay for the cost of the insurance that is currently being paid for by the American taxpayers. Only by ending the taxpayer-funded survival guarantee to large firms, both domestic and foreign, will we return basic market discipline to Wall Street and ensure that large financial firms face the same competitive pressures faced by firms operating on Main Street. In turn, this will ensure that future financial crises will be much less severe and the fixes to these crises will not involve putting trillions of taxpayer dollars at risk.

**STATEMENT OF RICHARD NEIMAN, SUPERINTENDENT OF  
BANKS, NEW YORK STATE BANKING DEPARTMENT**

Mr. NEIMAN. Thank you.

When the financial crisis hit in the fall of 2008, we had a Republican President and a Democratic Congress. This panel was created by that Congress to help hold the administration accountable in implementing the TARP program. There was no shortage of ideological objections from the Left and the Right when TARP was passed and there are no fewer today. But the American public's concern, it seems to me, has been far less ideological or partisan. Rather, they have retained the pragmatic focus asking the question, "Is the investment of our money serving the public well?"

It would have been difficult for this panel to assist with answering that question if we ourselves got distracted from it. Congress wisely placed both Democrats and Republicans on this panel to force us to be as pragmatic as the people we were appointed to serve. And our efforts toward that goal, over two years as the nation gained a new Democratic President and then gained a new Republican House of Representatives, remain the same.

Our five different perspectives and backgrounds could have led to more disagreement than agreement and ultimately a failure to shed light and create accountability regarding the most complex financial issues of the day. But one of the things that I will personally take away from this experience of the last two years is a renewed optimism that people can still work together for the public good during increasingly partisan times.

Even in the beginning, when ideology was at its height, prior panel members, Chair Warren, Congressman Hensarling and Senator Sununu who all had something important but different to contribute, found ways to come together. Elizabeth Warren deserves great credit for her leadership in the early days of this panel.

We have not been perfect however, and our oversight was always finite. So if someone asked me, "What is the single most important public service we were able to provide," I believe the answer could really only be one, I believe we helped empower the American public to fulfill their critical role as the true watchdogs of government. That's why we consistently called for more public data and more transparency. We demanded more information on TARP expenditures, HAMP mortgage modifications, non-HAMP mortgage modifications, bank health in lending and other TARP related areas. Our goal was to attain information on a systematic basis communicated as clearly as possible.

With this, people can assess what is happening today and others in the future can, with the benefit of time, truly assess what happened back in the first global financial crisis of the 21st century.

So our monthly reports and hearings come to a close this month, but the end of TARP oversight does not. I would humbly encourage our skillful fellow oversight body, SIGTARP and the GAO and the many reporters and bloggers who so often got the facts right, to continue to focus on ways to empower the public with clear information that provides opportunity to understand and have an impact.

The fact is that free markets work, but the other fact is, they don't work as well as we would always like. The reason for this ap-

parent inconsistency is often the lack of broadly available information that allows market participants and consumers to create fully functioning markets. We need continued light shedding oversight and reforms to make free markets work, it's simply good for the housing market, the financial market and the greater economy.

I'd like to conclude by thanking today's witnesses for their past and current support of our work and by thanking all our earlier witnesses. I feel particularly compelled to express great gratitude to my colleagues, Ken, Mark, Chairman Kaufman and Vice-Chair Silvers for solidifying a belief that people with different philosophies can still work together for greater good in Washington, D.C. Thank you. I look forward to our questions.

Congress of the United States  
 CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Richard Neiman  
 Congressional Oversight Panel Hearing  
 on the TARP's Impact on Financial Stability

March 4, 2011

When the financial crisis hit in fall 2008, we had a Republican President and a Democratic Congress. This Panel was created by that Congress to help hold the Administration accountable in implementing the TARP program.

There was no shortage of ideological objections from the left and the right when TARP was passed, and there are no fewer today. But the American public's concern it seems to me has been far less ideological or partisan. Rather their pragmatic focus has remained: Is the investment of our money serving the public well?

It would have been difficult for this panel to assist with answering that question if we ourselves got distracted from it. Congress wisely placed both Democrats and Republicans on this Panel to force us to be as pragmatic as the people we were appointed to serve. And our effort towards that goal over two years, as the nation gained a new Democratic President, and then gained a new Republican House of Representatives, remained the same.

Our five different perspectives and backgrounds could have led to more disagreement than agreement, and ultimately a failure to shed light and create accountability regarding the most complex financial issues of today.

But one of the things that I will personally take away from the experience of the last two years is a renewed optimism that people can still work together for the public good during increasingly partisan times. Even in the beginning, when ideology was at its height, prior panel members Chairwoman Warren, Congressman Hensarling, and Senator Sununu – who all had something important, but different, to contribute – found ways to come together. Elizabeth Warren deserves great credit for her leadership in the early days of this panel.

We have not been perfect, however, and our oversight was always finite. So if someone asked me what is the single most important public service we were able to provide, I believe the answer could really only be one: I believe we helped empower the American public to fulfill their critical role as the true watchdogs of government.

That's why we consistently called for more public data and more transparency. We demanded more information on TARP expenditures, HAMP mortgage modifications, non-HAMP mortgage modifications, bank health and lending, and other TARP-related areas. Our goal was to attain



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information on a systematic basis, communicated as clearly as possible. With this people can assess what is happening today, and others in the future can with the benefit of time truly assess what happened back in that first global financial crisis of the 21<sup>st</sup> Century.

So our monthly reports and hearings come to a close this month, but the end of TARP oversight does not. I would humbly encourage our skillful fellow oversight bodies, SIGTARP and GAO, and the many reporters and bloggers, who so often got the facts right, to continue to focus on ways to empower the public with clear information that provides opportunity to understand and have an impact.

The need for such opportunity could not be clearer than it is on the foreclosure front that is crushing too many people and stifling economic growth. Frankly, the crisis is simply too big for any one agency or even any one government to solve on its own. Sustainable solutions can only be achieved through a national effort where government fully engages housing advocates and people to be a full partner. To that end, we still desperately need:

- \* a widely utilized Web Portal that allows homeowners to submit mortgage modification applications, see that servicers have the documents, and be able to hold servicers accountable when documents are claimed to be incomplete or missing;

- \* a Homeowner Advocate's Office to hear complaints directly from homeowners, learn from those complaints, understand the big picture trends, and work to impose accountability on mortgage servicers; and

- \* a National Mortgage Foreclosure Database so missed mortgage payments and potential foreclosures can be monitored, trends can be identified, and people in need of help can quickly be alerted to the fact that help is available and often free.

The fact is that free markets work. But the other fact is that they don't work as well as we would always like. The reason for this apparent inconsistency is often the lack of broadly available information that allows market participants and consumers to create fully functioning markets. We need continued light-shedding oversight and reforms to make free markets work. Its simply good for the housing market, the financial market, and the greater economy.

I would like to conclude by thanking today's witness for their past and current support of our work, and by thanking all of our earlier witnesses. I feel particularly compelled to express great gratitude to my colleagues Ken, Mark, Chairman Kaufman, and Vice-Chair Silvers for solidifying a belief that people with different philosophies can still work together for the greater good in Washington DC.

The CHAIRMAN. Thank you. I'm pleased to welcome Timothy Massad, the acting assistant secretary of the Office of Financial Stability and thank him for joining us. He was here at the beginning. It's like bookends, it must be interesting to be at the beginning and the end.

We ask that you keep your oral testimony to five minutes, that we will have adequate time for questions. Your complete written statement will be printed in the official record of the hearing.

Please proceed with your testimony.

**STATEMENT OF TIMOTHY MASSAD, ACTING ASSISTANT SECRETARY FOR OFFICE OF FINANCIAL STABILITY, U.S. DEPARTMENT OF THE TREASURY**

Mr. MASSAD. Thank you, Mr. Chairman.

Chairman Kaufman, Members McWatters, Neiman, Silvers and Troske, thank you for the opportunity to testify today about the continued progress of the Troubled Asset Relief Program.

As this is your last hearing, I want to begin by thanking you and your staff for your hard work in overseeing TARP. Your reports have provided useful insights and your suggestions and questions have helped us refine and strengthen our programs. TARP is a success story today, and it was made possible by the tireless efforts of countless people, not only at Treasury, but also at COP and the other oversight bodies.

And as you noted, there is some irony or symmetry to this moment. I appear before you today as the Acting Assistant Secretary for Financial Stability, but I began my work on TARP with you in December, 2008, when I volunteered as your special legal advisory, to help prepare the first of your nearly 30 reports. It has been an interesting journey for all of us and I'm—think we can fairly conclude that the journey, the program, was successful by any objective measure.

First, TARP helped prevent a catastrophic collapse of our financial system and economy. In the fall of 2008 we were staring into the abyss, now we are on the road to recovery. TARP was not a solution to all of our economic problems, and there is still more work ahead. Unemployment remains unacceptably high and the housing market remains weak, but the worst of the storm has passed.

Second, we accomplished all this using much less money than Congress originally provided and we are unwinding TARP faster than anyone thought possible. Congress authorized 700 billion, but we will spend no more than 475 billion and we have already recouped two-thirds of what we have spent.

Third, the ultimate cost of TARP will be far less than anyone expected. The total cost was initially projected to be approximately 341 billion. According to the latest estimates, both from Treasury and the Congressional Budget Office, the overall cost of TARP will be between 25 and 50 billion and most of that will represent the money we spend to help responsible American families keep their homes.

Finally, our financial system is in far better shape today than before the crisis. It is stronger and on a path to recovery and Congress has adopted the most sweeping overhaul of our regulatory

structure in generations, which will give us tools we did not have in the fall of 2008. This work is not yet complete, but we have made great progress since this panel held its first hearing.

TARP was a bipartisan success. The Bush Administration acted quickly and decisively to stop the panic and when this Administration took office we adopted a broad strategy to restore economic growth, free up credit and return private capital to the financial system. Today people no longer fear that our financial system is going to fail. Banks are much better capitalized and the weakest parts of our financial system no longer exist. The credit markets, on which small businesses and consumers depend, have reopened. Businesses are able to raise capital and mortgage rates are at historic lows.

We have moved quickly to reduce the dependence of the financial system on emergency support. We have already recovered almost all of the funds invested in the banking system. And with this Administration provided funds to particular companies, we did so with tough conditions. Those companies are stronger today and have already—and we have already begun to recoup those investments.

For example, the assistance we provided to AIG, one of the government's most controversial actions, was necessary because the failure of AIG, at that time, in those circumstances, would have been catastrophic to our financial system and our economy. Now barely two years later the company has been restructured and the taxpayers are in a position, potentially, to recover every dollar invested, an outcome that many thought impossible back then.

Similarly, we've provided assistance to General Motors and Chrysler on the condition that they fundamentally restructure their businesses. Our actions helped prevent the loss of as many as one million jobs and have helped restore the companies and the industry to profitability. And we have completed a highly successful initial public offering of GM and we are working to exit our investments in Chrysler and Ally as well.

Finally, I want to address our efforts to help responsibility but struggling American homeowners. By reducing mortgage rates and providing sensible incentives to prevent avoidable foreclosures, our policies have helped hundreds of thousands of families stay in their homes and have helped to change the mortgage servicing industry generally. We have not helped as many homeowners as we originally estimated, and much work remains to be done. But we remain committed to do so, to helping as many eligible homeowners as possible in a manner that safeguards taxpayer resources and we hope the panel will continue to support these efforts.

Mr. Chairman and panel members, TARP succeeded in what it was designed to do. It brought stability to the financial system and it laid the foundation for economic recovery. Our comprehensive strategy and decisive action made our economy far stronger today than it was two years ago. We are proud of our actions and we appreciate all the help you've provided along the way.

Thank you again for the opportunity to testify and I welcome your questions.

[The prepared statement of Mr. Massad follows:]

**Acting Assistant Secretary Timothy G. Massad**  
**U.S. Department of the Treasury**  
**Written Testimony**  
**Congressional Oversight Panel**  
**March 4, 2011**

**Introduction**

Chairman Kaufman, members McWatters, Neiman, Silvers, and Troske, thank you for the opportunity to testify about the continued progress of the Troubled Asset Relief Program (“TARP”).

Today is the last hearing that this Panel will hold, and your work ends as of April 3, 2011. It is therefore appropriate that you are conducting a final review of TARP. I am happy to provide, as you have requested, Treasury’s overall assessment of the impact of TARP on the U.S. economy and financial sector. But before I do so, I wish to thank this Panel, its members, and its staff for their hard work in overseeing TARP. Your reports have provided useful insights and your questions and suggestions have helped us refine and strengthen the programs. The success of TARP is partly due to your vigorous oversight.

I also note that there is perhaps some irony to this moment. It is your last hearing, and my first appearance before you as the Acting Assistant Secretary for Financial Stability, having succeeded to that job as of September 30, 2010. But, I began my work on TARP with you. In December 2008, I volunteered as your special legal advisor and helped prepare the first of your almost 30 reports on TARP. It has been an interesting journey for all of us. And I think we can fairly conclude that the journey—the program—was a successful one.

Two years after Congress created TARP through the Emergency Economic Stabilization Act (“EESA”), we can safely say that this program has been remarkably effective by any objective measure. In the words of this Panel: “There is broad consensus that the TARP was an important part of a broader government strategy that stabilized the U.S. financial system by renewing the flow of credit and averting a more acute crisis...it eventually proved decisive enough to stop the panic and restore market confidence.” We have helped bring stability to the financial system and the economy at a fraction of the expected costs.

First, TARP helped bring our financial system back from the brink and paved the way for an economic recovery. Americans no longer fear that our major financial institutions will fail and cause disruption and damage in the broader economy. Banks are better capitalized, and the weakest parts of the financial system no longer exist. The credit markets on which small businesses and consumers depend—for auto loans, for credit cards and other financing—have reopened. Businesses can raise capital, and mortgage rates are at historic lows. There is still more work ahead, of course. TARP was not a solution to all our economic problems, nor was it designed to be. Unemployment remains unacceptably high; the housing market remains weak. But the worst of the storm has passed and our economy is on the road to recovery.

Second, we accomplished all this with fewer funds than were originally appropriated, and we are unwinding TARP faster than anyone thought possible. Congress originally authorized \$700 billion for the program. We will spend no more than \$475 billion. Of the \$411 billion disbursed to date, we have already received back a total of \$277 billion, including \$241 billion in repayments and \$36 billion in additional income. We expect to receive about \$9 billion more next week. About \$150 billion will then remain outstanding in various investments, and I am hopeful that we will recover most of that amount within the next few years, market conditions permitting.

Third, the ultimate cost of TARP will be far less than ever contemplated. The total cost was initially projected to be approximately \$341 billion. That number has steadily declined over the past two years. The latest estimates, both from Treasury and from the Congressional Budget Office (“CBO”), are that the overall cost of TARP will be between \$25 and \$50 billion. The TARP investment programs taken as a whole – including financial support for banks, AIG, the domestic auto industry, and targeted initiatives to restart the credit markets – are expected to result in very little or no cost to the taxpayer.

And finally, our financial system is in better shape today than before the crisis. We have adopted the most sweeping overhaul of our regulatory structure in generations, which will give us tools we did not have in the fall of 2008. This work is not yet completed either, but we have made great progress since this Panel began its work.

#### **Overview of the Government’s Actions**

Before I review in more detail the impact of TARP and the results of our actions, I think it is helpful to go back to where we were in the fall of 2008, and to review the actions we took then. In September 2008, we faced the risk of a second Great Depression. The forces that led to that moment had been building for years but had accelerated in the preceding six months. We had witnessed the failures of major financial institutions. As the crisis spread, the Bush Administration and the Federal Reserve took a series of unprecedented steps to stabilize a financial system that teetered at the edge of catastrophic collapse. These steps included:

- Provision of broad-based guarantees to the financial system through programs such as the FDIC’s Temporary Liquidity Guarantee Program and the Treasury Money Market Fund guarantee program;
- Initiation of extraordinary facilities through the Federal Reserve to support liquidity across the financial system; and
- Support for Government-Sponsored Enterprises (“GSEs”) pursuant to the Housing and Economic Recovery Act.

But the severe conditions required additional resources and authorities. Therefore, the Bush Administration proposed the Emergency Economic Stabilization Act, which created TARP. A bipartisan coalition in Congress approved the Act on October 3, 2008.

#### **Actions Taken by the Bush Administration under TARP**

The Bush Administration originally proposed TARP as a mechanism for the government to buy mortgage loans, mortgage-backed securities, and certain other “troubled assets” from banks. By early October 2008, lending between banks had practically stopped, credit markets had shut down,

and many financial institutions were under severe stress. It was clear that there was insufficient time to implement a new program in order to buy mortgage-related assets. The Bush Administration determined that the financial system required immediate capital injections in order to stabilize the banks and to avert a potential catastrophe. EESA provided this authority because Congress had broadened the statute during the legislative process.

During the fall and winter of 2008, the Bush Administration employed approximately \$300 billion of TARP authority as follows:

- \$234 billion was invested in banks and thrifts, including \$165 billion in eight of the largest financial institutions (plus commitments of additional funds to two of those banks);
- \$40 billion was invested in American International Group (“AIG”) along with additional funds from the Federal Reserve; and
- Approximately \$20 billion was provided to the auto industry.

The combined effect of the actions taken by Treasury, the Federal Reserve, and the Bush Administration helped to stop the panic and to slow the financial crisis. Despite these efforts, when President Obama took office in early 2009, the financial system remained paralyzed and the economy continued to contract at an accelerating rate.

The nation had already lost 3.5 million jobs in 2008 and was losing additional jobs at the rate of 750,000 per month. Home prices were falling and foreclosures were increasing. Businesses were cutting back on investments and could not raise capital. For individual families who needed credit—to buy a house or a new car—it was more difficult to borrow money than at any time since the Great Depression.

#### **Actions Taken by the Obama Administration under TARP**

Against this backdrop, the Obama Administration, working alongside the Federal Reserve, adopted a broad strategy to restore economic growth, free up credit, and return private capital to the financial system. The Administration’s strategy combined the American Recovery and Reinvestment Act (“Recovery Act”), a powerful mix of targeted tax measures and investments, with a comprehensive plan to repair the financial system.

The Administration’s Financial Stability Plan had three central components:

- to recapitalize and rebuild confidence in the banking system;
- to restart the credit markets that are critical to borrowing for businesses, individuals, and state and local governments; and
- to stabilize the crisis in the housing market.

The Financial Stability Plan shifted the focus away from supporting individual institutions to restarting the broad markets for capital and credit that are critical for economic growth. It was designed to maximize the chance that private capital would bear the burden of solving the crisis. We provided support for the housing market and for homeowners in order to facilitate broader economic recovery. When we did provide extraordinary assistance to individual firms, our assistance came with tough conditions.

The first piece of our strategy was to recapitalize our financial system. Towards this end, we conducted the Supervisory Capital Assessment Program (“SCAP”), or so-called stress tests. The goal of this program was to promote confidence in the markets by providing a greater degree of transparency and institutional accountability. Treasury worked with federal banking regulators to develop a comprehensive, forward-looking stress test for the nineteen largest bank holding companies in order to determine which ones required more capital to remain well-capitalized if economic conditions deteriorated more than expected. The stress test was conducted with unprecedented openness and transparency, which helped restore market confidence in our financial system. Treasury allowed banks needing capital to reapply for further assistance under TARP, but only one did so. The test forced these banks to disclose significant amounts of information about the risks they faced, so that private investors could differentiate among them and assess the underlying financial strength of each institution. Banks raised \$150 billion in private capital, saving hundreds of billions of TARP dollars, restoring market confidence, reopening credit markets, and laying the groundwork for recovery and economic growth.

A second key aspect of the Financial Stability Plan was to commit resources to restart key channels of credit to households and businesses.

- Through the Term Asset-Backed Securities Loan Facility (“TALF”), a joint program with the Federal Reserve, we helped to restart the asset-backed securitization markets that provide credit to consumers and small businesses. Since TALF was launched in March 2009, new issuances of asset-backed securities have averaged \$10.5 billion per month, compared to less than \$2 billion per month at the height of the crisis.
- Through the Public-Private Investment Program (“PPIP”) for legacy securities, we matched TARP funds with private capital to purchase legacy mortgage-related securities. This program returned liquidity to key markets for financial assets and cleaned up the balance sheets of major financial institutions. Since the announcement of PPIP in March 2009, prices for eligible residential and commercial mortgage-backed securities have increased by as much as 75 percent. Although the funds remain in their ramp-up phase, they have earned a positive return for taxpayers.
- Through the SBA 7(a) Securities Purchase Program, we unlocked credit for small business by purchasing securities backed by small business loans. Markets for these securities have since returned to healthy levels.

Finally, the Obama Administration took aggressive steps to address the crisis facing many American homeowners. Our strategy has focused on providing stability to housing markets and giving Americans who are struggling, but with a little help, can afford to stay in their homes a chance to do so. By reducing mortgage rates and by providing sensible incentives to prevent avoidable foreclosures, these policies have put a floor under housing prices and have enabled millions of Americans to stay in their homes.

#### **The Economic Impact of Our Policies**

In any assessment of a response to a financial crisis, there are several important measures of success. What is the effect on availability of credit and economic growth? How quickly is the government able to return the financial system to private hands? What was the direct financial cost of the interventions? Has the response left the financial system able to support—rather than impede—economic growth?

Macroeconomic Impact

Secretary Geithner appeared before this Panel in December to review the economic impact of TARP and the other actions taken by the government in light of these questions. Let me recap our views and then review in more detail the impact of each of the major TARP programs.

At the peak of the crisis, banks were not making new loans to businesses, or even to one another. Businesses could not get financing in our capital markets. Municipalities and state governments could not issue bonds at reasonable rates. The asset-backed securitization markets, which provide financing for credit cards, auto loans, and other consumer financing, had stopped functioning. And where credit was available, it was prohibitively expensive.

In response to the combined actions under TARP and the other government interventions, the cost of credit has fallen dramatically. For businesses, the cost of long-term investment grade borrowing has fallen from a peak of approximately 570 basis points to just 125 basis points over benchmark Treasury securities today.<sup>1</sup> Non-investment grade corporate bond spreads have fallen from approximately 2,200 basis points to 440 basis points over benchmark Treasuries.<sup>2</sup>

American families are spending less on mortgage payments. At the peak of the crisis, a family with an average 30-year, \$180,000 mortgage was borrowing at approximately 6.40 percent a year.<sup>3</sup> Today, that family is borrowing at approximately 4.85 percent, saving approximately \$2,100 each year.<sup>4</sup>

The securitization markets have also restarted. Although volumes have not reached pre-crisis levels, auto lending in particular have recovered, with spreads now below pre-crisis levels.

The economy as a whole has made substantial progress since the recession ended last summer. Real GDP has risen for six straight quarters, and GDP growth was stronger in the fourth quarter of 2010 than in the fourth quarter of 2007. Private sector firms have started hiring again. The housing market remains weak, although certain measures are stabilizing.

Although we can never be sure where we would have been today without these emergency policies, one of the most comprehensive independent analyses of the overall impact of our response, by economists Mark Zandi and Alan Blinder, concluded that without the Recovery Act, TARP, and other government actions, GDP would have still been contracting in 2010 at the astonishing rate of 3.7 percent, unemployment would have reached 16.5 percent, and we would be experiencing deflation. In short, they say, "this dark scenario constitutes a 1930s-like depression."

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<sup>1</sup> Based upon 10-year Treasury yield and FINRA/Bloomberg Investment Grade U.S. Corporate Bond Index yield as of February 25, 2011 according to Bloomberg LP.

<sup>2</sup> Based upon 10-year Treasury yield and FINRA/Bloomberg High Yield U.S. Corporate Bond Index yield as of February 25, 2011 according to Bloomberg LP.

<sup>3</sup> The U.S. average mortgage balance was \$181,225 in 2007 according to the Federal Reserve Bank of Kansas City.

<sup>4</sup> The U.S. 30-year fixed mortgage average rate was 4.85% as of February 25, 2011 according to BankRate (www.bankrate.com).



Impact of Particular TARP programs

Let me now turn to review the status of the various programs and initiatives taken under TARP.

*Support for the Banking System*

We have moved very quickly to reduce the dependence of the financial system on emergency support and to return our financial institutions to private hands as quickly as possible. Under the Capital Purchase Program ("CPP") and the Targeted Investment Program ("TIP"), Treasury invested \$245 billion in our financial institutions, including \$165 billion in eight of the largest financial institutions and an additional \$80 billion in another 700 banks. Treasury further committed to guarantee certain assets of Bank of America and Citigroup under the Asset Guarantee Program ("AGP").

We have already recovered a total of \$243 billion, including \$211 billion in repayments and \$32 billion in additional income from banks. From today on, practically every dollar we recover from these financial institutions will constitute a positive return to the taxpayer, one that we estimate will ultimately total around \$20 billion. When President Obama took office, the U.S. government had made investments in financial institutions representing 75 percent of the entire banking system by assets. Today, our remaining investments in banks represent only about 10 percent of the banking system.

The stress test in particular was critical to facilitating this recapitalization. The 19 banks subject to the stress test have raised \$150 billion in new equity, and 13 of the 17 institutions that received TARP assistance have fully repaid.

Citigroup was one of the largest recipients of TARP assistance; we invested a total of \$45 billion. At the time, many doubted whether Citigroup would survive and be able to repay the government. As of last December, we recovered the entire \$45 billion, and we realized a positive return in excess of \$12 billion on our overall investment. As a recent report by the Special Inspector General for TARP concluded, the government assistance provided to Citigroup was carefully designed and achieved its primary goal of restoring market confidence.

I want to address in particular the status of the smaller banks which have received TARP funds, a subject that this Panel has focused on. While Treasury under the Obama Administration made no further investments in the nation's largest banks, Treasury invested \$11 billion in more than 400 other banks and thrifts, most of which were small and community banks. The Obama Administration focused on small banks not only because EESA required that assistance be made available to financial institutions regardless of size, but also because of the critical role small banks play in our nation's communities. Small banks finance small businesses, which generate a large percentage of our private sector jobs, as well as serve the needs of many families. While it may ultimately take longer for Treasury to recoup its investment in these small banks, the fact remains that without TARP, many more of these institutions (and the communities they serve) would have been in jeopardy.

Today, Treasury maintains investments in nearly 539 small banks and thrifts. Their track to recovery is longer because these institutions have less access to the capital markets and greater exposure to the commercial real estate ("CRE") market. Although these institutions continue to face challenges, there are signs that the sector is strengthening. Over the past year, the CRE market and credit

conditions have shown signs of stabilization and, in some areas, modest signs of improvement. With the launch of the Small Business Lending Fund (“SBLF”), which is outside of TARP, Treasury will provide capital to qualified small banks. Treasury has received many applications from small banks across the country including from eligible TARP recipients who wish to refinance into SBLF. Treasury plans to announce the first round of SBLF investments in the coming weeks.

#### *Stabilizing the Auto Industry*

The Bush Administration provided loans to old GM and old Chrysler in December 2008 to prevent their uncontrolled liquidations and the loss of as many as one million jobs. The Obama Administration thereafter provided additional assistance to these entities.

The restructurings of these companies involved sacrifices from all stakeholders—shareholders, unions, auto dealers, and creditors—and they enabled the companies to become more competitive. This assistance also helped the many suppliers and ancillary businesses that depend on the automotive industry. Our actions saved jobs across the country—as many as one million, by one estimate—and created many new ones.

Our strategy is helping to restore the auto industry to profitability, and we have already begun to recoup our investments. Last week, General Motors reported net income of \$4.7 billion for 2010, its first annual profit since 2004. Chrysler reported four consecutive quarters of operating profit in 2010 totaling \$763 million. Ford’s 2010 net income reached \$6.6 billion, its best level in more than 10 years.

To date, we have recovered a total of almost \$30 billion of the \$80 billion invested in the auto industry (including the Ally securities sold this week). We completed a highly successful initial public offering of General Motors in November of last year. Since the company emerged from bankruptcy in July 2009, the government has recovered almost half of its \$50 billion investment and has reduced its stake in GM from 60.8 percent to 33.3 percent. We now have a pathway to exiting the remaining investment. We also are working to exit our investments in Chrysler and Ally Financial.

#### *Restructuring AIG*

One of the most controversial actions taken by the Government in response to the crisis in the fall of 2008 was the assistance provided to AIG. That assistance was provided because the failure of AIG, in September of 2008, would have been catastrophic to our financial system and our economy. Many doubted whether we would ever recover those funds. Now, barely two and a half years later, we have not only helped restructure the company but the Government is potentially in position to recover every dollar we invested.

Over the last two years, Treasury and the Federal Reserve have worked with AIG as it has taken aggressive steps to stabilize its business and sell non-core assets. As part of this effort, Treasury and the Federal Reserve worked with AIG to recruit an almost entirely new board of directors and several new members of senior management, including the Chief Executive Officer. The management team, in turn, has taken a variety of steps to reduce risk and to focus on AIG’s core insurance businesses.

In January, AIG, the Treasury and the Federal Reserve Bank of New York closed a major restructuring plan, which represented the culmination of two years of efforts to “resolve” AIG. This plan will accelerate the repayment of U.S. taxpayer funds and puts us in a position to recover our entire investment. AIG has since repaid the Federal Reserve \$47 billion and converted Treasury’s preferred stock investment into common shares, providing Treasury a pathway to exit as well.

Since market prices will fluctuate, there is no guarantee of what the ultimate returns will be. However, if we are able to sell our investments in AIG at current market values, including the AIG shares that Treasury received from the trust established by the Federal Reserve, taxpayers will get back every dollar put into AIG and will realize a positive return. This is a dramatic turnaround, and a result that stands in sharp contrast to what most observers expected in the fall of 2008.

#### *Helping Responsible but Struggling Homeowners*

We acknowledge that the TARP housing programs have been the most criticized component of TARP and it is an area where there is still much work to be done. It should be remembered, however, that the forces that created this housing crisis had been building for practically a decade. In particular, when the Obama Administration took office in January 2009, home prices had fallen for 30 consecutive months. Home values had fallen by nearly one-third and were expected to fall by another five percent by the end of 2009. Stresses in the financial system had reduced the supply of mortgage credit and crippled the ability of Americans to buy homes. Fannie Mae and Freddie Mac had been in conservatorship for over four months. Millions of American families could not make their monthly mortgage payments – having lost jobs or income – and were unable to sell, refinance, or find meaningful modification assistance.

The Obama Administration took several actions to confront this situation, including the purchase of agency mortgage-backed securities in order to help keep mortgage rates low, efforts to provide refinancing opportunities to homeowners, and the launch under TARP of the Making Home Affordable (“MHA”) Program to help responsible homeowners avoid foreclosure. The Home Affordable Modification Program (“HAMP”), the largest MHA program, to date, has helped over 600,000 struggling homeowners secure permanent modifications of their mortgages and thereby stay in their homes. These homeowners have reduced their mortgage payments by a median of over \$500 each month, and their total savings to date are approximately \$5 billion. On average, about 25,000 to 30,000 additional homeowners are getting assistance from HAMP permanent modifications each month. Moreover, many more homeowners have been helped indirectly as a result of the standards that HAMP has catalyzed across mortgage modifications industry-wide.

As the housing crisis evolved, Treasury responded with additional actions, including several at the suggestion of this Panel. The Panel’s suggestions that we focus more on the problems of unemployed homeowners and negative equity were particularly valuable. We expanded MHA to address the problem of second liens, to provide incentives for other alternatives to foreclosure such as short sales, to provide additional help to the unemployed, and to encourage targeted principal reduction. In addition:

- Treasury launched the Housing Finance Agency Hardest Hit Fund to help state housing finance agencies provide additional relief to homeowners in the states hit hardest by unemployment and house price declines.

- Treasury and the Department of Housing and Urban Development created the FHA Short Refinance program to enable homeowners whose mortgages exceed the value of their homes to refinance into more affordable mortgages.

Many, including this Panel, have criticized HAMP because it will not achieve 3-4 million permanent modifications. It is important to remember that the program was not intended to help all homeowners or stop all foreclosures. Today, there are approximately 5 million delinquent mortgages. Yet only about 1.4 million are currently eligible for HAMP because the program's eligibility requirements exclude:

- high cost mortgages in excess of \$729,750;
- mortgages on vacation, second homes or investor-owned properties;
- mortgages on vacant homes;
- homeowners who can afford to pay their mortgage without government assistance; and
- homeowners with mortgages that are unsustainable even with government assistance.

In addition to these strict eligibility criteria, and to further protect taxpayer resources, HAMP and most of the other housing initiatives have pay-for-success incentives: funds are spent only when transactions are completed and continue only for as long as those modifications remain in place. Accordingly, most of the funds have not yet been disbursed.

Beyond those immediately helped, TARP housing programs have also had a positive impact on mortgage servicing. At the outset of the crisis, we were faced with a mortgage industry that was ill-equipped and unwilling to respond to the foreclosure crisis. Mortgage servicers lacked sufficient resources to meet the needs of a market reeling from increasing foreclosures. In addition, we had to address the fact that their servicing expertise and infrastructure were focused on overseeing collections and foreclosing on those who failed to pay. HAMP provided servicers with standards that could be applied to all modifications, such as the need to make modifications affordable for the homeowner. As a result, these standards soon became national, industry-wide models that have been applied to many servicers' own proprietary modifications as well.

Over the past two years, we have developed policies and procedures in the MHA program to ensure that responsible homeowners who meet the eligibility criteria are offered meaningful modifications, or where appropriate, other alternatives to foreclosure. To address servicer shortcomings, we have urged servicers to increase staffing and to improve customer service. We have developed specific guidelines and certifications on how and when homeowners must be evaluated for HAMP and other options before foreclosure. We developed a defined process for escalating homeowner complaints to be resolved promptly and fairly. We also have a comprehensive compliance program to ensure that homeowners are fairly evaluated for HAMP and that servicer operations comply with Treasury guidance.

We have faced many challenges in developing and implementing these programs. We often have to balance conflicting policy goals—such as how to design programs that encourage the participation of struggling borrowers and help them get back on their feet, while minimizing the cost to the government, moral hazard, adverse selection, and operational and financial risks and complexity. Implementation has been difficult, and much work remains to ease the housing crisis. But that should not obscure the importance of what has been accomplished, nor the fact that these programs can continue to help ease the pain of this terrible crisis. Millions of families have avoided the intense

pain, cost, and disruption of losing their homes because of these programs. Their neighbors and their local communities have benefited as well since a vacant home is dangerous and costly to a neighborhood.

We will continue to help as many eligible homeowners as possible, in a manner that safeguards taxpayer resources, and we hope that the Panel supports that effort.

### **Reform**

It is important to also take stock of the fact that our financial system is stronger today. Our response to the crisis has brought about a fundamental restructuring of the system. The weakest parts of the financial system no longer exist. The large firms that remain were subjected to a stress test that demonstrated their viability without government assistance. Our financial system today has substantially higher levels of capital relative to risk than before the crisis and is also better capitalized than its international competitors. And the Dodd-Frank Act has provided the government with critical tools it did not have during the crisis – including the ability to wind down firms that pose a significant threat to our financial system.

### **TARP Achieves Results at Fraction of Anticipated Costs**

In terms of direct financial cost, TARP will rank as one of the most effective crisis response programs ever implemented. Independent observers, such as the CBO, initially estimated that TARP would cost \$350 billion or more. Now, because of the success of the program, TARP is likely to cost only a fraction of that amount. Most recently, CBO estimated that the cost of the program would be as little as \$25 billion.

The cost of TARP is likely to be no greater than the amount spent on the program's housing initiatives—expenditures that were necessary to prevent even greater losses and hardships to American families and local communities and that were never intended to be returned. The remainder of the programs under TARP—the investments in banks, AIG, credit markets, and the auto industry—likely will result in very little or no cost.

Furthermore, the cost of the government's broader response efforts is remarkably low when compared to past systemic crises. An IMF study found that the average net fiscal cost of resolving roughly 40 banking crises since 1970 was 13 percent of GDP. The GAO estimates that the cost of the U.S. Savings and Loan Crisis was 2.4 percent of GDP. In contrast, the direct fiscal cost of all our interventions, including the actions of the Federal Reserve, the FDIC, and our efforts to support the GSEs, is likely to be less than one percent of GDP. The true cost of this crisis to the economy, however—the jobs, wealth and growth that it erased—is much higher than previous crises, but that damage would have been far worse without the government's emergency response.

### **Robust and Effective Oversight**

TARP has been subjected to unprecedented oversight since its inception. Treasury welcomes this oversight. This Panel has issued nearly 30 reports on all aspects of TARP and its component programs. These reports have made important contributions to the development, strength, and transparency of TARP programs.

This Panel also encouraged transparency as a tool to maximize the effectiveness of TARP programs and Treasury has taken many steps which we believe have made TARP one of the most transparent programs in the federal government

EESA required that there be separate, audited financial statements for TARP. In its first two years of operations, TARP's financial statements received unqualified ("clean") audit opinions from the GAO, and separate reports on internal control over financial reporting found no material weaknesses—unprecedented achievements for a start-up operation with an extraordinary emergency mission. As a result of these efforts, the Office of Financial Stability received a Certificate of Excellence in Accountability Reporting ("CEAR") from the Association of Government Accountants.

Treasury has also published hundreds of comprehensive reports and other information about TARP so that the public knows how its money was spent, who received it, and on what terms. This includes:

- A monthly report to Congress that details how TARP funds have been used, the status of recovery of such funds by program, and information on the estimated cost of TARP;
- A monthly housing report containing detailed metrics on the housing programs;
- A quarterly report on the PPIP program that provides detailed information on the funds, their investments, and returns;
- A report on each transaction (such as an investment in or repayment by an institution) within two business days of completing the transaction;
- A quarterly report that details all dividend and interest payments;
- Periodic reports on the sale of warrants, which includes information on auctions as well as on how the sale price was determined in the case of any repurchase of warrants by a TARP recipient;
- Monthly lending and use-of-capital surveys that contain detailed information on the lending and other activities of banks that have received TARP funds;
- A list of all the institutions participating in TARP programs and of all the investments Treasury has made; and
- Releasing every contract and financial agency agreement it has entered into.

Treasury also agrees with this Panel that it is in the public interest to provide periodic disclosure of the estimated value of the TARP portfolio so that the public knows the value of the investments that Treasury has made. Treasury publishes valuations of the TARP investments in its annual financial statements and periodically during the year. Treasury has recently prepared new disclosures in its monthly reports that make it easier to track TARP funds and the current cost of the programs.

### **Conclusion**

TARP succeeded in what it was designed to do: it brought stability to the financial system and laid the foundation for economic recovery. And it did so at a fraction of the expected cost. TARP was not designed to solve all our economic problems. The damage from this financial crisis has not yet been completely repaired, and many American families are still struggling in its aftermath. We will continue to manage our exit from our remaining investments in the interest of the taxpayer and the recovery. Nevertheless, today, thanks to a comprehensive and careful strategy to address the financial crisis, we are in a much stronger position to address remaining economic challenges.

The CHAIRMAN. Thank you, Mr. Secretary. There's a lot of different reasons for this hearing and the last hearing and this report we're going to come out. And we're going to go back in history and what happened and the rest of it. What I'd like to focus today in my questions, as I said in my opening statement, is kind of what have we learned. What are the lessons learned? What—kind of—you know, we get in this kind of situation again, coming back, what did we learn?

Now this is difficult to do because when TARP was originally set up, as I said in my opening statement, you—everybody at Treasury, everybody at the Fed was under incredible pressure. I mean the place was going down and going down fast. A lot of decisions were made. And I'm—this is not—I'm not here to be a Monday morning quarterback and go back and look at those decisions, although I'm sure other panel members will ask that and it will be in our report.

But in term of lessons learned, going forward, if in fact you were summing up, we made some mistakes and things didn't turn out the way we wanted to, in the area of moral hazard, which everyone, I think, has referred to, what do you think? What does Treasury believe could have been done, would have been done or you would do differently if, in fact, you were faced with this problem again, to mitigate the moral hazard?

Mr. MASSAD. Mr. Chairman, that's a very good question and something we've thought a lot about. I think the main lesson we learned is that we did not have the tools to deal with this crisis, at the time. And that is what, unfortunately, necessitated this program, which no one really wanted to have to do but we had to do it. We have now passed Dodd-Frank, the most comprehensive overhaul of our regulatory system, which I think gives us a variety of tools that should enable us to minimize and prevent these sorts of conditions again.

Now, much work remains to implement that. But to me that is the principal lesson that we learned and that is the principal way we are trying to address the moral hazard issue, which many of you have, so rightly, noted.

The CHAIRMAN. I mean just for the record, specifically what in Dodd-Frank do you think would reduce moral hazard?

Mr. MASSAD. Well, I think the fact today that we have resolution authority, with respect to non-bank institutions, the fact that we have a manner for regulating systematic risk, the fact that we have the Office of Financial Research, Financial Stability Oversight Council, we have higher capital standards. All of those measures, I think, enable us to say that we now have the tools to try and prevent and minimize the effects of crises like this in the future. And therefore, render the sort of assistance we had to provide under TARP unnecessary.

The CHAIRMAN. How about the method of the assistance?

Mr. MASSAD. I'm sorry?

The CHAIRMAN. How about the method of the assistance, how would that have changed with Dodd-Frank? How would you—would you have done it differently?

Mr. MASSAD. Well, I think Dodd-Frank, for example, gives you the tools to dismember a non-bank financial firm. We didn't have

that, that was one of the problems with the situation we confronted with AIG. So I think now we have that authority.

The CHAIRMAN. And do you have any idea why most people believe, and you listen to economists talk about it of all parts and spectrum believe that we still have banks that are Too Big to Fail, that our major financial institutions that are Too Big to Fail?

Mr. MASSAD. I think obviously the moral hazard issue is a very serious one and it's one we have to continue to look at and address. I think though, the focus should be now on implementing Dodd-Frank.

The CHAIRMAN. No, I got that. I'm just—and I understand that, but I'm just trying to figure out what you learned, that specifically you would do. And you're saying essentially you have implemented—you have, in Dodd-Frank, all the things that Treasury would like to have had that could have helped them resolve this and eliminate—

Mr. MASSAD. I don't know.

The CHAIRMAN [continuing]. Eliminate moral hazard or mitigate moral hazard.

Mr. MASSAD. Mr. Chairman, I guess I would say we have all the tools Congress decided to give us.

The CHAIRMAN. Yeah. Well that's—this is your chance to tell—to say—this is your chance to lay out everything that wasn't included in that bill that you would have liked to have had, if in fact we were moving forward with this.

Mr. MASSAD. Well, I don't know that I want to re-litigate the battle over Dodd-Frank. I think the main thing is that we did achieve, in a very short time, a dramatic overhaul and I think our focus should be on implementing that. Now, we may, at a future date, look at was that enough, do we need to do more. I think those are very good questions and we'll continue to address those.

The CHAIRMAN. How about—you know, one of the—and again, I think most of the panelists mentioned this, there is a widespread perception, not perception, I think it's personally a reality, that Main Street did a lot worse than Wall Street on this. Are there some things that TARP, that Treasury could have done in the beginning of this program to kind of—more better balance between what was going to Main Street, the benefits would accrue to Main Street as opposed to Wall Street?

Mr. MASSAD. I guess I would say this, Mr. Chairman. I think the main benefit to Main Street of this program was that we did stop the panic. And again, when I say “this program” I should say in conjunction with all the other actions that were taken, because it wasn't just TARP, but we did stop the panic and we did prevent a second Great Depression, which could have resulted, as many economists have estimated, of rates of unemployment of 16 percent, 20 percent possibly even higher. It also allowed us to start to get credit flowing again. Those are the main benefits to Main Street.

Now obviously particular programs also had direct benefits. Under the Capital Purchase Program we invested in 400 to 500 very small banks, banks that small businesses and communities depend on.

I agree with you that the perception was that this program provided support to Wall Street and many people didn't think it did



much for them. I understand that. This is still a very tough economy and people that are unemployed or in danger of losing their homes feel that way. We understand that and that's why I say there's still a lot of work to be done.

The CHAIRMAN. I'll revisit this, but it's not a tough economy on Wall Street. It's a tough economy everywhere else, but it's not a tough economy on Wall Street.

Mr. McWatters.

Mr. MCWATTERS. Thank you, Senator. And welcome again, Mr. Massad.

Following up on Dodd-Frank, if I may quote and I hope I'm not quoting out of context, which is always a risk here, Professor Stiglitz's testimony. He says, "Resolution authority has made little difference because few believe that the government will ever use the authority at its disposal with these Too Big to Fail banks."

So we have Dodd-Frank, we have a blueprint to take down not only financial institutions, which we had the authority under FDIC to do before, but now AIG and others. Will there be the courage in a time of panic to actually do this, to actually take them down, as opposed to just simply writing a check with another bailout?

Mr. MASSAD. Mr. McWatters, I would certainly hope so. And I believe now that these tools are very good ones. But obviously it remains to execute on this, it remains to promulgate the regulations necessary and to act. And it will require regulation that is nimble. It will require regulation that is responsive to changes in the industry as we go forward. But I think we've come a long way and I think we should give these tools a chance to work before we judge.

Mr. MCWATTERS. And I know in one of the footnotes to my opening statement I make the observation that there was not the courage to take down some of the most insolvent financial institutions in early to mid 2009. I don't mean the last quarter of 2008 when the markets were frozen, okay, that might unto itself have sent a different message. But once the markets had stabilized in the last quarter of 2008, begun to stabilize more in 2009 and certain institutions came back and said, "You know, oh by the way, we're still insolvent, we're still insolvent by the tune of many billions of dollars," at that point there were rules on the books of the FDIC to take down these institutions and they were not.

So it really makes me question that now you have new rules for new institutions, when it comes right down to it will this happen or will simply more checks be written and as more questions are written, more moral hazard will be created. Any thoughts on that?

Mr. MASSAD. Certainly. You refer to events in 2009, the Obama Administration did not provide a single dollar to a large bank. Most of the money provided to the banks was provided under the Bush Administration, decisions with which I agree. I think they made the right decisions under the circumstances, though I was not involved in those. The Obama Administration provided \$11 billion in additional funds to banks, most of that went to small banks. Where we provided assistance to additional firms, we did so with tough conditions. I think if you look at what we did with the auto industry, we imposed some very tough conditions that required them to restructure. Those companies—GM is now profitable, post-

ed the first full year profit since 2004. Chrysler has an operating profit.

So I don't think there was a lack of courage. I think we acted very forcefully and decisively.

Mr. MCWATTERS. Yeah, but there were other actions going on underneath the surface, underneath TARP, which admittedly TARP was grabbing most of the headlines, that the FDIC was taking certain actions, the Federal Reserve was taking certain actions. Quantitative easing, one where the Federal Reserve purchased a trillion plus dollars of mortgage-backed securities, government-backed, mortgage-backed securities which would not have been purchased at a fair market value if Fannie and Freddie had been permitted to fail. So the bailout of Fannie and Freddie seems to me to have a direct correlation to the health of financial institutions and their ability to pay back the funds. So I mean there were a number of things going on here.

Mr. MASSAD. Be happy to respond to that. You've raised a number of interesting points. First of all, I agree with you and with your opening comment that one must look at the cost of this, in terms of all the government programs, not simply TARP. But when you do that, the overall cost currently estimated is at about one percent of GDP, which is far less than the cost, for example, to resolve the S&L crisis.

Secondly, you mentioned pricing of credit. In a crisis the government is acting because private capital isn't flowing. So we are pricing that under what the market would otherwise charge, because the market isn't stepping up. The trick is to still price it properly so that we don't encourage excessive reliance on it, number one, and to impose conditions so that we don't create a bigger moral hazard problem than is necessary. I agree that any government assistance comes with a moral hazard problem. But I think we did that and I think, again particularly when the Obama Administration launched the stress tests and provided the Capital Assistance Program, we said that is going to come with very tough conditions. No one took the money.

Mr. MCWATTERS. My time is about up, but I'll just leave it by saying that I think that there were some private market participants. Mr. Buffett and another—among others who, you know, cut better deals. So.

The CHAIRMAN. Thank you.

Mr. Silvers.

Mr. SILVERS. Mr. Secretary, first before I ask you any questions I wanted to just expand a moment on my opening remarks in respect to your work and the work of your predecessor.

I think it's no secret that I have been critical of the economics of TARP transactions, but I want to, on the record, commend you and your predecessor for the work you've done since the spring of 2009 in managing—in a.) in managing TARP's—the TARP assets that you, so to speak, inherited and in the execution of the transactions that occurred since you and your predecessor came to work managing the TARP. I think particularly of the improvement in the economics from the public's perspective of the warrant repurchases and the way in which both Citi and AIG's investments have been managed, as purely as investment assets. So I want to make clear

that I think you all have done a fine job in that respect and the overall cost numbers that you've been citing are substantially driven by that achievement.

Now I want to turn to I think the exchange you just had with my colleague, Mr. McWatters, because I think that it's important in this final hearing to maybe shine a light on a couple of key moments in the history of the TARP. Do you agree that when the Obama Admin—I take your point and I've noted it for a long time, that under the Obama Administration there was not significant additional capital infused into large banks. Do you agree though, that there was a set of decisions made by the Obama Administration about what to do about the large banks and the government's investments in TARP in the early months of the Obama Administration?

Mr. MASSAD. There were decisions made by Treasury and by the regulators. But as you note, with respect to the Obama Administration and Treasury in particular, under TARP, we inherited those investments and our focus was on managing those investments and exiting them. The regulators really had the primary responsibility to look at the health of those institutions and—

Mr. SILVERS. Mr. Secretary, that's not exactly what I was asking you.

Mr. MASSAD. Okay.

Mr. SILVERS. The Treasury Department released a plan in the early spring of 2009, which included the stress tests, the stress tests were the centerpiece of that plan.

Mr. MASSAD. Yes.

Mr. SILVERS. All right. The regulators executed that plan in substantial part, but it was an Administration and Treasury Department plan.

Mr. MASSAD. Absolutely.

Mr. SILVERS. Is that correct?

Mr. MASSAD. Yes, that's correct.

Mr. SILVERS. Now, that plan appears to me to represent a key strategic decision moment, right, for the Administration. Can you explain a little bit about—can you amplify that a little bit if you agree that that's true, about what those strategic decisions were that were made at that moment—

Mr. MASSAD. Certainly.

Mr. SILVERS [continuing]. By the current president's administration?

Mr. MASSAD. Certainly. It's a very good question. A central component of the financial stability plan was to recapitalize the financial system with private capital as efficiently as possible. And to do that we worked with the regulators to formulate the stress test for the largest 19 bank holding companies. And those tests were done with extraordinary and unprecedented transparency, because without those tests the market was not willing to reinvest in these institutions.

I think the record of those stress tests and what followed is evidence of the success. Banks were able to raise a large amount of private capital following the results of those tests. So I think it was a very good strategy and executed successfully.

Mr. SILVERS. I would just observe that I think the nub of Mr. McWatters' dispute with you and perhaps another my—of my evaluation of TARP has to do with that moment and that set of decisions, in respect to the question of restructuring banks and the like. I don't want to spend what time we have arguing about that, but I want to make clear on the record that that, I think, is the key question.

Can I just ask you, before my time has expired, what are your, going forward as this panel goes out of business, what are your greatest concerns? What worries you, both about TARP and about the issues TARP was designed to address, financial systemic stability?

Mr. MASSAD. I'm very focused on our housing programs. We have not helped as many people as we would like. But I think the programs are very important and continuing to help tens of thousands, and I'm very concerned about efforts to eliminate those. I think without those programs many, many Americans who otherwise could be helped into an affordable mortgage will not have that opportunity to do so.

Secondly, I'm very focused on managing and exiting our remaining investments as quickly as we can. I think it's very important to get the government out of the business of owning stakes in private companies. I think we've got a very good record there, we've made a lot of progress, but we still have more work to do. And in particular, with respect to our smaller banks, their path to recovery has been a little harder and we need to continue to work with them on that.

Mr. SILVERS. All right. Thank you. My time has expired.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you. I better turn on my mic. Thank you.

I want to come back to one—hopefully come back to some of Damon's and Mark's questions about stress tests, but I wanted to start by talking more about TARP mandate.

As you know, in addition to the core goal of restoring stability and liquidity to the financial system, the legislation directed Treasury to consider such goals as maximize overall returns and minimize the impact of the national debt, protect American jobs, savings and retirement security, help families keep their homes, stabilize communities, and on and on.

Do you think that TARP, the mission of TARP was too broad? And do you think that this broad mandate clearly, I think a number of people have indicated, in terms of stemming the financial crisis, many people would agree that it would be a success. We are going to hear from some economists later. It's these other things that seem to be where the economy is still struggling. And by trying to throw all of that into a single piece of legislation, do you think that in some sense that doomed TARP to get the stigma that it has today?

Mr. MASSAD. That's a very good question, Mr. Troske. We interpreted the considerations that you've referred to as things that we should take into account in how we went about executing the authorities we were given. The authorities we were given were narrower than that. The authorities we were given were to purchase troubled assets from financial institutions. We weren't given \$700

billion and told—reduce the unemployment rate in any way you see fit. We were given a specific mandate to promote the stability and liquidity of the financial system. We were given the authority to do that through the purchase of troubled assets. And in doing so we were supposed to take those other considerations into account.

I agree with you though, that because of the breadth of those, many people did feel it was up to TARP to resolve all of these economic problems, very important economic problems that we need to resolve. But I don't think it was the job of TARP to do that alone.

Dr. TROSKE. And I guess, I mean do you think Treasury has done a good job of communicating its actions regarding TARP to the public? You know, are there areas or programs within TARP where Treasury—you feel Treasury could have done a better job articulating its objectives, similar to what you just said to me?

Mr. MASSAD. Sure. Again, a very good question. I think we certainly could have done a better job explaining what we were doing, explaining why we were doing it. I think there is a tendency, where you're very focused on a crisis like this and taking action, to assume that people know a lot about what you're doing or know more than they may know. You know, I recognize most people in this country don't follow what goes on in Washington day by day the way many of us who live in Washington do. They're focused on their families, their homes, their jobs, keeping their homes, keeping their jobs, getting their kids through school. And yeah, we certainly could have done a better job communicating what we were doing.

Dr. TROSKE. I want to return to the questions about the stress test. So I don't know whether you saw there was a column in Wednesday's New York Times alleging that banks supplied the measures that were used in the latest round of stress test, ensuring that they would look good and rendering the tests rather meaningless.

I think part of this comes from the fact that these latest rounds of stress tests, the results have been kept somewhat private and were not as public as the first time around. And I guess I want you to maybe address why, and obviously this is the Fed's decision, not Treasury's, but whether Treasury pushed the Fed to make them public, what are the benefits and costs from making these results public and do you have any idea why the Fed has tended to think that the benefits were less than the costs in making the results public.

Mr. MASSAD. Well as you know, the current round of stress tests is being conducted by the Fed. It was designed by the Fed. I had no involvement in it and Treasury generally did not, to my knowledge. So I can't really answer why the Fed structured it the way they have or their decisions about what they were going to publicize. Other than the fact that, I would note the following: Traditionally bank supervisory information and the testing that our regulators do, and they do it on an ongoing matter, is not made public. The exception was the stress tests of the spring of 2009. And we did that at that time, just given the gravity of the crisis.

Dr. TROSKE. But as you noted, you attributed a lot of success to that. One would have thought we would want to follow up with that success.

Mr. MASSAD. Well, I think again, one has to do extraordinary actions in a crisis and I think in the crisis it was appropriate to conduct those stress tests with the transparency with which we did.

But I think there are good reasons why we have a model in this country of bank regulation and supervision in which a lot of the detailed information is not made public, but certain conclusions and other information is made public.

Dr. TROSKE. I'll note that we—one of our later panelists is a Nobel Prize winning economist who won his Nobel Prize for his work on asymmetric information so I think it's going to be interesting to hear his take on keeping information secret.

Mr. MASSAD. I look forward to that. Unfortunately I cannot stay, but I look forward to reading the transcript later, of both the panels that follow.

The CHAIRMAN. We will send you the transcript.

Superintendent Neiman.

Mr. NEIMAN. Thank you.

Mr. Massad, thank you very much for your role. I was here when you volunteered your work on the COP panel, which was very helpful at the time. I also very much appreciate the fact that you continued in that role when asked to serve by the Treasury Department. I also want to acknowledge the work of your predecessor, Herb Allison for his efforts and his coordination with this committee.

I want to follow up with your answer to Damon's question about what worries you the most. The first point you mentioned was related to the housing programs and your concern that those could be eliminated.

This is my area of interest because this week there were calls from lawmakers to eliminate Treasury's foreclosures mitigation programs. Some have referred to the approximately \$50 billion set aside to American homeowners, as a waste of money. But few mention that very little of the money has actually been spent, and that lack of spending frustrates those of us who believe that effective government investment into the housing market is essential for further financial stability and economic recovery.

But with only \$1 billion spent on the HAMP so far, as estimated by the CBO and nearly 600,000 mortgages permanently modified, it's difficult to conclude that HAMP has been a waste of money. Even just as a back of the envelope estimate, that's around \$2,000 per permanent mod and we know that there are certainly other more complicating factors, re-default rates and servicer incentives and the role that the GSEs have played.

But, could you comment, from a cost benefit of analysis—

Mr. MASSAD. Sure.

Mr. NEIMAN [continuing]. As to the value of those dollars spent on those 600,000 permanent mods?

Mr. MASSAD. Sure. I think it's been dollars very well spent. First of all, let me say that the money, as you know, is spent over time for once there is a permanent modification of a mortgage, the payments are made over time as long as the homeowner continues to make his or her payments. And you know, we estimate basically that over time a permanent modification will cost the government about \$20,000. So we'll see that number go up and as long as we

can continue to roll out the program we expect that, you know, more people will enter. We're getting 25,000 to 30,000 additional permanent modifications a month.

Keep in mind also that we have reallocated some of that \$50 billion, it's actually \$46 billion total, but we reallocated some of that to other programs, to the Hardest Hit Program, to the FHA Short Refinance Program and there are other subprograms within Making Home Affordable. So we're looking at the total cost that we think will be spent, it will be below the \$46 billion, but it will be significantly higher than where we are today, of course.

Mr. NEIMAN. Could you talk to the benefits of those programs, both to the borrowers, I think—

Mr. MASSAD. Sure.

Mr. NEIMAN [continuing]. Which are more obvious, but also to the underlying economy?

Mr. MASSAD. Certainly. You know, this is the worst housing crisis that we've seen since the Great Depression and what we're trying to do through these programs is to help people modify their mortgage where it makes economic sense to do so. And by doing so you avert a lot of costs. A foreclosure, for any family that goes through it, is obviously a terrible economic loss, it's also a great social and—or great psychological and emotional loss. It's a loss to the community, the community suffers from it because neighboring house prices fall, particularly where you have a vacant home that can be then subject to vandalism, that hurts the community.

So, you know, this situation is a drag on our economy as a whole. So the more that we can help people get into sustainable modifications, which is the focus of our program, it's not simply kicking the can down the road, as some people have alleged, we're helping people get into a sustainable situation, I think our country is much better off.

Mr. NEIMAN. And before my time expires, could you comment on the impact of ending those programs would have on the economy?

Mr. MASSAD. Certainly. I think it means that tens of thousands of people that could otherwise get help directly will not get that help. In fact more—

Mr. NEIMAN. And what of the impact on non-HAMP mods? Do you see a direct correlation—

Mr. MASSAD. Absolutely.

Mr. NEIMAN [continuing]. If the HAMP program ended?

Mr. MASSAD. I think—excuse me. Absolutely. I think one of the things that our program has done is it has set standards that have now been followed by the industry widely. There were no modifications getting done prior to the launch of this program. We've set standards, not only for how do you do a sustainable modification, what should be its terms, but also standards for borrower protection. Dual track, for example, the procedure where some of the servicers were talking to a homeowner about a modification at the same time that they were foreclosing. It's very, very confusing to the homeowner and very frustrating.

Mr. NEIMAN. And the elimination of that program could certainly jeopardize the standardization, the focus on those?

Mr. MASSAD. Absolutely. Absolutely.

Mr. NEIMAN. Thank you. My time has expired.

The CHAIRMAN. Thank you.

Just to finish up on the moral hazard. I saw a quote, because as you—as everybody’s pointed out, it’s really a government problem. I saw a quote by Secretary Geithner and I just thought—right here in Financial Times, on January 14th, he said, “In the future we may have to do exceptional things again if we face a shock that large. You just don’t know the systemic, not until you know the nature of the shock.”

Is this kind of backing away from the fact, no time, no way, no are we ever going to bail any bank out again?

Mr. MASSAD. Chairman, it’s a very good question. The Secretary—I’ve talked to the Secretary about that statement—

The CHAIRMAN. Yeah.

Mr. MASSAD. And he was referring to the use of the tools under Dodd-Frank. I think it’s clear that we don’t know what the next crisis will be. And as I said earlier, we believe that the tools that we now have under Dodd-Frank give us the ability to minimize the effects, but it requires, as I say, effective implementation and use of those tools.

The CHAIRMAN. Is there any concern that—widespread belief that there still are banks Too Big to Fail. The market seems to indicate by the spreads that they give to the larger banks, that they’re Too Big to Fail, that people all over the world are trying to figure out. I know there’s a new study going to come out on resolution authority across borders, which has not been dealt with in Dodd-Frank and would be an incredible problem. Does any of that kind of concern you in terms of moving forward, with moral hazard?

Mr. MASSAD. Certainly concerns me. I think the moral hazard issue is obviously a very, very significant one. And as you all have noted, it’s a very significant issue in light of what we had to do under TARP. But, again I think it’s up to us now to take the tools that Congress has given us and work to minimize that risk.

The CHAIRMAN. One of the frustrations I think that people—I mean not just people, everyone has, it’s not just me, everyone, and that is the fact that, you know, we went in, we helped out the banks, we helped out the corporations and then the jobs just didn’t come, the investment didn’t come, the banks held on to the money, they’re still not investing the money, the corporations didn’t invest the money. Is there some way that TARP could have been structured to—I mean it sounds an awful lot like trickle down to a whole lot of people that didn’t trickle.

Mr. MASSAD. Um hmm.

The CHAIRMAN. And so is there any way that you think, looking back on it, that TARP could have been structured so that it would be a better chance that we’d actually get economic growth and jobs for small business and for regular people?

Mr. MASSAD. I think that the key thing was that TARP alone wasn’t enough.

The CHAIRMAN. No, I mean but again, we’re just focusing on TARP.

Mr. MASSAD. Um hmm.



The CHAIRMAN. Could TARP have been structured, do you think, in some way so that we would have at least mitigated that if not eliminated it?

Mr. MASSAD. Yeah. You know, I think policymakers, historians, probably this panel will explore that issue. I think it's one we should explore. Sitting here today, you know, I'm very focused on—

The CHAIRMAN. Right, I got it.

Mr. MASSAD [continuing]. Exiting the program and wrapping it up.

The CHAIRMAN. One final thing. But one of the simple things was the panel I know right in the beginning said that there should be better support tracking of funds. And I know we've been concerned about the transparency of tracking where the funds went. Do you think, in retrospect, again the time, it was a tough time, everybody's running around. But now looking back in the calm of two years, two and a half years later, do you think maybe it would have been a better—good idea to track the funds better?

Mr. MASSAD. Well, you know, we implemented the recommendations of SIGTARP in this regard. It was done, you know, later after a lot of the money went out the door.

You know, on the lending point though, I would simply note, as I think this panel noted in a very excellent report, that the lending issue is not simply a supply of capital issue, it's also a demand issue, it's also a regulatory issue. In other words, the level of lending in this country and how you get that back up. And you're going to see that fall in a recession.

So these are complex problems and while it may be that we could have done things differently under TARP, I think that, you know, the focus now should be to work with the tools we have and try to process—

The CHAIRMAN. No, I have that. What I'm trying to get at is kind of a history so that if we go, start over again, god forbid anything like it should ever happen again, we're not starting without some of the best suggestions. So my question—and you can think about that, maybe you want to get back to me on that, kind of what are some of the things that we could have done to have mitigated that.

Mr. McWatters.

Mr. MCWATTERS. Thank you, Senator.

If I may, I will go back to the written testimony of Professor Stiglitz, first page, and I'll read a quote and would like to hear your comments. Towards the bottom of the first paragraph Professor says, "The normal laws of capitalism where investors must bear responsibility for their decisions, were abrogated. A system that socializes losses and privatize gains is neither fair nor efficient. Admittedly, the big banks were given money—were given many enormous gifts,"—and he uses the term gifts—"of which TARP was only one. The United States government provided money to the biggest of the banks in their times of need, in generous amounts and on generous terms but have been forcing ordinary Americans to fend for themselves."

Would you care to comment on that?

Mr. MASSAD. Certainly. Well, first of all, I agree that we need to have a financial system where firms can fail, regardless of how big

they are. The question is, when you were in the midst of the crisis that we faced, in the fall of 2008, what should we have done? And again I think the actions taken were appropriate in light of the situation that we confronted and the tools we had. But we obviously have to work toward a system where that never becomes necessary again and where firms do fail if they have taken excessive risks.

Mr. MCWATTERS. Okay. Moving to the testimony of Professor Zingales. Page 3, I read from the last full paragraph of the page, “TARP was the largest welfare program for corporations of its—and their investors ever created in the history of humankind. That some of the crumbs have been donated to auto worker unions does not make it any better, it makes it worse. It shows that this redistribution was no accident, it was premeditated pillage of defenseless taxpayers by powerful lobbyists.”

Do you agree with that or do you not agree with that?

Mr. MASSAD. I don’t agree with that.

Mr. MCWATTERS. Okay. On what basis?

Mr. MASSAD. Again, I think that we were confronted with an extraordinary situation in the fall of 2008 and we took actions that were necessary to prevent the collapse of our financial system which would have had terrible effects for everyone in this country. And I think the actions we took succeeded in doing that.

Mr. MCWATTERS. You know, I don’t think—my time is up, but I don’t think either one of these gentlemen is saying that in October of 2008 the response by the United States Government was to do nothing. Okay? But it’s more of a nuance issue as to, okay, once the meltdown threat is over, just a few months later, which from our recollection, then we need to be able to turn on a dime and maybe apply the rules somewhat differently.

But, my time is up and I’ll end there.

The CHAIRMAN. Thank you. Mr. Silvers.

Mr. SILVERS. Mr. Secretary, we’ve had a lot of conversations in this room and privately with the Treasury Department which kind of end with the issue of, well, with the problem of, “Well that would be a good idea to do but we don’t have the power to do it.” In that vein, as you look at the powers you have and don’t have to manage TARP going forward after this committee disbands, and with the notion that Congress is listening, what powers would you like to have that you don’t have?

Mr. MASSAD. Well, I guess I’ve assumed we’re not amending the TARP at this juncture

Mr. SILVERS I assume we’re not either. I’m trying to build a record. [Laughter.]

Mr. MASSAD. You know, I think the work that remains to be done, particularly in the area of housing, is obviously critical.

Mr. SILVERS. Yes.

Mr. MASSAD. And as you know—

Mr. SILVERS. So let’s take housing. I mean I think we—I think a lot of us agree on that and agree with, I think, the—I think the sentiments you expressed a few minutes ago, which I hope that you and your colleagues keep repeating.

So let’s take housing. You’ve got agreements, you’ve got a legal structure with the HAMP participants. If you could rewrite those agreements today, knowing what you know, what would you do?

Mr. MASSAD. Well, if we were to rewrite the agreements, again within the framework of the powers we have, we would have simply—

Mr. SILVERS. Assume someone gives you a magic wand, what would you do with it? [Laughter.]

Mr. MASSAD. You know, it's just difficult to answer the hypotheticals in terms of rerunning the history. In terms of going forward—

Mr. SILVERS. Going forward, yeah.

Mr. MASSAD [continuing]. I think there, you know, I will leave it to the Congress. I don't mean to dodge the question, but I think there's a variety of things that have been considered. They range from the simple ones, which I know you've taken an interest in, that we concluded we couldn't even use TARP funds, for example, to pay for legal aid and broad counseling in the housing program, because—

Mr. SILVERS. But would it be a good idea to do that?

Mr. MASSAD. Yes.

Mr. SILVERS [continuing]. I mean I'm not—I know that—

Mr. MASSAD. We supported the legislation to do that. And it didn't go anywhere.

Mr. SILVERS. So that's one that's item one.

Mr. MASSAD. That's a small one. That's a small one. You know, I think there are a range of things, such as cram down or reform of the bankruptcy codes so that, you know, people could—that judges could write down mortgages.

Mr. SILVERS. That would be item two then.

Mr. MASSAD. That could be item two, but you know, I think we can certainly provide you potentially with others. I'm very focused, obviously, on just executing the authorities we have.

Mr. SILVERS. Okay. I don't know if I'm allowed to ask one more question?

Several of the witnesses that we—in written testimony, have suggested that we ought to have sliding scale capital requirements for larger banks. That was in this panel's regulatory reform report at the beginning of our work. It is within the powers granted to the bank regulators and the systemic risk regulator. What is your view of that proposition?

Mr. MASSAD. I will leave that one to the regulators and the Financial Stability Oversight Council. I think it's a very important question but I would note simply that, you know, we have raised the level of capital in the system significantly since where we were. Our banks are better capitalized, far better capitalized today. But as to the exact details of whether there should be a sliding scale and what that sliding scale should look like, I would defer to those who have that power.

Mr. SILVERS. Mr. Secretary, if the Treasury Department has a view on that question, I know I sort of caught you by surprise on that—

Mr. MASSAD. Certainly.

Mr. SILVERS [continuing]. If the Treasury Department has a view in its role in the systemic risk process—management process, I think we'd appreciate that in writing.

Secondly and finally, we've had—a number of us have had a back and forth with you about these fundamental strategic decisions that were made in early 2009. Our expert witnesses have a lot to say about that and a lot of it's quite critical. I would offer you the opportunity, in writing, to respond if you and the Treasury Department would wish, to make your view on those questions known.

Mr. MASSAD. Thank you.

The CHAIRMAN. Thank you.

Dr. Troske.

Dr. TROSKE. Thank you. I want to refer back to the quote that Chairman Kaufman referred to and I know it's always awkward to put someone in the position of criticizing their boss, but Secretary Geithner, Treasury Secretary Geithner did say, "You just don't know what's systemic and what's not, until you know the nature of the shock."

The statement seems to be sort of in contrast to some of the calls by many economists, including some of our next panel and of course including myself in my opening statement, that the government needs to clearly define what they view as a systemically risky firm or systemic risk so that the market has a very clear understanding of what that means and what we view that—what we view is systemically risky.

Could you sort of tell me why you don't think, or perhaps maybe you do think, we can—why aren't we defining what we mean by systemically risky?

Mr. MASSAD. Well, I think there is a process going on to address that. I think what the Secretary was referring to is that it's not simply a quantitative determination or a simple determination, it's also going to be a determination that changes over time. But I think the Dodd-Frank legislation gives us the ability to do that. I think the initial work in that area has indicated that there will be a variety of criteria used that are both quantitative, qualitative, that involve looking at capital levels, leverage, interconnectedness and other factors.

So I think the meaning of the Secretary's statement was simply that it is a complex determination.

Dr. TROSKE. I mean—and I guess I want to push a little bit on that. Do you view that at some point there's going to be a clear statement to the markets, very transparent statement, "This I want we view as systemically risky," so that someone from outside looking in would come to approximately the same conclusion about which firms are systemically risky as say a future Treasury secretary?

Mr. MASSAD. That is a subject that the Financial Stability Oversight Council and its various members will look at and consider, and I'm sure they'll have more to say about that in the future.

Dr. TROSKE. Going back to the original TARP legislation, one in which was supposed to involve the purchasing of troubled assets, you know, toxic assets of the books of banks. That's not the way it was implemented and, I guess in my opinion, rightfully so. But I guess that—those troubled assets, presumably, are still sitting on banks' books. Do you have a sense of how big that—the problem is today? Do you have a sense of the—and whether the Federal Reserve's ultimate purchase of 1.2 trillion in residential mortgage-

backed securities was, in addition to the other affects, a way of removing those troubled assets from banks' books and shifting them to the Feds books?

Mr. MASSAD. Well, I would say a couple of things. It's a very good question. I think what we've seen is we have seen substantial write-offs by the industry, number one. Number two, I think we've seen asset quality generally improve. Number three, I think we've seen that the performance of the big banks at least has actually been better than what the stress tests predicted. The stress tests were designed to look at, you know, what was the riskiness of those assets in the bank situation.

Is there more work to do? I would defer to the regulators on that, about the principal responsibility for overseeing those banks. We're obviously still on the road to recovery.

Dr. TROSKE. Thank you.

The CHAIRMAN. Superintendent Neiman.

Mr. NEIMAN. Thank you. I'd like to come back again to the foreclosure issues. And as I mentioned in my opening, I believe the best thing this panel can do is to establish a precedent and a process to get good information to the public. And that's why some of our, I think greatest frustrations around the HAMP program have been with respect to the release and obtaining of information.

The first being really around non-HAMP modifications. I think in the defense of the HAMP program, you rightfully point to the fact that not only did you create a system for modifications, but also that it encouraged non-HAMP modifications outside of the HAMP program, and I think they probably exceed three to one the number of HAMP.

But despite our continued calls for information—and it's been supported by the Secretary himself—when Secretary Geithner was here last December he acknowledged how important that kind of information was. He pledged to us, "We are looking for ways we can get better information out there to assess these programs." What progress has been made since December in obtaining and publicly releasing this data, regarding proprietary bonds?

Mr. MASSAD. Thank you, Mr. NEIMAN. That's a very good question and I know it's been an issue that you've been very focused on. And I agree with you, we need more data on those non-HAMP modifications.

As you know, those are outside of our program and therefore outside of the system, the reporting system that we set up. There was no reporting on any modifications in this country, prior to HAMP. And we set up—

Mr. NEIMAN. Have servicers been asked to voluntarily submit that?

Mr. MASSAD. We have suggested that to several of the servicers. I know you've raised it with HOPE NOW in your conversations with them and when they appeared before this panel. And I know the regulators are also looking at that issue.

Mr. NEIMAN. So again, I think we would encourage you certainly to put a process in place. This is something that certainly, if not voluntarily submitted, should be a high priority to find a way to require that information to be submitted and publicly released.

The other area has been around the web portal. And we've been talking about this web portal to allow not only housing counselors and borrowers to submit data directly through a web based system to their servicers, but even more importantly, to allow them to assess the status of their modification.

Mr. MASSAD. Um hmm.

Mr. NEIMAN. We continue to read and hear about the slow implementation and even the slow pick up on usage. Can you give us an update as to how frequently and the volume of usage on that system?

Mr. MASSAD. Let me get back to you on that. I don't have those figures at my fingertips or the status of that. I know it has taken a lot of work to get to where we want to be. There are issues of, you know, making sure that it not only works, but that it protects privacy. But I'd be happy to get back to you on that.

Mr. NEIMAN. Okay. And the last, if you bear with me, is something I've asked at our last hearing. I've asked Ms. Caldwell and I've asked the Secretary himself regarding the need for a national foreclosure database. And I've been given polite noncommittal responses each time. So I wouldn't want you to feel that you were left out today. [Laughter.]

So, well what is it? What do you think would be the reluctance for starting a program that would provide mortgage performance data across the board, across state, across national, across all lines, for banks and nonbanks?

Mr. MASSAD. Again, a very good question, Mr. Neiman. I think we're at a point in time where we're going to see very dramatic change, overall, in the mortgage servicing industry which will lead to things like national servicing standards and presumably a national database on a number of these issues. It's been clear throughout this crisis that we didn't have data, we didn't have standards and that's been a large part of the problem.

So I think there is a lot of work going on on a number of fronts to look at those. I can't give you a specific prediction as to where we'll be when, but I think we will see some significant change there.

Mr. NEIMAN Thank you. I look forward to your follow-up response on the web portal. Thank you.

The CHAIRMAN. Thank you, Acting Assistant Secretary Massad. Thank you for being here today, but thank you so much for your public service.

Mr. MASSAD. Thank you for having me.

The CHAIRMAN. It's a real—it really is—appreciate it.

One thing, one question I have is you said that you've raised bank capital requirements significantly. I don't want to ask that question now, if you could just submit in writing kind of what you did to raise bank capital requirements significantly.

Mr. MASSAD. Yeah. Certainly. It wasn't us, but just generally what I meant was that bank capital levels have increased.

The CHAIRMAN. Okay. I'd just like some details on that.

Thank you very, very much.

And the next panel come forward, please.

Welcome. I am generally pleased to welcome our second panel. We're joined by Jason Cave, deputy director of the Office of Com-

plex Financial Institutions Monitoring at the FDIC; Patrick Lawler, chief economist and associate director for Policy Analysis and Research at FHFA; and William R. Nelson, deputy director, Division of Monetary Affairs, Federal Reserve.

Thank you all for joining us. Please keep your oral testimony to five minutes so that we will have ample time for questions. Your complete written statement will be printed in the official record of the hearing.

We'll begin with Mr. Cave.

**Follow Up from Congressional Oversight Panel Hearing of March 4, 2011**  
**Testimony of the Department of the Treasury Acting Assistant Secretary Timothy Massad**

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The following are requests for responses made by Panel Members at the March 4, 2011 hearing on the Troubled Asset Relief Program (TARP).

**Question: Could TARP have been structured in such a way as to mitigate or eliminate the moral hazard presented by providing government support for financial institutions?**

**Response:** In the fall of 2008, the Emergency Economic Stabilization Act (EESA) was passed to provide the tools necessary to help manage an unprecedented financial crisis. The Troubled Asset Relief Program, created under EESA's authority, helped stabilize the financial system and pave the way for economic recovery -- at a far lower cost than anyone initially estimated.

At the time TARP was passed, financial regulators did not have the proper tools to deal with the failure of large interconnected financial institutions. Through the creation of an orderly liquidation authority and the consolidated supervision of the largest, most inter-connected financial companies among other things, the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) ends "too-big-to-fail." Under the DFA, the Federal Deposit Insurance Corporation has the authority to wind down any firm whose failure would pose substantial risks to our financial system. Under this liquidation authority, failing firms will be placed into a government-run receivership, holders of common stock and other providers of regulatory capital to the firm will be forced to absorb any losses, and culpable management of the firm will be terminated.

**Question: Please submit in writing what the Department of the Treasury did to raise bank capital requirements. What is Treasury's view on implementing sliding scale capital requirements for large banks and its role as a tool to manage systemic risk?**

**Response:** The Treasury Department does not have the authority to set capital requirements for banks -- this responsibility rests with the independent regulatory agencies. Treasury has, however, worked with the federal banking regulators to address these issues, including through the development of the Supervisory Capital Assistance Program (SCAP), or "stress test". The purpose of SCAP was to ascertain the capital needs of the 19 largest U.S. bank holding companies should losses materialize at greater than expected rates during the crisis period. Treasury also provided the Capital Assistance Program under TARP to make capital available to institutions that needed to raise capital but were unable to do so.

Additionally, working with the US regulatory agencies, Treasury played a significant role in gaining commitment from G20 Leaders and Finance Ministers to support substantial improvements in international capital standards. The new Basel III standards will significantly increase the quality and quantity of capital that banks must hold, as well as implement a new supplementary leverage ratio. These new standards will better align regulatory capital requirements with the risks to which banks are exposed.

When Assistant Secretary Massad testified, he noted that capital levels in the banking industry had increased, and Chairman Kaufman asked Treasury to provide information in support of that



view. In this regard, Tier 1 capital for banks industry-wide has grown 19% percent since the third quarter of 2008 and Tier 1 capital ratios are substantially higher than during the pre-crisis period. Tier 1 capital ratios for the U.S. banking industry reached 12.7% in 3Q10, up from 11.7% in 4Q09 and 10.0% in 4Q08. For bank holding companies that participated in the SCAP program, the Tier 1 capital ratios also rose over the same period of time, reaching 12.2% in 3Q10, up from 11.3% in 4Q09 and 10.0% in 4Q08.

**Question: As you look at the powers you have and don't have to manage TARP going forward after this committee disbands and with the notion that Congress is listening, what powers would you like to have that you don't have? Assume someone gives you a magic wand, what powers that you do not have, would you like to have?**

*Response:* As you know, our authority to make new financial commitments or implement new programs under TARP has ceased, and we have made substantial progress in winding down TARP. Our focus today is to divest the remaining investments made under TARP in an orderly manner and to continue to implement the housing programs created under TARP. We have the powers we need to accomplish both tasks.

In the area of housing, there has been discussion of whether there are alternative or additional programs or measures that should be implemented to help address the housing crisis, and we continue to work with Members of Congress who wish to explore such options.

Our immediate legislative focus, however, is to oppose the efforts to terminate the Home Affordable Modification Program (HAMP) and other housing programs already in place. Ending the Making Home Affordable (MHA) Program now, without a meaningful alternative in place, would extinguish a program that has addressed and will continue to address the needs of hundreds of thousands of struggling homeowners. In addition, ending the FHA Short Refinance program, at a time when the program is gaining interest and traction among lenders, will eliminate a program that can provide a new loan that is cheaper and more sustainable for the homeowner and reduces their negative equity.

**Question: The web portal allows not only housing counselors and borrowers to submit data directly through a web-based system to their servicer, but even more importantly, to allow them to assess the status of those modifications. Can you give us an update as to how frequently and the volumes of usage on that system?**

*Response:* The Department of the Treasury does not operate a borrower document portal. However, pursuant to the Dodd-Frank Act, Treasury is in the process of preparing a website that provides an evaluation of the net present value (NPV) of a mortgage modification. This web portal will allow borrowers to input borrower and mortgage-related data into a calculator and be provided with an assessment that could be used to determine if the borrower may be eligible for modification under HAMP. The calculator will perform a calculation based on Treasury's methodology for determining NPV. Based on this determination, borrowers will be able to bring this result back to their servicer to help determine if the inputs used by their servicer in making NPV calculations were correct, thereby increasing the transparency of the process. While the model will evaluate potential eligibility, only the servicer can make the final evaluation and underwriting decision. We expect the portal to be available on the website this spring.

**STATEMENT OF JASON CAVE, DEPUTY DIRECTOR FOR COMPLEX FINANCIAL INSTITUTIONS MONITORING, FEDERAL DEPOSIT INSURANCE CORPORATION**

Mr. CAVE. Chairman Kaufman and members of the panel, I appreciate the opportunity to testify on behalf of the FDIC concerning the Temporary Liquidity Guarantee Program or TLGP.

A significant contributor to the financial crisis was a disruption in credit markets, which significantly impaired the ability of even credit-worthy companies to refinance their commercial paper and long term debt.

The FDIC's TLGP was one of several extraordinary measures taken by the U.S. Government, in the fall of 2008, to address the crisis in the financial markets and bolster public confidence. The FDIC TLGP helped to unlock the credit markets, calm market fears and encourage lending during these unprecedented disruptions.

The TLGP provided a guarantee, for a limited period of time, for certain new senior unsecured debt issued by financial institutions. We designed this program to be as inclusive as necessary to ensure that credit—particularly between banks—began to flow again. This calmed what was becoming “the perfect storm,” whereby creditors refused to roll their debt beyond weeks or even overnight and demanded more collateral at the exact time that banks needed these funds to continue to finance their operations.

Additionally, the TLGP fully guaranteed certain non-interest bearing transaction deposit accounts. This provided stability to insured banks, particularly smaller ones, enabling their commercial customers to continue to do business without disruption. The creation of this aspect of the program was necessary because we were seeing that smaller, healthy banks were losing these accounts to their much larger competitors because of uncertainties in the financial system.

At its peak, the FDIC guaranteed almost \$350 billion of debt outstanding. As of December 31, 2010 the total amount of remaining FDIC guaranteed debt was \$267 billion. Of that amount, \$100 billion, or 37 percent will mature in 2011, and the remaining \$167 billion will mature in 2012.

The TLGP has worked as it was intended to. Credit markets have returned to some level of normalcy, and private investors have resumed their roles as credit providers at market terms. Financial institutions are in the process of repairing their balance sheets, increasing cash positions and reducing their reliance upon short term debt.

The FDIC as deposit insurer and as guarantor of TLGP supports these needed improvements. Given that \$267 billion in TLGP remains outstanding, it is important that financial institutions continue to replace government guaranteed debt with private funds. The FDIC is closely monitoring the funding plans that institutions have developed to ensure that TLGP can be fully repaid through the private credit markets. The next two years will be important, given the significant amount of debt that is coming due.

The financial system benefited from a prompt, coordinated response across regulatory agencies. The FDIC believes it is just as

important to have that same level of coordination in evaluating the health of these large financial institutions coming out of the crisis.

Currently we are working with the Federal Reserve to review the dividend plans at the large banking organizations. We believe that a comprehensive review of dividend and capital repayment plans across large firms is critical since these payments were a large drain on cash reserves prior to the crisis, leaving financial institutions more vulnerable to the disruptions that followed.

This is why the dividend plan review and TLGP repayment plans are intertwined. The regulators should not approve dividend and capital repurchases which involve significant cash outlays by financial firms until we are all fully confident that these firms will have the financial resources, under both normal and stressed conditions, to repay debt guaranteed by the FDIC.

In conclusion, while the measures taken by the FDIC and other governmental agencies to address the financial crisis were unprecedented in nature, these measures were successful at stabilizing the credit markets and creating an environment that allowed for economic recovery. Now we are actively working to ensure that the program winds down in an orderly fashion by the end of 2012.

Thank you. I will be pleased to answer any questions from members of the panel.

[The prepared statement of Mr. Cave follows:]

**STATEMENT OF**

**JASON C. CAVE  
DEPUTY DIRECTOR FOR COMPLEX FINANCIAL  
INSTITUTIONS MONITORING  
OFFICE OF COMPLEX FINANCIAL INSTITUTIONS  
FEDERAL DEPOSIT INSURANCE CORPORATION**

**on**

**THE TEMPORARY LIQUIDITY GUARANTEE PROGRAM**

**CONGRESSIONAL OVERSIGHT PANEL**

**March 4, 2011  
Washington, D.C.**

Chairman Kaufman and members of the panel, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the Temporary Liquidity Guarantee Program (TLGP). My testimony will provide background on the inception of the program, where the program stands today and the FDIC's role in overseeing the repayment of remaining TLGP debt through 2012.

Background on the Temporary Liquidity Guarantee Program

As you recall, in 2008, conditions in the financial markets shook people's confidence in domestic and international financial systems. Credit markets did not function normally, contributing to a rising level of distress in the economy. The decline in confidence resulting from the cumulative effect of these events resulted in the U.S. and foreign governments taking action to bolster public confidence in financial institutions and the global economy.

Along with the other extraordinary measures taken by U.S. government officials in the fall of 2008, the FDIC's TLGP helped to calm market fears and encourage lending during these unprecedented disruptions in financial markets in the U.S. and abroad. The TLGP provided a guarantee, for a limited period of time, for certain newly issued senior unsecured debt issued by U.S. banks, thrifts, holding companies and certain affiliates. Additionally, the TLGP fully guaranteed certain noninterest-bearing transaction deposit accounts, which provided stability to insured banks, particularly smaller ones, enabling their commercial customers to continue to do business without disruption. By providing the ability to issue debt guaranteed by the FDIC, institutions were able to extend maturities and obtain more stable unsecured funding. This calmed what was becoming

“the perfect storm” whereby creditors refused to roll their debt beyond weeks, days or even overnight and demanded more collateral at the exact time that banks needed these funds to continue to finance their operations.

The failure of the credit markets in the fall of 2008, particularly the interbank lending markets, significantly impaired the ability of even creditworthy companies to issue commercial paper, particularly at longer maturities. In the U.S., during the last two weeks of September 2008, data compiled by the Board of Governors of the Federal Reserve System (the FRB) showed that the average issuance of longer-term (i.e., maturities over 80 days) AA-rated asset-backed commercial paper fell by 82 percent, from \$4.7 trillion in mid-September to \$809 billion at month-end — a decline so significant it represented a virtual shut-down of the market. Even more pronounced, however, was the decline in issuance of other longer-term commercial paper, which fell by 88 percent, from \$8.2 trillion in mid-September to \$969 billion at month-end.

Also, at that time, market participants were showing more pronounced concern regarding counterparty credit risk. On October 10, 2008, the difference in interest rates between short-term U.S. Treasury securities and comparable Eurodollars (the TED spread) sharply increased to 464 basis points from a traditionally stable level of about 30 basis points. Unsure which financial institutions were exposed to the greatest risk and fearful about their own liquidity, market participants continued to hold on to available cash.

On October 14, 2008, the U.S. Treasury, the FRB and the FDIC jointly announced a coordinated response to the financial crisis. Following a determination of systemic risk

by the Secretary of the Treasury, after consultation with the President and upon the recommendation of the Board of Directors of the FDIC and the Board of Governors of the FRB, the FDIC announced and implemented the TLGP in an effort to increase healthy financial institutions' liquidity by restoring their access to funding markets and by stabilizing bank deposits. The TLGP consists of two components: (1) the Debt Guarantee Program (DGP) — an FDIC guarantee of certain newly issued senior unsecured debt; and (2) the Transaction Account Guarantee Program (TAGP) — an FDIC guarantee in full of noninterest-bearing transaction accounts.

*The Debt Guarantee Program*

Under the DGP, the FDIC initially guaranteed in full, through maturity or June 30, 2012, whichever came first, the senior unsecured debt issued by a participating entity between October 14, 2008, and June 30, 2009. Although improved, the credit markets had not yet fully stabilized by mid-year 2009. Thus, the issuance period was extended through October 31, 2009. The FDIC's guarantee on each debt instrument also was extended in 2009 to the earlier of the stated maturity date of the debt or December 31, 2012. The FDIC charged a fee based on the amount and term of the debt issued. More than half of the eligible entities opted in to the DGP at its inception. Of these, 121 institutions paid premiums for, and issued, TLGP debt.

The DGP enabled financial institutions to meet their financing needs during a period of system-wide turmoil and record high credit spreads. The AAA-rating assigned to TLGP debt, because of the explicit government guarantee, reopened the short- and medium-term debt markets for banks and other eligible institutions by allowing them to

issue an array of debt instruments at a time when financial institutions were unable to roll over this debt on any terms. By year-end 2008, shortly after the inception of the TLGP, 64 financial entities — 39 insured depository institutions and 25 bank and thrift holding companies and nonbank affiliates — reported \$224 billion in TLGP guaranteed debt outstanding. On January 7, 2009, less than three months after the first TLGP medium-term note was issued, the spread between a composite of three-year TLGP debt and comparable three-year U.S. Treasury securities was 88 basis points, while the spread between a composite of previously issued three-year non-guaranteed bank debt and comparable Treasury securities was 458 basis points.

By the end of the DGP issuance period (October 2009), access to funding had improved markedly. Spreads on both guaranteed and non-guaranteed debt had narrowed. Three-year TLGP guaranteed debt was trading at 31 basis points over comparable Treasury securities. Also, three-year non-guaranteed bank debt was trading at 158 basis points over comparable Treasury securities. Recently, as of February 23, 2011, three-year TLGP debt was trading at 13 basis points over comparable Treasury securities, while three-year non-government guaranteed bank debt was trading at a 112 basis points spread.

In short, the DGP and other government actions aided the successful return of the credit market to near normalcy, despite the recession and slow economic recovery. Banks and their holding companies are now successfully issuing non-guaranteed debt. For example, in January 2011, non-guaranteed debt issued by financial firms was \$32.9 billion, which was comparable to pre-crisis levels. Furthermore, the TED spread dropped dramatically at the beginning of 2009, indicating a growing confidence in counterparty



risk levels. Since September of 2009, the TED spread has been hovering below its long-term average and on February 23, 2011 stood at 19 basis points, in stark contrast to its peak of 464 basis points in October 2008.

This improvement in the credit markets was reflected in the increasing ability of banks and their holding companies to issue longer-term debt over the course of the DGP issuance period. At the inception of the program, firms heavily relied upon the DGP to roll over short-term liabilities given the fragility in the credit markets and investors' continued aversion to risk. As the program took hold, financial institutions began to issue debt with longer maturities and financial institutions gradually shifted to medium-term note issuance. As of October 31, 2009, 75 percent of TLGP debt outstanding had a maturity of more than two years from the date of issuance, while less than 5 percent had a maturity within one year of issuance.

At its peak, the FDIC guaranteed almost \$350 billion of debt outstanding. As of December 31, 2010, the total amount of remaining FDIC-guaranteed debt outstanding was \$267 billion. Of that amount, 37 percent will mature in 2011 and the remaining \$167 billion will mature in 2012.

#### *The Transaction Account Guarantee Program*

Deposits provide the primary source of funding for most banks, and are particularly important for smaller institutions. The TAGP brought stability and confidence to this funding mechanism by removing the risk of loss from accounts that are commonly used to meet payroll and other business transactions purposes, allowing institutions, particularly smaller ones, to retain these accounts and maintain the ability to

make loans within their communities. Through the TAGP, the FDIC initially guaranteed, in full, all domestic noninterest-bearing transaction accounts held at participating banks and thrifts through December 31, 2009. This deadline was extended twice and expired on December 31, 2010. The FDIC charged a fee for the TAGP. Last year, Congress saw the benefit of this program to small businesses and banks in weathering the economic downturn and, in the Dodd-Frank Act, replaced it with a provision mandating temporary full deposit insurance coverage for all non-interest bearing transaction accounts at all insured depository institutions. This temporary insurance will last for two additional years (until December 31, 2012).

Over 7,100 banks and thrifts, or 86 percent of FDIC-insured institutions, initially opted into the TAGP. At the peak of the program in December 2009, more than 5,800 of these FDIC-insured institutions reported having noninterest-bearing transaction accounts over \$250,000 in value, representing \$834 billion in TAGP-guaranteed deposits.

#### *Fees and Costs*

Through the DGP, the FDIC collected approximately \$10 billion in fees and surcharges. Further, only four participating entities that had issued guaranteed debt had defaulted on their debt as of December 31, 2010. Claims filed through the end of 2010 total \$8 million. Losses through the end of the DGP guarantee period in 2012 are expected to be limited.

As of December 31, 2010, the FDIC had collected \$1.1 billion in fees under the TAGP. Estimated TAGP losses as the result of insured depository institution failures as of December 31, 2010, totaled \$2.35 billion.

In determining whether the TLGP has experienced a loss, the FDIC will combine fees and losses from the DGP and the TAGP. Overall, TLGP fees are expected to exceed the losses from the program. Remaining TLGP funds after payment of guarantee obligations will be added to the DIF balance.

*Evaluation of the TLGP*

The TLGP, in concert with other government programs, helped bring stability to U.S. financial markets in a time of crisis. Credit market conditions improved significantly at the start of 2009 and began normalizing by mid-year amid still-elevated levels of problem loans. Interest-rate spreads had retreated from the highs established during the depth of the crisis during the fall of 2008, and activity in interbank lending and corporate bond markets had increased. Banks, thrifts and their holding companies are now able to issue debt without a government guarantee; the DGP is winding down and the TAGP has expired. While not the purpose of the program, the FDIC expects a net gain in revenue for the DIF from the TLGP for assuming the risk. Overall, the TLGP was an important component of bringing stability to financial markets and the banking industry during the crisis period.

While financial firms have been issuing significant amounts of nonguaranteed unsecured debt, thus bolstering their liquidity reserves, which serve as the primary source of repayment for FDIC-guaranteed debt, the approximately \$267 billion that is still subject to a TLGP guarantee is a large number that warrants continued close scrutiny. Overall, the balance sheets at our largest financial firms have improved since the crisis. Firms have deleveraged since the crisis, as measured by stronger leverage and risk-based

capital ratios. Further, many of the complex structures that concealed additional leverage and exposure, such as structured investment vehicles and other off-balance-sheet conduits have been largely consigned to the history books. Cash and liquid securities represent larger percentages of the balance sheet, while reliance on short term debt has declined. These are all positive trends from the FDIC's perspective as deposit insurer and guarantor of TLGP debt.

#### Exit Strategy

In addition to supporting the improvements in balance sheet management, we are closely monitoring the FDIC's exposure to ensure that issuers have concrete and practical plans in place to fully repay their TLGP debt under normal and adverse scenarios. While liquidity and funding structures have improved, banking organizations are still reliant upon short-term liabilities to fund assets of varying maturities. Maintaining a stronger liquidity reserve in today's credit environment is good, but in no way serves as a substitute for proper contingency planning for tomorrow's uncertainties.

To ensure that repayment plans are reasonable and practical, the FDIC and the FRB currently are evaluating the validity of liquidity plans at the biggest users of TLGP debt, and we will challenge assumptions that seem overly optimistic. The agencies are closely reviewing liquidity reserves to ensure that ample funds will be available to meet redemptions when they come due.

Understanding that stress assumptions are just that — assumptions — we believe that firms should be actively considering balance sheet management strategies that lock in low cost long term funding today while credit conditions remain favorable, rather than

waiting to issue new debt as TLGP debt matures later this year, or next. While no one knows for certain what is in store for the credit markets in late 2011 or 2012, we want firms to be more prepared for the possibility that rates could increase or credit become restricted at the very point in which significant amounts of TLGP debt comes due.

*Unsecured debt*

The FDIC understands that issuing unsecured debt even in a low rate environment has costs. Following passage of the Dodd-Frank Act, the FDIC adopted a rule making extensive changes to the deposit insurance assessment system. Among other things, the rule calibrated the existing reduction in assessment rates that institutions receive for issuing long-term unsecured debt to the new Dodd-Frank Act mandated assessment base calculation of assets minus equity to ensure that the assessment rate reduction will continue to lower the cost of long-term unsecured borrowing for banks and thrifts.

*Dividend practices*

We are also working with the FRB to review the dividend plans at the large banking organizations. We believe that the comprehensive review of dividend and capital repayment plans across large firms is entirely necessary since these payments were a large drain on cash reserves prior to the crisis, leaving institutions more vulnerable to the disruptions that followed.

This is why the dividend plan review and TLGP repayment plans are intertwined; the regulators should not approve dividend and capital repurchases, which involve significant cash outlays by financial firms, until we are all fully confident that these firms

will have the financial resources — under both normal and stressed conditions — to repay debt guaranteed by the FDIC. The FDIC and FRB are closely reviewing liquidity reserves to ensure that ample funds will be available to meet redemptions when they come due. For this reason, it is of critical importance that financial institutions continue to restructure their balance sheets and extend their debt maturities.

To “de-link” these two exercises, or to defer the review of TLGP repayments because the majority of the debt does not come due for another twelve to eighteen months, would be short-sighted and inappropriate as funding was indeed the linchpin in the recent crisis.

Simply put, plans that result in lower capital and/or liquid resources place the FDIC at greater exposure to TLGP, therefore, we will continue to be very active in these discussions to ensure that dividend and capital buybacks are reasonable in both a normal and adverse environment. We believe the FRB shares our concerns and we look forward to continuing to work with them on the dividend and TLGP repayment reviews.

This process is important to us, as any changes to the capital structure or reduction in cash has a potential impact on our TLGP position, thus, the FDIC is involved in the analysis and needs to be comfortable with the conclusions.

#### Conclusion

As a result of the severe disruption to the financial system that started in 2008, it was necessary that the FDIC and other government agencies take measures to stabilize the financial markets and the economy. While the TLGP clearly led to a positive

outcome, it is important that financial institutions replace their reliance on government guaranteed debt with private borrowing. As such, the FDIC has embarked on a prudent exit strategy that will assure that private markets take on this role as the financial industry returns to health.

The CHAIRMAN. Thank you.  
Mr. Lawler.

**STATEMENT OF PATRICK LAWLER, CHIEF ECONOMIST AND  
HEAD OF THE OFFICE OF POLICY ANALYSIS AND RESEARCH,  
FEDERAL HOUSING FINANCE AGENCY**

Mr. LAWLER. Thank you. Chairman Kaufman, members of the panel, thank you for the invitation to present FHFA's perspective on the impact of TARP on the economy and the financial sector.

I'm going to be referring to some charts in the back of my testimony, if you've got that handy.

TARP was created when financial markets were in the midst of a crisis. Collectively, TARP programs made important contributions to reestablishing financial stability by increasing confidence and adding liquidity to financial markets. The oversight board, on which FHFA's director sits, concluded that without TARP the severity of the crisis and its impact on the economy would have been materially greater.

Given the origins of the crisis and housing financial markets, the conservatorships of Fannie Mae and Freddie Mac were designed from the start to maintain access to funds for sound, new mortgages. To assist borrowers who were struggling to make payments on poorly structured and unaffordable loans, FHFA worked with the Treasury, HUD and others to develop a series of programs, including the Home Affordable Modification Program, which used TARP funds for non-GSE loans to enhance incentives for borrowers and servicers.

In all cases, FHFA has been guided by its responsibilities as conservator of each enterprise to limit activities to those that make business sense, are safe and sound and are consistent with the enterprises' charters and the goals of conservatorship. These programs have benefited the enterprises by mitigating risks and reducing both direct losses on loans where foreclosure is avoided, and indirect losses on properties where housing markets are stabilized, which reduces defaults on other loans.

As shown in Figure 1, with these and other programs, including notably the Federal Reserve's large program for purchasing mortgage securities, the cost of mortgage borrowing declined, both absolutely and relative to yields on reference Treasury securities.

In Figure 2, cheaper financing and foreclosure prevention programs helped stabilize house prices, as measured by FHFA, almost immediately and by other measures within a few months.

In Figure 3, serious delinquencies continued to rise sharply in 2009 as the recession worsened, but they have since eased somewhat. Inventories of houses currently or potentially for sale are very high in portions of the country, so significant risks remain, despite recent price stability and lower delinquency rates.

The enterprises have significant responsibilities with respect to TARP through their implementation of Making Home Affordable programs for mortgages on their own books as well as through their roles as Treasury's financial agents.

Turning to Figure 4, in 2010 the enterprises completed nearly a million foreclosure prevention workouts. More than double 2009 total and nearly two and a half times the number of foreclosure



sales in 2010. Most workouts are home retention actions intended to keep borrowers in their homes.

While HAMP has not produced the volume of loan modifications the Treasury Department initially hoped for, we believe it has been instrumental in standardizing and streamlining the industry's modification process. And in that way it has contributed greatly to the sharp rise in non-HAMP modifications that has taken place over the past two years.

The quality of the modifications also appears to have improved, as indicated in Figure 5. Although it is still too soon to judge how successful recent modifications will ultimately prove to be, re-defaults of loans modified by the enterprises have been much lower since the implementation of HAMP than previously.

In addition to foreclosure prevention programs, the enterprises used the Home Affordable Refinance Program, HARP, to help homeowners whose property values has fallen to take advantage of historically low interest rates by refinancing their mortgages which can help them avoid future default. In Figure 6, the volume of HARP refinances has also been much less than Treasury—the Treasury Department anticipated, but refinances outside HARP, many with a similar streamlined structure, have been ten times as large with Fannie Mae and Freddie Mac mortgages.

FHFA has worked closely with the Treasury Department on critical issues brought on by the housing crisis and general financial and economic disruptions over the past few years. The interactions have been frequent and professional, respectful of our differing roles and legal responsibilities but collaborative toward our common goal to bring stability and liquidity to housing markets and seek foreclosure alternatives whenever feasible.

Thank you. I'll be happy to answer questions.

[The prepared statement of Mr. Lawler follows:]



Statement of

Patrick Lawler  
Chief Economist  
Federal Housing Finance Agency

Before the  
Congressional Oversight Panel

“TARP’s Impact on Financial Stability”

March 4, 2011

**Statement of Patrick Lawler  
Chief Economist  
Federal Housing Finance Agency  
Before the Congressional Oversight Panel  
“TARP’s Impact on Financial Stability”  
March 4, 2011**

Chairman Kaufman and members of the Panel, thank you for the invitation to present FHFA’s perspective on the impact of the Troubled Asset Relief Program (TARP) on the economy and the financial sector. I understand this is the last hearing to be held by this Panel prior to the issuance of your final report on TARP and we hope our testimony this morning will help inform your report. You asked us to focus on the following broad areas:

- The impact of TARP on financial stabilization and recovery in the U.S. economy and financial sector;
- Fannie Mae and Freddie Mac’s responsibilities with respect to TARP; and
- The Federal Housing Finance Agency’s interaction with Treasury with respect to the Enterprises and the federal government’s initiatives to promote financial stability.

**The Impact of TARP**

My agency, the Federal Housing Finance Agency (FHFA), regularly reviews the impact of the TARP, as the FHFA Director is a member of the Financial Stability Oversight Board, which was created by Congress to help oversee TARP and review its effects on the economy. TARP was created when financial markets were in the midst of a crisis. Collectively, TARP programs injected capital into the banking system, invested in other systemically significant failing institutions, supported various securities markets and developed a variety of foreclosure prevention approaches. These actions made important contributions to reestablishing financial stability. As the Oversight Board concluded, without TARP, the severity of the crisis and its impact on the economy would have been materially greater.

The sharp deterioration of the subprime mortgage market began in early August of 2007. Most large financial institutions experienced sharply diminished access to credit. Indicators of the market’s increased reluctance to provide funding, such as the spread between LIBOR and overnight index swap rates and the cost of credit default swaps for large commercial and investment banks became highly elevated, and they spiked in September 2008 after Lehman Brothers collapsed. Under such conditions, the ability of non-financial firms to obtain funds through normal channels was threatened. Early TARP actions helped stabilize markets and limit the damage to the economy.

Given the origins of the crisis in housing finance markets, the conservatorships of Fannie Mae and Freddie Mac were designed from the start to maintain access to funds for the production of sound new mortgages. To assist borrowers who were struggling to make payments on poorly structured and unaffordable loans, FHFA worked with the Treasury, HUD and others to develop a Streamlined Modification Program (SMP) for GSE mortgages in the fall of 2008. In early 2009, the Home Affordable Modification Program (HAMP) for GSE and non-GSE mortgages, was developed that uses TARP funds to create additional incentives for borrowers and servicers

to participate. At the same time, the Home Affordable Refinance Program (HARP) was developed, outside of TARP, to facilitate refinances of GSE mortgages in areas where house prices had declined and mortgage insurance companies had restricted their support for home lending. Lower payments for borrowers in such areas can reduce their likelihood of defaulting. Also outside of TARP, FHFA worked with the Treasury on methods of aiding the funding of state housing finance agencies.

In all cases, FHFA has been guided by its responsibilities as conservator of each Enterprise to limit activities to those that make business sense, are safe and sound, and are consistent with the Enterprises' charters and with the goals of conservatorship. These programs have benefited the Enterprises by mitigating risks and reducing both direct losses on loans where foreclosure is avoided, and indirect losses on properties where housing markets are stabilized, which reduces defaults on other loans. Later in this testimony, I will describe effects of HAMP and HARP in greater detail.

With these and other programs, including notably the Federal Reserve's large program for purchasing mortgage securities, the cost of mortgage borrowing declined both absolutely and relative to yields on reference Treasury securities (figure 1). Cheaper financing and foreclosure prevention programs helped stabilize house prices as measured by FHFA almost immediately and within a few months by others measures (figure 2). Serious delinquencies continued to rise sharply in 2009 as the recession worsened, but they have since eased somewhat (figure 3). Inventories of houses currently for sale, coupled with shadow inventories of houses recently withdrawn from sale or currently held by distressed borrowers and at risk of foreclosure are very high in portions of the country. Continuation of the recent price stability or resumption of gains cannot be safely assumed, but lower unemployment rates would help considerably.

#### **Fannie Mae and Freddie Mac's TARP Responsibilities**

The Enterprises have significant responsibilities with respect to TARP through the Making Home Affordable (MHA) programs from their foreclosure avoidance programs for mortgages on their own books, as well as from their roles as MHA Agents.

##### *HAMP/HARP Programs*

MHA and related programs are funded by TARP. These programs, along with comparable MHA programs at the Enterprises, were intended to help financially struggling homeowners avoid foreclosure by modifying loans to a level that is affordable for borrowers now and sustainable over the long term. For some homeowners who could not achieve affordability through loan modifications, MHA programs provided other alternatives to foreclosure, such as short sales or deeds-in-lieu.

The Enterprises' comparable MHA programs, however, do not use TARP funds to support their lending and loan workout activities. While the Enterprises' comparable MHA programs include incentive payments to servicers and borrowers, the Enterprises pay the incentives rather than Treasury with TARP funds. Nevertheless, Fannie Mae and Freddie Mac's active involvement in homeownership preservation efforts is consistent with the conservatorships' goals of restoring confidence in the Enterprises, enhancing their capacity to fulfill their mission and mitigating the systemic risk that contributed directly to instability in financial markets. A key purpose of the

conservatorships is to safeguard each Enterprise's assets and property and to restore the Enterprises to a sound condition. This includes minimizing losses on the mortgages already on the books.

Even though they do not receive TARP funds, the Enterprises contribute significantly to overall HAMP loan modification program volume. Although the Enterprise mortgages represent roughly 33 percent of the total delinquent mortgages that are eligible for HAMP, the Enterprises represent 54 percent of total active HAMP trial and permanent modifications.

In 2010, the Enterprises completed 946 thousand foreclosure prevention workouts, a 120 percent increase over 2009's total and nearly 2 ½ times 2010's completed foreclosures of 392 thousand (figure 4). Approximately 88 percent of workouts are home retention actions, intended to help borrowers stay in their homes. Home retention actions include loan modifications, repayment plans, and forbearance plans. The remaining workouts are foreclosure alternatives, such as short sales and deeds-in-lieu of foreclosure. These alternatives are intended to reduce the severity of the Enterprises' losses resulting from a borrower's default while minimizing the impact of foreclosures on borrowers, communities, and neighborhoods.

The Enterprises focus on loan modifications as a primary workout solution for distressed homeowners. Borrowers are offered loan modifications through the MHA-comparable Home Affordable Modification program (HAMP) or through the Enterprises' proprietary non-HAMP loan modification programs. The Enterprises also offer repayment plans and forbearance plans to assist borrowers experiencing short-term financial difficulty, including unemployment. In addition to foreclosure prevention programs, the Enterprises use the Home Affordable Refinance Program (HARP) to help homeowners, whose property values have fallen, take advantage of historically low interest rates by refinancing their mortgages. Owner-occupants may refinance as much as 125 percent of their home's current value through any Enterprise-approved lender. As with all refinance activity, the volume of HARP refinance loans is affected by the interest rate environment.

FHFA reports monthly to Congress on the full range of Enterprise foreclosure prevention activities through the *Foreclosure Prevention / Federal Property Manager's Report*, the latest edition of which can be found on the agency's website.

While HAMP has not produced the volume of loan modifications the Treasury Department initially hoped for, we believe it has been instrumental in standardizing and streamlining the industry's modification process and in that way has contributed greatly to the sharp rise in non-HAMP modifications that has taken place over the past two years. The quality of the modifications also appears to have improved. Although it is still too soon to judge how successful those actions will ultimately prove to be, re-defaults of loans modified by the Enterprises have been much lower since the implementation of HAMP than previously (figure 5). The volume of HARP refinances has also been much less than the Treasury Department anticipated, but refinances outside HARP, many with a similar streamlined structure, have been ten times as large (figure 6).

*Enterprises as Agents*

TARP funds are used by the Treasury Department to fund the MHA program administrative and compliance tasks performed by Fannie Mae and Freddie Mac as Financial Agents for the Treasury. Fannie Mae is Treasury's MHA Program Administrator and Freddie Mac is Treasury's MHA Compliance Agent. Treasury has budgeted nearly \$126 million for Fannie Mae MHA program administration expenses in FY 2011 and \$66.5 million for Freddie Mac compliance activity expenses in FY 2011.

As Treasury's MHA program administrator, Fannie Mae oversees the implementation and execution of MHA new and existing programs. Fannie Mae's role includes designing and implementing standardized MHA programs, serving as record keeper and pipeline manager and coordinating with the paying agent for disbursement of Treasury and Enterprise funded incentives. Fannie Mae provides guidance to borrowers and servicers, develops and maintains websites, systems, and program tools and trains servicers. Fannie Mae also continues to sponsor outreach events in some of the hardest-hit cities across America, maintains call centers, and issues reports to inform the public and government agencies about the program.

As Treasury's Compliance Agent, Freddie Mac conducts examinations and reviews of servicer compliance with the MHA published program rules and directly reports results to Treasury's Compliance Committee. Servicers reviewed are those who have executed Servicer Participation Agreements that are applicable to non-Enterprise loans. In cases of noncompliance, MHA Compliance consults with Treasury on appropriate courses of action, with Treasury having the final say on the content of reports to servicers and required corrective actions. Freddie Mac MHA Compliance also provides the Treasury Compliance Committee with advice, guidance and lessons learned to improve the operation of the program. Examinations and reviews are primarily conducted on-site at the servicers' operations.

Each quarter, Fannie Mae and Freddie Mac receive performance assessments from the U.S. Treasury Office of Financial Agents for their work as Financial Agents, based on a number of quantitative and qualitative performance factors. Both Fannie Mae and Freddie Mac have consistently been rated by Treasury as meeting performance expectations.

**FHFA – Treasury Interaction**

You asked us to describe FHFA's interaction with Treasury with respect to the Enterprises' and the federal government's initiatives to promote financial stability. In both the Bush and Obama Administrations, FHFA worked closely with the Treasury Department on critical issues facing the nation's economy brought on by the housing crisis, and the general financial and economic disruptions of the past few years. The interactions have been frequent and professional, respectful of our differing roles and legal responsibilities but collaborative toward our common goal to bring stability and liquidity to housing markets and to seek foreclosure alternatives wherever feasible.

The following list highlights some of the key FHFA – Treasury interactions and collaborations since FHFA's inception:

- The Housing and Economic Recovery Act of 2008 (HERA) created FHFA and gave FHFA the authority to appoint a conservator or receiver for the Enterprises. At the same

time, Section 1117 of HERA gave to Treasury the authority to provide financial support to the Enterprises by permitting the Secretary to purchase securities issued by an Enterprise on such terms and conditions as the Secretary may determine. This became the basis for developing the approach to address the deteriorating financial condition of Fannie Mae and Freddie Mac in September 2008 with the appointment of FHFA as conservator and Treasury establishing the Senior Preferred Stock Purchase Agreements that provided the necessary financial support for the conservatorships. It was also the basis for other temporary initiatives announced at the time that have since expired, including a backstop liquidity program to support all the housing Enterprises, if needed.

- HERA also created the Federal Housing Finance Oversight Board to advise the FHFA Director on strategies and policy. The Treasury Secretary is a member of this board.
- The Emergency Economic Stabilization Act of 2008 (EESA) that created TARP made FHFA a federal property manager responsible for maximizing assistance to homeowners, including encouraging the development of programs to minimize foreclosures while considering the net present value of such actions to taxpayers. Nearly identical language instructed the Treasury Secretary to prevent foreclosures through appropriate loan modification activity through TARP program. This formed the statutory basis for FHFA and Treasury to work together on an array of foreclosure avoidance activities, including the SMP, HAMP, and HARP, as discussed above.

As described previously in this testimony, FHFA's participation with HAMP has had two key components:

- FHFA directed the Enterprises to adopt HAMP in their own seller-servicer guides so that loan modifications of Enterprise loans followed the same protocols as for non-Enterprise loans. This approach was initially taken to simplify the new processes and procedures required of servicers in an effort to promote consistency for servicers and fairness of treatment for homeowners seeking a modification. As HAMP evolved, FHFA and the Enterprises have continued to provide input toward program modifications, and the Enterprises have implemented various modifications to HAMP that are consistent with the goals of the conservatorships.
- FHFA also permitted the Enterprises to serve as financial agents for Treasury in the implementation of HAMP. This action was in recognition of the Enterprises' unique role in the housing finance system and it resulted in the Enterprises' expertise being leveraged for the benefit of HAMP, thereby meeting the goals of EESA.
- You asked if this latter role affected the Enterprises' ability to operate and meet the requirements of the conservatorship. While these responsibilities added operational demands to each Enterprise, it is FHFA's view that HAMP promotes housing market stability and, with the Enterprises backing more than half the mortgages in the country, such stability benefits the Enterprises and thus supports the goals of conservatorship. In a few instances we discussed with Treasury

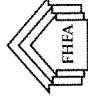
particular tasks or initiatives that might have been undertaken by an Enterprise but ultimately agreed not to go in that direction to avoid possible operational issues that could conflict with the goals of conservatorship.

- The FHFA Director is a member of the Financial Stability Oversight Board, as previously mentioned.
- The Dodd-Frank Act created numerous requirements for FHFA – Treasury interaction and collaboration on an array of activities and rulemakings designed to promote financial stability. The Act also made the FHFA Director a member of the Financial Stability Oversight Council, which is chaired by the Secretary of the Treasury.

Finally, Treasury and HUD recently released a white paper on housing finance reform. FHFA provided technical briefings to these agencies as they did research in preparation of this paper, but FHFA did not participate in the development of the proposal itself, as that was an Administration policy matter.

Thank you. I will be happy to answer your questions.

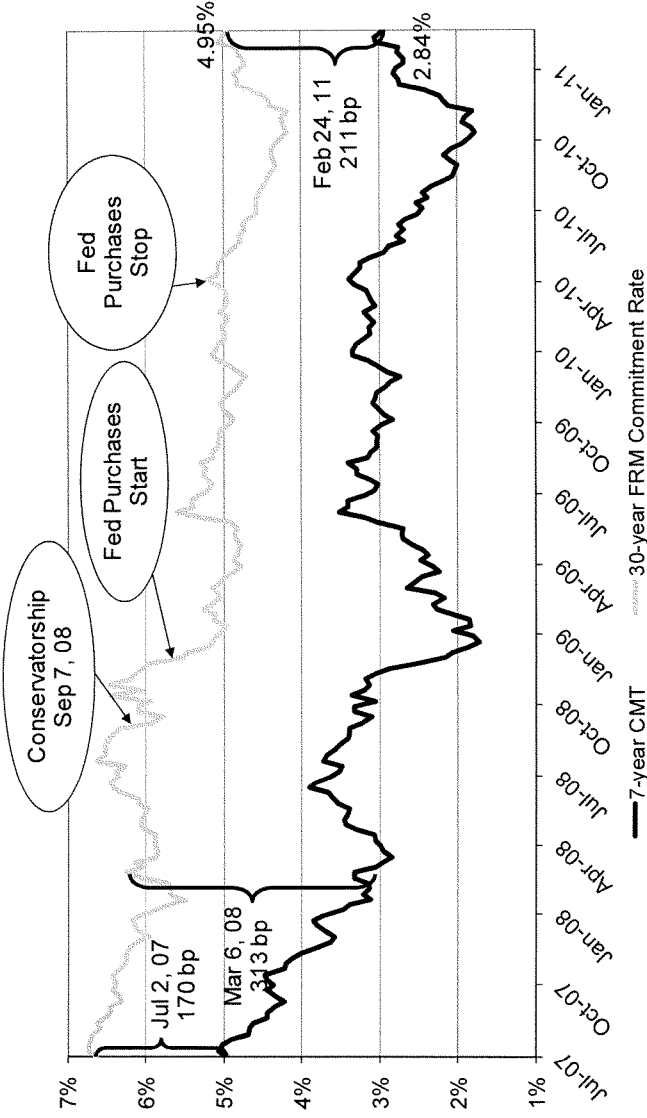




**Figure 1: Mortgage Rates and Treasury Yields**

**Yield on 7-Year Constant-Maturity Treasury and  
30-Year Fixed-Rate Mortgage Commitment Rate**

July 2007 - February 2011

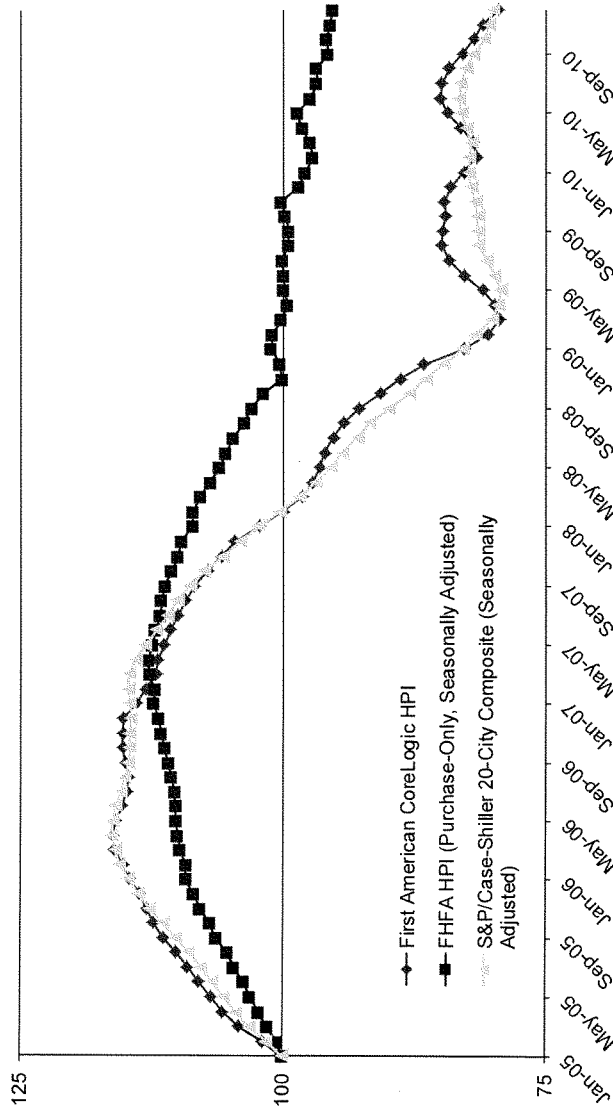


Sources: Freddie Mac, Federal Reserve Board.

**Figure 2: House Price Indexes, 2005 – Present**



First American HPI, FHFA House Price Index, and  
S&P/Case-Shiller House Price Index  
Jan 2005 - December 2010

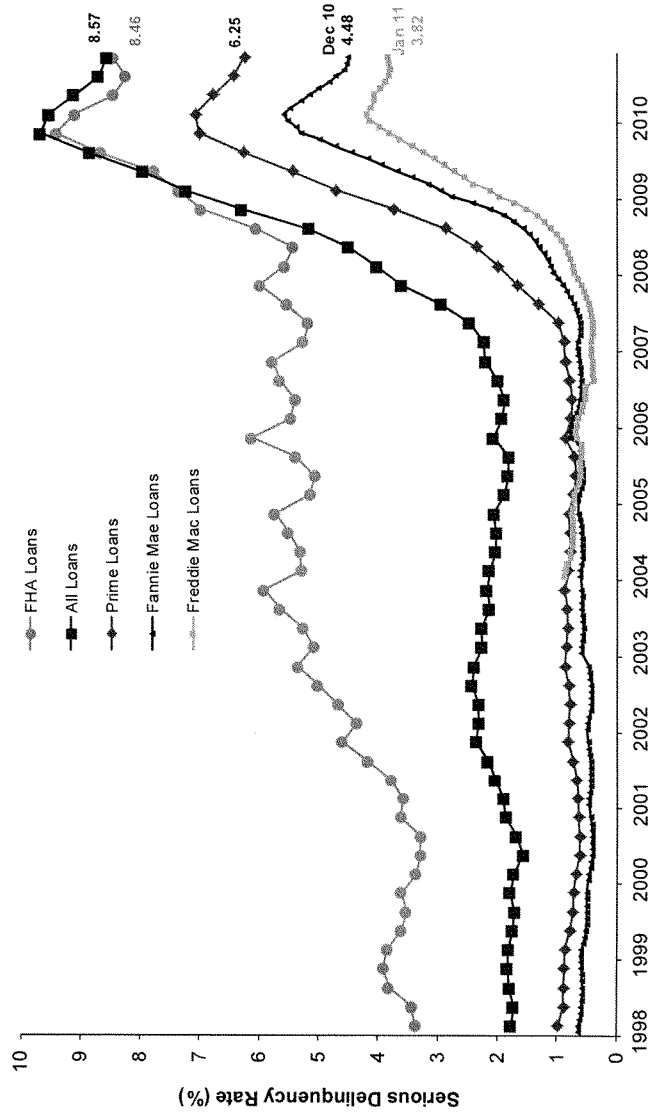


Note: For purposes of comparison, all three indexes have been re-based to equal 100 in January 2005.  
Sources: FHFA, Standard & Poor's, First American.

**Figure 3: Serious Delinquencies Improving**



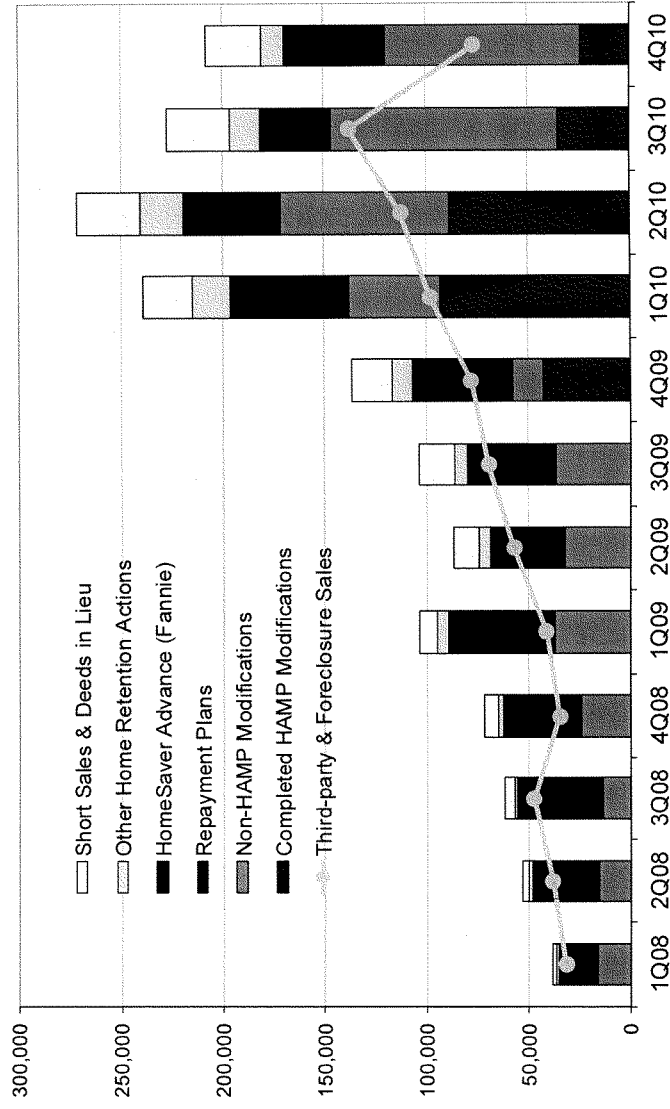
**Single-Family Mortgages  
Jan. 1998 - Jan. 2011**



Sources: Mortgage Bankers Association, Fannie Mae, Freddie Mac.

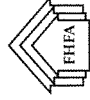


**Figure 4: Foreclosure Prevention Actions Outpace Foreclosures**  
**Enterprise Foreclosures and Foreclosure Prevention Actions by Type**  
 2008Q1 - 2010Q4

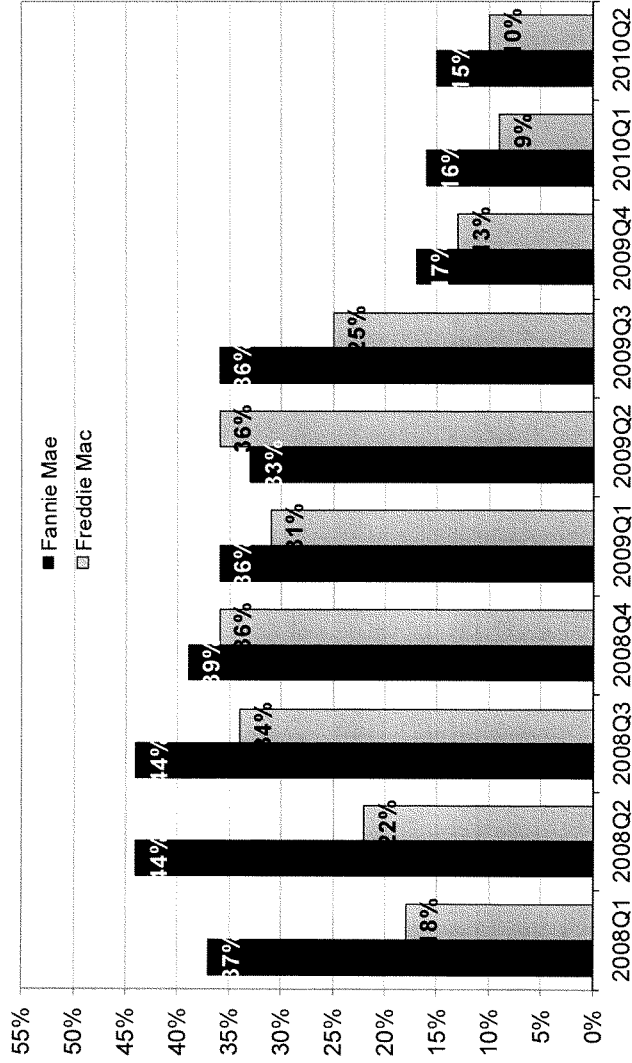


Source: FHFA.

**Figure 5: Re-Defaults of Modified Mortgages**



**Sixty-plus Delinquency Rate of Modified Mortgages  
Six Months After Modification, by Modification Date  
2008Q1 - 2010Q2**

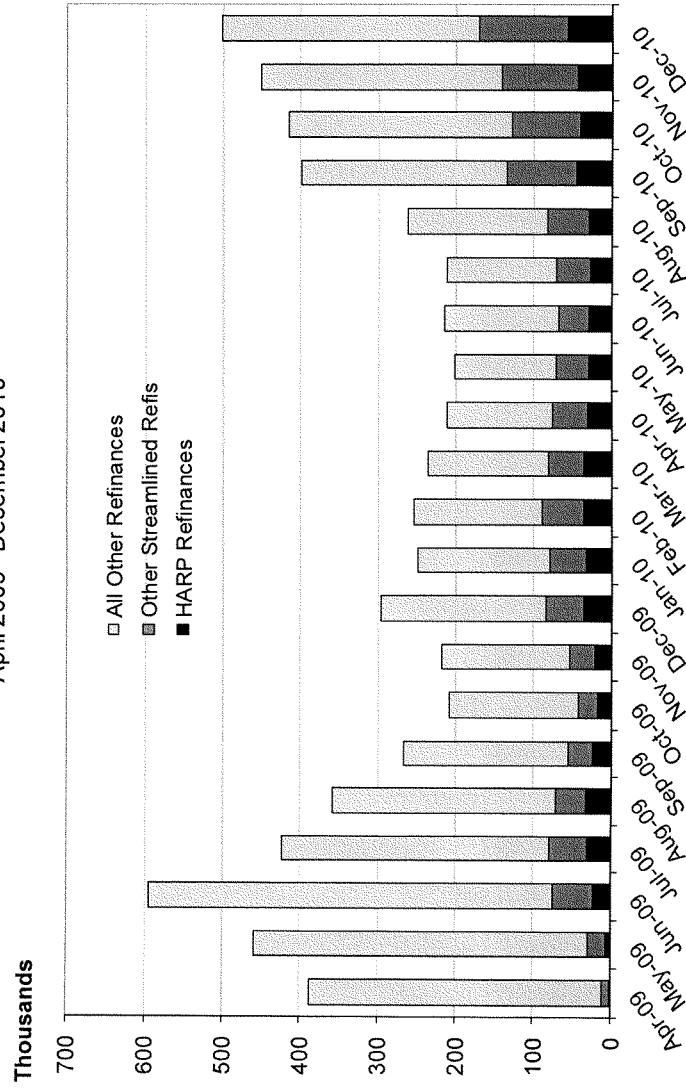


Source: FHFA.

**Figure 6: HARP and Enterprise Refinancing Activity**



**Fannie Mae and Freddie Mac Mortgage Refinance Activity**  
 April 2009 - December 2010



Source: FHFA.

The CHAIRMAN. Thank you.  
Mr. Nelson.

**STATEMENT OF WILLIAM R. NELSON, DEPUTY DIRECTOR, DIVISION OF MONETARY AFFAIRS, FEDERAL RESERVE SYSTEM**

Mr. NELSON. Chairman Kaufman and members of the Congressional Oversight Council. Thank you for the opportunity to testify about the Term Asset Backed Securities Loan Facility, TALF, which was established by the Federal Reserve and Treasury Department during the financial crisis to increase the availability of credit to households small businesses. Treasury provided credit protection for the TALF under the Troubled Asset Relief Program, TARP.

When the financial crisis intensified in the fall of 2008 investor demand for highly rated asset-backed securities, or ABS, evaporated. Spreads on ABS widened dramatically and issuance of new ABS dwindled to near zero. In response, lenders that relied on securitization for funding pulled back on the credit they provided to households and businesses contributing to the severe contraction in the economy that followed.

Among the many actions taken by the Federal Reserve and the Treasury in response to these events, was the creation of the TALF, which was designed to encourage renewed issuance of ABS. Under the TALF the Federal Reserve Bank of New York provided loans to investors for the purchase of certain ABS backed by consumer and business loans. TALF loans had maturities ranging from three to five years. The interest rate spreads on TALF loans were set below spreads on highly rated ABS prevailing during the financial crisis, but well above spreads in more normal market conditions, providing investors an incentive to repay the loans as financial conditions normalized.

To protect the Federal Reserve and the Treasury, several layers of risk controls were built into the TALF program and are detailed in my prepared remarks.

The TALF contributed importantly to a revival of ABS markets and a renewed flow of credit to households and businesses. Issuance of non-mortgage ABS jumped to \$35 billion over the first three months of TALF lending in 2009 after having slowed to less than \$1 billion per month in 2008.

During its initial months of operation the TALF financed about half of the issuance in the ABS market. Over the life of the program the TALF supported nearly 3 million auto loans, more than 1 million student loans, nearly 900,000 loans to small businesses, 150,000 other business loans and millions of credit card loans.

When the program closed in June, 2010, \$43 billion was outstanding. As a result, in July, 2010 the Federal Reserve Board and the Treasury agreed that it was appropriate for the Treasury to reduce the credit protection provided by the TALF under the TARP, from \$20 billion, ten percent of the authorized size of the program, to \$4.3 billion, ten percent of the loans outstanding when the program closed.

As I noted, the TALF loan interest rates were set at spreads chosen to be well above those that prevailed in more normal financial conditions, yet below those at the height of the crisis. The TALF

has earned nearly \$600 million of net interest income to date. If there were to be any losses on TALF loans, the losses would first be absorbed by the accumulated net interest income. The TARP funds would absorb any losses that exceeded the accumulated net interest income, up to the commitment provided by the Treasury.

The experience to date suggests that the multiple risk controls built into the TALF program have been effective and losses appear unlikely. Because market conditions have improved, TALF loans now appear expensive, as intended, and more than two-thirds of the loans have been repaid early. All the remaining TALF loans are current regarding payments of interest and principal. All of the collateral backing the outstanding loans have retained their AAA ratings and the market value of the collateral backing each of the loans has remained well above the loan amount.

As a result, we see it as highly likely that the accumulated interest will be sufficient to cover any loan losses that may occur without drawing on the dedicated TARP funds.

In conclusion, we believe that the TALF program represents a highly successful use of TARP funds. The TALF program helped restart the ABS markets at a critical time, thereby subordinating the provision of credit to millions of American households and businesses. Moreover, its careful design has protected the taxpayer and in the end the program almost certainly will remit a net profit to the Treasury.

Thank you for the opportunity to discuss the TALF program today. I would be pleased to take any questions that you have.

[The prepared statement of Mr. Nelson follows:]



For release on delivery  
10:00 a.m. EST  
March 4, 2011

Statement by  
William R. Nelson  
Deputy Director  
Division of Monetary Affairs  
Board of Governors of the Federal Reserve System  
Before the  
Congressional Oversight Panel  
Washington, D.C.  
March 4, 2011

Chairman Kaufman and members of the Congressional Oversight Panel, thank you for the opportunity to testify about the Term Asset-Backed Securities Loan Facility (TALF), which was established by the Federal Reserve and the Treasury Department during the financial crisis to increase the availability of credit to households and small businesses. The Treasury provided credit protection for the TALF under the Troubled Asset Relief Program (TARP). In my remarks today, I will review financial market conditions when the Federal Reserve and the Treasury established the program, how the program worked, its effects, and the steps we took to control risk.

Asset-backed securities (ABS) are a common instrument used to finance a variety of types of consumer and business loans, including small business loans, auto loans, student loans, business equipment loans, and credit card loans. For example, about one-half of credit card loans and one-third of auto loans were funded through securitization in the years leading up to the financial crisis.

Prior to the financial crisis, many investors in highly rated ABS relied on short-term funding markets, such as the repurchase and asset-backed commercial paper markets, to finance their ABS investments. However, beginning in the summer of 2007, creditors pulled back from lending in short-term funding markets in what has been well characterized as a run on the shadow banking system. When the financial crisis intensified in the fall of 2008, concerns about ratings on structured products and the economic consequences of the financial crisis deepened and conditions in short-term funding markets deteriorated further. As a result, investor demand for highly rated ABS evaporated. Spreads on ABS widened dramatically, and issuance of new ABS dwindled to near zero. In response, lenders that relied on securitization for funding tightened their lending terms and standards. For example, the average interest rate on auto loans extended by finance companies--companies that were heavily dependent on securitization--rose

from 3.25 percent in July 2008 to more than 8 percent by December 2008. This sharp deterioration in credit conditions contributed to the severe contraction in the economy that followed.

Among the many actions taken by the Federal Reserve and the Treasury in response to these events was the creation of the TALF, which was designed to encourage renewed issuance of ABS. The program was announced in November 2008 and began operations in March 2009. Under the TALF, the Federal Reserve Bank of New York provided loans to investors for the purchase of newly issued, highly rated ABS backed by new or recently extended auto loans, credit card loans, student loans, and small business loans. TALF loans had maturities ranging from three to five years. The interest rate spreads on TALF loans were set below spreads on highly rated ABS prevailing during the financial crisis but well above spreads in more normal market conditions, providing investors an incentive to repay the loans as financial conditions normalized.<sup>1</sup> TALF loans were collateralized by the ABS purchased but did not provide for further recourse to the borrower except in limited circumstances.

The TALF was subsequently expanded to include newly issued, highly rated securities backed by business equipment loans, loans to retailers to finance their inventories, mortgage servicer advances, vehicle fleet receivables, insurance premium loans, and commercial mortgages (CMBS), as well as highly rated existing CMBS. The Federal Reserve and the Treasury considered but ultimately decided not to accept newly issued or existing residential mortgage-backed securities or newly issued collateralized loan obligations because the TALF

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<sup>1</sup> TALF loan rates were set as a spread over a variable base rate (usually Libor (London interbank offered rates)) for loans secured by variable-rate collateral, and as a spread over a fixed base rate (the Libor swap spread) for loans backed by fixed-rate collateral. The spreads for TALF loans that were backed by government-guaranteed collateral (Small Business Administration ABS and Federal Family Education Loan Program student loan ABS) were 50 basis points. For other TALF loans, the spreads were 100 basis points.

appeared unlikely to be able to improve conditions in the markets for those securities at acceptable levels of risk.

The Federal Reserve Board initially authorized the TALF to make \$200 billion in loans, but because of the improvement that occurred in financial markets in the latter half of 2009, only about \$70 billion in loans were extended under the program. Nearly 200 different borrowers participated in the TALF, including traditional asset managers, pension funds, hedge funds, and banks, as well as many smaller companies. The specific details on each loan--including the names of the borrowers, the terms of the loan, and the collateral backing the loan--are publicly available on the Federal Reserve Board's website.<sup>2</sup> The Treasury provided the Federal Reserve with credit protection through the TARP equal to \$20 billion, 10 percent of the authorized size of the program; as a result, the Federal Reserve was able to participate in the program in its traditional role as liquidity provider without taking on more than minimal credit risk despite the longer terms and nonrecourse nature of the loans provided.

The Federal Reserve Board, the Federal Reserve Bank of New York, and the Treasury collaborated in designing the TALF. Staff members conferred daily, and all major decisions were reviewed by the Board of Governors, the leadership of the New York Fed, and the leadership of the Treasury. Although the Treasury provided credit protection for the Federal Reserve, the risk controls built into the TALF, which I will describe in more detail in a moment, were designed to keep the risk for the U.S. government as a whole very low.

The TALF contributed importantly to a revival of ABS markets and a renewed flow of credit to households and businesses. Issuance of nonmortgage ABS jumped to \$35 billion over the first three months of TALF lending in 2009, after having slowed to less than \$1 billion per

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<sup>2</sup> See "Usage of Federal Reserve Credit and Liquidity Facilities" on the Board's website at [www.federalreserve.gov/newsevents/reform\\_transaction.htm](http://www.federalreserve.gov/newsevents/reform_transaction.htm).

month in late 2008. During its initial months of operation, the TALF financed about half of the issuance in the ABS market, with the degree of support then declining as market functioning improved. Over the life of the program, the TALF supported nearly 3 million auto loans, more than 1 million student loans, nearly 900,000 loans to small businesses, 150,000 other business loans, and millions of credit card loans. Auto lenders that funded their operations in part with ABS supported by the TALF told us that the program allowed them to provide more credit to consumers and at lower rates than they would have been able to do otherwise. The TALF also facilitated the first issuance of a commercial mortgage-backed security following a year-and-a-half drought, a security that provided an important benchmark for pricing and helped establish the higher credit standards now seen in the market.

The TALF closed for new loans backed by ABS and existing CMBS in March 2010, and for new loans backed by new-issue CMBS in June 2010. When the program closed in June, \$43 billion in loans was outstanding. As a result, in July 2010, the Federal Reserve Board and the Treasury agreed that it was appropriate for the Treasury to reduce the credit protection provided the TALF under the TARP from \$20 billion to \$4.3 billion--10 percent of the loans outstanding when the program closed.

To protect the Federal Reserve and the Treasury, several layers of risk controls were built into the TALF program. First, TALF loans were extended only to finance purchases of securities acquired in arms-length transactions--an investor borrowing from the TALF had to be unaffiliated with the originator or seller of the ABS presented as TALF collateral, and no side-payments could be made between the investor and seller.

Second, the securities were required to have triple-A ratings from two or more rating agencies and could not have a rating below triple-A from any rating agency. For CMBS, those ratings had to be from one of five credit rating agencies that had been qualified to provide ratings

for the TALF, and the collateral was subject to an additional credit review by the Federal Reserve Bank of New York before being accepted. For ABS, initially, credit ratings were accepted from the three largest rating agencies, and no separate credit review was performed. Starting in the third quarter of 2009, however, the Federal Reserve established criteria for credit rating agencies for ABS pledged to the TALF, and the ratings of four agencies were accepted. At the same time, an internal credit review process for ABS was established.

Third, the maximum allowable amount of each TALF loan was always less than the market value of the ABS purchased by an amount referred to as the haircut, which depended on the riskiness of the collateral. The haircuts were calibrated based on the historical price volatility and credit-loss experience of the eligible securities.<sup>3</sup> Since the borrower provided the funds to cover the haircut as a down payment on the ABS, the haircut served to reduce the likelihood that a borrower would default on the loan in the event that the underlying securities declined in value. In addition, because the borrower had its own money invested to cover the haircut, and stood to lose that money if the ABS declined in value, the borrower had an appropriate incentive to rigorously evaluate the securities it purchased and pledged to the TALF.

And fourth, the TALF loan interest rates were set at spreads chosen to be well above those that prevailed in more normal financial conditions yet below those at the height of the crisis, and the resulting excess interest income was designed to serve as a buffer against losses. The TALF has earned nearly \$600 million of net interest income to date, which is equal to more than 2-1/2 percent of the TALF loans currently outstanding. If there were to be any losses on TALF loans, the losses would first be absorbed by the accumulated net interest income. The

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<sup>3</sup> The haircuts varied from 5 percent for securities with short maturities and strong track records, such as credit card ABS, up to 18 percent for longer-dated securities with higher historical loss experiences and more volatile prices, such as CMBS.

TARP funds would absorb any losses that exceeded the accumulated net interest, up to the \$4.3 billion commitment provided by the Treasury.

The experience to date suggests that the multiple risk controls built into the TALF program have been effective and losses appear unlikely. Because market conditions have improved, TALF loans now appear expensive, as intended, and many borrowers have elected to repay their loans early. More than 2,000 TALF loans totaling \$70 billion were extended, and although no loans have come due yet, 1,400 loans totaling \$49 billion have been repaid early, leaving \$21 billion outstanding currently. All of the remaining TALF loans are current regarding payments of interest and principal. All of the collateral backing the outstanding loans have retained their triple-A rating, and the market value of the collateral backing each of the loans has remained well above the loan amount, significantly reducing the likelihood of borrower default. As a result, we see it as highly likely that the accumulated interest will be sufficient to cover any loan losses that may occur without recourse to the dedicated TARP funds.

In conclusion, we believe that the TALF program represents a very successful use of TARP funds. The TALF program helped restart the ABS markets at a critical time, thereby supporting the provision of credit to millions of American households and businesses. Moreover, its careful design has protected the taxpayer, and in the end, the program almost certainly will return a net profit to the Treasury.

Thank you for the opportunity to discuss the TALF program today. I would be pleased to take any questions you may have.

The CHAIRMAN. Thank you very much.

And we'll start—we'll have one round of questions.

Mr. Cave, can you talk a little bit about the plans of the—that you mentioned in your testimony about plans for large banking organizations to increase dividends and how you think that works and why you think that works and what has to be done before that should go forward?

Mr. CAVE. Yes, thank you. I'd be happy to answer that question.

The Federal Reserve is the lead agency with responsibility for administering the stress tests and the review of the dividend plans. We are involved as well. We think that this is a positive program. Before the crisis you had institutions that paid out significant amounts of cash in dividends and in capital repurchases, leaving them more vulnerable when the crisis did hit. So the process that's being used—before institutions can begin to increase dividends and capital repayments—is a programmatic approach that we view as an improvement over the past. And we are very much involved in that as well.

The CHAIRMAN. Do you have any thoughts about the timing of this at this particular time?

Mr. CAVE. The staffs are working presently on this. It's a priority. There is interest in having responses to institutions for the first quarter of 2011, so this is a very important time where a lot of work is going into this as well.

The CHAIRMAN. Mr. Nelson, do you have any comments on that, the dividends plans of large banks?

Mr. NELSON. No, I do not.

The CHAIRMAN. Okay. Mr. Lawler, what's your view about Fannie Mae and Freddie Mac having conflicts as their roles as investors in residential mortgages and their roles as Treasury agents with respect to HAMP?

Mr. LAWLER. I don't think it creates important conflicts. They are investors. They do have an interest in trying to reduce foreclosures to the maximum extent possible. I think it's very consistent with the Treasury Department's goals with these programs. They're working together to try and create programs that will work to keep people in homes and reduce costs to taxpayers.

The CHAIRMAN. But the—one of the problems is, is there are conflicts involved throughout the whole process, with the servicers. Do you agree? And as Fannie Mae and Freddie Mac, you don't see they—where they have any conflict?

Mr. LAWLER. With servicers?

The CHAIRMAN. Yeah.

Mr. LAWLER. Servicers have some conflicts in some parts of the process. For example, if they hold a second lien—

The CHAIRMAN. Right.

Mr. LAWLER [continuing]. On a property where they're also servicing the first lien, that's a conflict and that's certainly an issue.

The CHAIRMAN. Fine. Mr. Nelson, did TALF work, in your opinion?

Mr. NELSON. Yes, sir, it was very effective. For example, in research that was just released on the Federal Reserve's website yesterday, my colleagues and I at the Federal Reserve have found that the TALF had a very consequential affect on lowering ABS spreads,



both for consumer ABS and in commercial mortgage-backed securities.

In other research, my colleagues have found a link between the issuance of TALF ABS and lower loan rates extended by the lenders that funded themselves with TALF ABS.

And finally, I'd add that we talked to issuers when the program was in operation and in subsequent surveys and asked them what the effects of the program were for them and they indicated that the program helped them to lower rates and that without the program they would have lent less and there conceivably been a much more severe contraction of credit.

The CHAIRMAN. Great. Follow on Dr. Troske's question, Mr. Cave. Are you concerned about how we get troubled assets off the balance sheets of banks?

Mr. CAVE. I think that what we are seeing are some improvements in troubled asset levels compared to what we saw during the crisis. Our latest review, the Quarterly Banking Profile that we released last week, showed that we're seeing some improvements in delinquencies and net charge-offs from the crisis levels. But again, levels are elevated compared to historical averages and there still remains work to be done to continue the process of balance sheet repair.

The CHAIRMAN. Thank you very much.

Mr. McWatters.

Mr. MCWATTERS. Thank you. Following up on that. Do these troubled assets, which are estimated at around a trillion dollars, as presently constituted, do they pose a systemic risk to the economy? Mr. Cave?

Mr. CAVE. Compared to where we were with troubled assets during the crisis, we are at a point where levels have receded. It is still very much something the FDIC monitors closely. Also, we look to ensure that institutions have proper reserves and capital and liquidity to be able to deal with their problem assets. Something that, again, we look at very closely.

Mr. MCWATTERS. Okay. And I'm putting words in your mouth and saying that sounds like a no to me. I mean it sounds like a no answer. It's not that these troubled assets, a trillion dollars on the books, do not pose a systemic risk today. Is that a fair statement or?

Mr. CAVE. I would need to get additional information to you on that.

Mr. MCWATTERS. Okay. Fair enough.

Mr. Lawler or Mr. Nelson, do you have any thoughts on that?

Mr. NELSON. No, sir.

Mr. MCWATTERS. Okay.

Mr. LAWLER. At Fannie Mae and Freddie Mac and the home loan banks there are troubled assets, but because Fannie Mae and Freddie Mac are currently under conservatorship and backed by the Treasury, they're not currently creating a systemic risk.

Mr. MCWATTERS. But if the bailout of Fannie Mae and Freddie Mac somehow went away, then the answer could be different?

Mr. LAWLER. Yeah, that's a hypothetical, so.

Mr. MCWATTERS. Okay. Okay.

How about the robo-signing problems and the breach of representations that we read about a lot a couple months ago? Did those create a systemic risk in the opinion—

Mr. LAWLER. If the foreclosure process were to stop functioning entirely that would create some significant problems. Most of the—my understanding of those issues were that the processes were not followed correctly, but if they can be created, so that they do work properly, then that's not a systemic risk. If we simply were unable to foreclose on properties then that could create more serious problems.

Mr. MCWATTERS. Well, what about a systemic risk that could develop when financial institutions, the servicers, the originators, the securitizers are sued, particularly the financial institutions are sued and wearing any of those hats, perhaps multiple hats of the—being the securitizer and the originator? I mean there are claims now before the courts that investors were materially misled and they're asking for a significant amount of damages. I understand lawsuits, they happen all the time, but is the cumulative effect of these lawsuits, do they present a systemic risk to these financial institutions?

Mr. LAWLER. Again, not to Fannie Mae and Freddie Mac, because they're not—

Mr. MCWATTERS. Okay.

Mr. LAWLER [continuing]. The ones being sued.

Mr. MCWATTERS. Mr. Cave, what do you think?

Mr. CAVE. I think that in our view this is very much a question for the Financial Stability Oversight Council. As you have noted, this situation involves various financial market participants as well as regulators and we believe that this is something that should be a question for the FSOC.

Mr. MCWATTERS. Mr. Nelson, the Fed, what's the Fed's view of this?

Mr. NELSON. I'm sorry, sir, this is not an area of my expertise.

Mr. MCWATTERS. Okay. Okay. Fair enough.

So it sounds like no one is saying, well, with the exception of Mr. Lawler, because his client is—has an unlimited check from Treasury, that the answer is simply uncertain.

Let me ask one final question in the few seconds I have. If you had to do this all over again and you were back in 2008 and you were gearing up, would you do anything differently? Would you have different programs? Would you have the programs that you have now but would you tweak them some way?

Mr. Cave.

Mr. CAVE. Thank you for the question. From our perspective, the TLGP program, so far, has been a success and has done what it was intended to do, unlock the credit markets and allow institutions to extend their liabilities. We think that's very important. What was happening prior to the crisis was that institutions' balance sheet liabilities were getting shorter and funding was getting more complicated. So again, we think that the TLGP was successful in addressing that issue. There is still more time to go. We still have exposure and we are monitoring that very closely. So I think that is working as expected.

The Dodd-Frank Act has provided us with greater authorities to do things that we could not do prior to the crisis. And we view, very much, the proper implementation of the Dodd-Frank Act as a key thing to do as we move forward.

Mr. MCWATERS. Okay. Thank you, Mr. Cave.

Mr. Lawler, Mr. Nelson, any thoughts?

Mr. LAWLER. Putting Fannie Mae and Freddie Mac into conservatorship was the right thing to do and that helped provide funding, continued funding for housing markets. We did not, at that time, appreciate, when we put them into—first put them into conservatorship, how serious the recession would be and how bad unemployment would be and what the implications would be for the housing market from that point forward.

We did move with the Bush Administration to start the streamline mortgage modification program, but as we did that and as we moved into HAMP we learned a lot of lessons about how to institute such a program. We'd never done anything remotely like this before, trying to get all large servicers in the country working on a single program, doing things the same ways with systems that were entirely different. So we learned a lot as we implemented that and as we shifted from SMP to HAMP that had we gone through the experience before we would have been able to do faster.

Mr. MCWATERS. Okay. Thank you. My time is up. Sorry.

The CHAIRMAN. Mr. Silvers.

Mr. SILVERS. So this hearing and the wind up of our work is really focused, I think on two really major issues that I want to address with you all. One—and the relevance of your testimony to these two issues. One is the question of the stability, the health of the banking system and the other is the question of the housing market and the continuing foreclosure crisis.

Let me start with the housing market. Mr. Lawler, let me make sure I have—I understand the GSE's position here correctly in terms of their exposure to the housing market and the foreclosure crisis. The GSEs have obligations to their—to the holders of GSE issued securities. And the GSEs bought some stuff during the run up to the financial collapse. It turns out probably to have been a mistake.

Am I right in understanding that, and as a general matter, the more foreclosures there are, the more housing prices fall, the more the value—the more GSEs have difficulty meeting their obligations to their security holders and the lower the value of those assets they purchased fall, is that basically right?

Mr. LAWLER. Right. If they can prevent unnecessary foreclosures then that will help the market and makes their securities more valuable.

Mr. SILVERS. So if housing prices fall secularly across our economy, the losses the GSEs will suffer and that—the money that will be paid out per the guarantee Mr. McWatters was talking at, will increase, right?

Mr. LAWLER. Right.

Mr. SILVERS. So from the perspective of the interests of the GSEs as at least nominally independent firms, the fiduciary duties of the trusteeship over those entities, there seems like a compelling rea-

son to try to do everything you can to keep housing prices from falling further. Is that right?

Mr. LAWLER. Right.

Mr. SILVERS. Okay. Now, the GSEs are today the, as far as I understand it, the really the only providers of a secondary market of any consequence, for mortgages in the United States. Is that true?

Mr. LAWLER. Conventional mortgages. Ginnie Mae handles—

Mr. SILVERS. Yes, there's Ginnie Mae and FHA, but there's not a private label mortgage market of any consequence today?

Mr. LAWLER. That's right.

Mr. SILVERS. Right? So you—so the GSEs really are—the GSEs have, shall we say, a fair amount of market power right now?

Mr. LAWLER. Okay.

Mr. SILVERS. Right? Would you agree that's true?

Mr. LAWLER. Yes.

Mr. SILVERS. All right. Does it make—isn't it—is it consistent with the GSEs business purposes, right and the duties owed to the GSEs by the governance of the GSEs, is it consistent with that to use that market power to ensure that the housing market doesn't fall further, all right, to—and to thus minimize the losses the GSEs are going to incur in the future? Does that make sense?

Mr. LAWLER. Well it does, except that the prices they charge directly affect what their earnings or losses are as well, so there's a balance that—

Mr. SILVERS. Right. No, I'm saying in totality the GSEs should be managing their business to minimize the losses they're going to incur. And this has everything to do with the broad movements of housing prices and stability in the housing market. Am I right?

Mr. LAWLER. That's right.

Mr. SILVERS. Okay. So would you agree then that to the—that because foreclosures, as a general matter, all right, some foreclosures are unavoidable, but that foreclosures as a general matter contribute to falling housing prices and greater losses to the GSEs, as a pure business matter the GSEs ought to use every instrument and every power in their disposal to ensure that no unnecessary foreclosure occurs?

Mr. LAWLER. And "unnecessary" is an important word there.

Mr. SILVERS. But you agree with that, as a business matter?

Mr. LAWLER. Their program—

Mr. SILVERS. I said as a business matter—

Mr. LAWLER. Right.

Mr. SILVERS [continuing]. Not as a public policy matter, not as a matter of social do-gooderism, but as a pure business matter for the GSEs, you agree that that's true?

Mr. LAWLER. That's what their programs are designed to do.

Mr. SILVERS. Okay. Excellent. Thank you.

Mr. Cave, your testimony, which I found very interesting expresses some concerns about dividends. And not surprisingly, the FDIC appears concerned that the—loans which the FDIC has guaranteed be paid first before any dividends get issued. I am concerned further beyond that about the quality of earnings at the large banks that are proposing paying dividends. Do you have—does the FDIC share my concern?

Mr. CAVE. Thank you. Based on our recent Quarterly Banking Profile report, the earnings and the state of the industry have improved. We saw 2010 as a turnaround year with stronger earnings. But, a portion of that was due to reductions in loan loss provisions, which had a benefit for earnings. Revenues did not see as much improvement. That's an area we are looking at very closely to ensure that those reductions in provisions are appropriate given the current risk of the assets. I think that's an area that—

Mr. SILVERS. Right.

Mr. CAVE [continuing]. Further work is needed. But we are looking at that very closely.

Mr. SILVERS. Now my time is expired, but if I can ask the Chairman's indulgence. I just want to clarify that for the non-bank regulators who might be listening. What we're talking about here, and you tell me if I'm wrong, all right, is that a fair amount of the earnings of the large banks does not reflect actual cash that has gone into those banks. It reflects changes in assumptions about future losses. The dividends that would be paid would involve actual money, not assumptions or promises or other things, but actual money so that on the one hand you have no money coming in for that part of those earnings and on the other hand dividends would involve real money coming out. Is that, in a sort of simple-minded way, is that what we were just discussing?

Mr. CAVE. I think that would be a fair representation. Dividends would be cash coming out and there are various attributes of the earnings stream that have various levels of quality.

Mr. SILVERS. All right. I'm concerned about that. Thank you.

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you. So I'll start with you, Mr. Nelson. In a recent paper Professor Zingales and a co-author estimated that the CPP program, along with the FDIC's Temporary Liquidity Guarantee Program increased the value of banks participating in these two programs by approximately \$130 billion, of which 40 billion represented a direct taxpayer subsidy to banks, it seems clear that many of the programs implemented by the Federal Reserve's including its purchase of mortgage-backed securities and the Primary Dealer Credit Facility also provided significant financial assistance to banks. Do you think the assistance from these other programs and other agencies enabled large banks to repay their TARP funds more quickly?

I know that these efforts were coordinated between Treasury and the Fed and the FDIC. Was there some discussion about this and if so, do you think that these other programs allowed some of the shifts—some of the costs of TARP to be shifted—to these other what I would call less scrutinized programs? Do you have any thoughts on that?

Mr. NELSON. The Federal Reserve's response to the financial crisis could be divided up into two broad categories. One would be their provision of liquidity through the discount window, a traditional lender of last resort response, their liquidity facilities of which TALF was one. Those facilities were intended to increase the liquidity of financial markets and ultimately allow for greater credit to flow to consumers and businesses as I discussed.

The purchases of agency mortgage-backed securities, something you mentioned before all of the Federal Reserve's purchases of securities were government guaranteed securities. Those were designed to act very much like traditional monetary policy, by lowering interest rates, encouraging spending, bringing down unemployment and achieving the macroeconomic objectives that the Congress gave to the FOMC.

I don't know anything about any additional objectives along the lines of what you just described.

Dr. TROSKE. But I mean it certainly is the case that they entered into a market in which the mortgage-backed security market was close to not functioning and they dumped \$1.2 trillion into that market. And I'm not arguing with—that that was not part of an active monetary policy and that that was not the right policy to adopt. But clearly that had to have some affect on the mortgages that were, you know, the liquidity that banks had with these mortgages and allowed them to move them off their balance sheets. Is that correct?

Mr. NELSON. Well, Dr. Troske, I'd respectfully disagree. The government guaranteed mortgage-backed securities market functioned very well throughout the financial crisis. And the liquidity of those assets was very well maintained. They were government guaranteed assets. And during the financial crisis there was quite a bit of demand for the safety and security of government guaranteed assets.

So it is true that by the nature of the actions, lowering interest rates raises the prices of securities, that's how it works. So, by lowering interest rates anyone who was holding those securities would have had an asset that went up in value, but that was not the objective of the programs.

Dr. TROSKE. Mr. Cave, I guess I'd direct the same question to you. Do you think that the FDIC's actions sort of benefited large banks and in some sense allowed them or enabled them to be more quickly pay back their TARP funds? I mean and I'm not arguing that that was the main purpose but was that one of the consequences of this action?

Mr. CAVE. I don't believe that that was a consequence. The TLGP was very much a programmatic—systematic—approach that provided help to the markets, not just for large institutions.

There were two parts to the program. It's important to know with the TLGP debt guarantee program that the main purpose there was to address the situation where money was coming due very quickly and debt was getting shorter. The TLGP allowed institutions to refinance as institutions were becoming less liquid. So it was very important.

There was also the Transaction Account Guarantee program that benefited large banks, but also very much benefited small banks as well, because we were seeing issues there with these accounts. That provided some stability, not just to large institutions, but small institutions as well. We were taking a combined approach. These were broad programs with broad participation that provided the improvements to the situations that we were seeing at that time.

Dr. TROSKE. Okay. And Mr. Nelson, let me ask you one more question. I guess throughout this crisis it seems as if, and perhaps rightfully so, there was a blurring in distinction of the Fed is traditionally the agency that conducts monetary policy, Treasury is traditionally the—one of the agencies that conducts fiscal policy. Many of the programs of the Fed looked a lot like fiscal policy, lending money to AIG, Primary Dealer Credit Facilities that I mentioned before. Financial stability program of the Treasury looked a lot like monetary policy, an effort to remove liquidity from the market to tamp down inflationary expectation.

Does that concern you about this blurring of the distinction between who does monetary policy and who does fiscal policy? Perhaps it was necessary and I guess—do we think that at some point we can put the genie back in the bottle and get back to more traditional roles?

Mr. NELSON. Dr. Troske, I agree. This is a very good question and it's very important that the independence of the Federal Reserve and the separation of monetary policy from fiscal policy be maintained. Being a lender of last resort is a very traditional role of a central bank and of the Federal Reserve. It's part of the reason why the Federal Reserve was created.

You mentioned the Primary Dealer Credit Facility, that was a facility that was created using our emergency authority. But it looked like a traditional discount window facility rather than lending to depository institutions, in the case of the Primary Dealer Credit Facility, we lent to primary dealers who are generally large investment banks, for very short terms with very good collateral.

And all of the Federal Reserve's interventions were against very good collateral. And all of the Federal Reserve's credit facility loans, apart from the TALF loans, which I've discussed, have all been repaid with no cost to taxpayers. So, I would argue that the Federal Reserve's actions during the crisis have been consistent with the traditional role of a central bank, as a lender of last resort, as a liquidity provider.

In the case of the TARP and the TALF, which we're discussing today, that was a very important role of the TARP in allowing the Federal Reserve to participate in the TALF with the Treasury and yet maintain its position as a liquidity provider by having the credit protection provided by that program.

Dr. TROSKE. Thank you.

The CHAIRMAN. Superintendent Neiman.

Mr. NEIMAN. Thank you.

I'd like to shift to another area, probably one that you're not expecting, and that's the critical lesson that we learned from the financial crisis on the inextricable link between safety and soundness and consumer protection and the fact that loans that are made to individuals—either on onerous terms or loans that cannot be paid back—have a clear impact on financial stability.

One of the most prominent steps to fix this problem, in Dodd-Frank, was the establishment of the Consumer Financial Protection Bureau. But regulators, particularly some of the witnesses here today, clearly are not off the hook when it comes to consumer protection. Certainly regular institutions below the \$10 billion level

continue to be reviewed for compliance by their existing federal regulators.

But what I'm interested in, and maybe we could start with Mr. Cave as deputy director of the Complex Institution Unit at the FDIC, is how do you incorporate consumer protection into your risk assessment at these large institutions, particularly those over 10 billion, where you no longer have responsibility for direct consumer compliance examination that will be shifted to the CFPD?

Mr. CAVE. I'd be happy to answer that question. First off, at the FDIC we view safety and soundness and consumer protection as going hand-in-hand. We have made some changes in our structure at the FDIC recently, creating a new Division of Consumer Protection to continue to give that very much the focus that's necessary. That group will work very closely with our supervision group.

But, it's a very important issue. I think that the recent foreclosure situation highlights the fact that what can happen on the consumer issues can have an impact for the large institutions. And it goes to show the importance of having the structures and controls in place to deal with those issues. Regulators very much look at those structures and controls to ensure that those are in place because consumer issues could create risks to these institutions.

Mr. NEIMAN. So how will the actual supervision process change going forward? So I assume there will be a formal process for sharing exam information with the CFPB when they take on that responsibility. But the risk—you're still responsible for assessing risk within those institutions, assessment management. So how will you be able to assess management, assign ratings without having a clear understanding of the processes and controls around risk? Will it be beyond simply relying on the information from the CFPB?

Mr. CAVE. For the large institutions, our role will continue to be in a back up capacity. So we're used to being in that role, of having to work with other regulators to ensure that we have the information we need to assist. From that standpoint, for the large institutions, we have some experience there. We've made some improvements to where things weren't as enhanced, I think we would continue to work along those lines.

Mr. NEIMAN. Thank you. I don't want to exclude other witnesses. And you know, when blame is assessed there's often fingers being pointed across the board with respect to institutions and credit rating agencies, and regulators are certainly not left out of that list. One of the issues that comes up frequently is the ability of regulators and examination personnel to stay current and have the expertise to understand the complexity of transactions at some of the largest most sophisticated financial institutions in the world.

I'd like to get your sense of if this is an issue. How do you change or are you changing, either the incentives or the hiring? What are the issues around of being able to stay ahead and on top of these complex transactions at some of the most sophisticated institutions in the world?

Mr. LAWLER. We are indeed trying to develop a new program of examiner training, internally, to address just those kind of problems.

Mr. NEIMAN. Mr. Cave.



Mr. CAVE. At FDIC we recently created the Office of Complex Financial Institutions. I'm the Deputy Director of the monitoring section. There's a few things going on there that are important to note. We'll have a group that is responsible for having onsite presence in the largest institutions. So we will have teams that will look at specific institutions and look at all of the risks associated with those. In addition, we'll be creating a systemic risk branch that will look at institutions horizontally—across institutions—to see where there might be outliers, where there might be areas of risk, and where there might be certain portfolios that require our onsite teams to devote more attention.

So by covering the waterfront, both looking vertically at the institution and horizontally, we believe that we'll get a better picture of what's going on. And that will feed very much into our resolutions group that will also be part of the Office of Complex Financial Institutions and be responsible for the resolution plans. This will provide information to say, "We're seeing some things here that concern us, I think we need to look further into the resolution plans, see how the institutions are dealing with it." So, we have that hand-in-hand.

The other area we have is an international section. Because, as it was noted in the earlier panel, having the coordination for these large institutions beyond the U.S. borders is essential to ensure that we will have plans that actually mean something when they're needed. So we will have a group that will be dedicated to working with the international regulators to make sure we're talking the same language.

Mr. NEIMAN. Thank you. So there is no doubt, the fact that I am a current regulator, I am totally confident that regulators have the ability, that the types of people they are attracting have the ability and experience to stay current in order to provide that kind of oversight role. This is something that we should never lose sight of and though it will continue to be a challenge, it will certainly be a top priority.

So thank you all.

Mr. LAWLER. And I should have added, as Jason and also the Fed and the FDIC and all of the regulators that are part of FSOC have developing units to address systemic risk issues that go across institutions.

Mr. NEIMAN. Thank you.

The CHAIRMAN. And thank you very much. Thank you for being witnesses. Thank you for your public service.

I think as Superintendent Neiman said, it goes without saying that one of the features of our democracy is that we have regulators that have to work. And it only works because we have good people in regulatory agencies. And the sacrifices made by people in the regulatory agencies and people in public service and especially people in the federal service is something I've always been amazed at.

So I just want to thank you again. And we'll bring up the next panel.

I am very pleased now to welcome our third panel of distinguished economists. Joseph Stiglitz, a Nobel Laureate, University Professor at Columbia University; Allan Metzger—Meltzer, the

Allan H. Meltzer University Professor of Political Economy at Carnegie Mellon; Simon Johnson, the Ronald A. Kurtz Professor of Entrepreneurship at MIT Sloan School of Management and a senior fellow at the Peterson Institute for International Economics and Luigi Zingales, the Robert C. McCormack Professor of Entrepreneurship and Finance and the David G. Booth Faculty Fellow at the University of Chicago Booth School of Business. Thank you very much for coming. I want to thank you all.

Please keep your oral testimony to five minutes so we can have ample time for questions. Your complete written statement will be printed in the record.

We'll begin with Mr. Stiglitz.

**STATEMENT OF JOSEPH E. STIGLITZ, NOBEL LAUREATE AND UNIVERSITY PROFESSOR, COLUMBIA BUSINESS SCHOOL, GRADUATE SCHOOL OF ARTS AND SCIENCES (DEPARTMENT OF ECONOMICS) AND THE SCHOOL OF INTERNATIONAL AND PUBLIC AFFAIRS**

Dr. STIGLITZ. Well thank you very much for this opportunity to share with you my views about the success and failures of TARP.

TARP and the recovery of troubled assets were not ends in themselves, but means to an end, namely the recovery of the economy. TARP was justified to the American people as necessary to maintain the flow of credit. It was hoped that it would provide—play a pivotal role in dealing with the flood of mortgage foreclosures and the collapse of the real estate market that led to the financial crisis.

In these ultimate objectives TARP has been a dismal failure. Four years after the bursting of the real estate bubble and three years after the onset of recession, unemployment remains unacceptably high, foreclosures continue almost unabated and our economy is running far below its potential, a waste of resources in the trillions of dollars. Lending, especially to small- and medium-size enterprises, is still constrained. While the big banks were saved, large numbers of the smaller community and regional banks that are responsibility for much of the lending to SMEs are in trouble. The mortgage market is still on life support.

But TARP has not just failed in its explicit objectives, I believe the way the program was managed has, in fact, contributed to the economy's problems. The normal laws of capitalism where investors must bear responsibility for their decisions were abrogated. A system that socializes losses and privatizes gains is neither fair nor efficient. TARP has led to a banking system that is even less competitive, where the problem of Too Big to Fail institutions is even worse.

There were six critical failings of TARP. First, it did not demand anything in return for the provision of funds. It neither restrained the unconscionable bonuses or payouts and dividends, it put no demands that they lend the money that they were given to them, it didn't even restrain their predatory, speculative practices. Secondly, in giving money to the banks it should have demanded appropriate compensation for the risk borne. It is not good enough to say that we were repaid or we will be repaid or we will be almost repaid.

If we had demanded arm's length terms, terms such as those that Warren Buffett got when he provided funds to Goldman Sachs, our national debt would be lower and our capacity to deal with the problems we had would be stronger. The fairness of the terms is to be judged *ex ante*, not *ex post*, taking into account the risks at the time.

Thirdly, there was a lack of transparency. Fourthly, there was a lack of concern for what kind of financial sector should emerge after the crisis. There was no vision of what a financial sector should do. And not surprisingly, what has emerged has not been serving the economy well.

Fifthly, from the very beginning TARP was based on a false premise, that the real estate markets were temporarily depressed. The reality was that there had been an enormous bubble for which the financial sector was largely responsible. It was inevitable that the breaking of that bubble, especially given the kinds of mortgages that had been issued, would have enormous consequences that had to be dealt with. Many of the false starts, both in asset recovery and homeowner programs, have been a result of building on that false premise.

Particularly flawed was the PPIP, a joint public/private program designed to have the government bear a disproportionate share of the losses, the private sector, while putting up minimal money, would receive a disproportionate share of the gains. It was sold as helping the market re-price but the prices that were—that would emerge would be prices of options, not of underlying assets. The standard wisdom in such a situation is summarized in a single word, “restructure.” But TARP, combined with accounting rules changes, made things worse.

The sixth critical failure of TARP was that some of the money went to restructuring securitization under the TALF program, without an understanding of the deeper reasons for the failure of mortgage securitization. These attempts to revive the market have failed, and to me this is not a surprise.

There were alternative approaches, evident at the time of the crisis and even more so as time went on, that I describe more fully in my written testimony. These approaches, had they been taken, would have led not only to a strong economy today but would have led to our government being in a stronger fiscal position.

We might say, “Oh, this is water over the dam,” but it's not. We have not repaired our banking system and indeed, with the enhanced moral hazard and concentration in the financial sector, the economy remains very much at risk, in spite of Dodd-Frank. Our economy is not back to health and will not be until and unless lending can be restored, especially to small- and medium-size enterprises. This means that we need a more competitive financial sector and one more focused on its core mission of lending.

A wide—there is a wide array of important activities performed by the financial sector, but not all of them should be undertaken by government-insured banks. Banks won't focus on lending if they can continue to make more money by publicly underwritten speculation and trading or by exploiting market power in the credit and debit card markets. Moreover, Too Big to Fail institutions, whether they be mortgage companies, insurance houses or commercial in-

vestment banks, pose an ongoing risk to our economy and the soundness of government finances.

I want to conclude with two more general comments. First, we should not forget the process by which TARP and this oversight panel were created. That political process does not represent one of the country's finest moments. At first a short three-page bill was presented giving enormous discretion to the Secretary of Treasury and without congressional oversight and judicial review. Given the lack of transparency and potential abuses to which I have already referred, which occurred even with full knowledge that there was to be oversight, one could only imagine what might have occurred had the original bill been passed.

Fortunately, Congress decided that such a delegation of responsibility was incompatible with democratic processes. On the other hand, the political deals required to get TARP passed, with an estimated \$150 billion in largely unjustified and unjustifiable tax breaks, do not speak well for our democracy. When we think of the cost of TARP, surely the price tag associated with those tax breaks should be included in the tally.

Nor should we underestimate the damage of the correct perception that those who were responsible for creating the crisis were the recipients of the Government's munificence. And the lack of transparency that permeated this and other government rescue efforts has only reinforced public perceptions that something untoward has occurred.

For these and the other failings of TARP, our economy and our society have paid and will continue to pay a very high price.

[The prepared statement of Dr. Stiglitz follows:]

Witness Testimony of Joseph E. Stiglitz  
Congressional Oversight Panel  
Hearing on Impact of the TARP on Financial Stability

March 4, 2011

Thank you for this opportunity to share with you my views about the successes and failures of TARP. We cannot say for sure what would have happened in the absence of strong government action following the bankruptcy of Lehman Brothers. It almost surely played a role in pulling us back from the brink. But this success, as important as it was, should be seen in the light of a broader set of failures. TARP was justified to the American people as necessary to maintain the flow of credit, the lifeblood of an economy. It was hoped that it would play a pivotal role in dealing with the flood of mortgage foreclosures and the collapse of the real estate market that led to the financial crisis.

TARP and the recovery of troubled assets were not ends in themselves, but means to an end, namely the recovery of the economy. In that ultimate objective, TARP has not only been a dismal failure—four years after the bursting of the real estate bubble and three years after the onset of recession, unemployment remains unacceptably high and our economy is running far below its potential, a waste of resources in the trillions of dollars—but the way the program was managed has, I believe, contributed to the economy's problems. Nor should we underestimate the damage of the (correct) perception that those who were responsible for creating the crisis were the recipients of the government's munificence; and the lack of transparency that permeated this and other government rescue efforts has only reinforced public perceptions that something untoward has occurred.<sup>1</sup> The normal laws of capitalism, where investors must bear responsibility for their decisions, were abrogated. A system that socializes losses and privatizes gains is neither fair nor efficient. Admittedly, the big banks *were* given many enormous gifts, of which TARP was only one. The United States government provided money to the biggest of the banks in their times of need, in generous amounts and at generous terms<sup>2</sup>—but have been forcing ordinary Americans to fend for themselves.

That decisions had to be made quickly is no excuse. The problems were anticipated, or at least should have been. Certainly, by the time of the demise of Bear Stearns, markets recognized the high risk that Lehman

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<sup>1</sup> I am thus in total agreement with the COP when it claims: "The program is now widely perceived as bailing out Wall Street banks and domestic auto manufacturers while doing little for the 14.9 million workers who are unemployed, the 11 million homeowners who are underwater on their mortgages, or the countless other families struggling to make ends meet. Treasury acknowledges that, as a result of this perception, the TARP and its programs are now burdened by a public "stigma" [...] [the Panel] has called for Treasury to make banks accountable for their use of the funds they received. It has also urged Treasury to be transparent with the public, in particular with respect to the health of the banks receiving the funds. The lack of these data makes it more difficult to measure the TARP's success and thus contributes to the TARP's stigmatization." (COP, September Oversight Report, Sep 16 2010, pp.3-4.)

<sup>2</sup> Flouting Bagehot's rule to lend freely, but at a punitive rate. See footnote 4 below for a discussion of the enormous magnitude of these gifts.

would be next.<sup>3</sup> The evident lack of contingency plans from both the Fed and the Treasury is inexcusable. But beyond that, there have been more than a hundred crises around the world since the era of deregulation began three decades ago. Economic theory and policy experiences could and should have provided guidance. But those who were wedded to false economic doctrines that claimed the economy was stable and efficient on its own, that self-regulation would suffice, paid little attention to the lessons that might be gleaned from theory and policy. Rather, they turned to the advice of those in the financial market who had wrought the devastation on our economy. Not surprisingly, self-interest, not national interest, was the guiding principle behind the financial markets' advice—and they succeeded in persuading others that what might be good for the big banks would, in the end, prove good for the country. There were alternative approaches, evident at the time of crisis, and even more so as time went on. These approaches, had they been taken, would have led not only to a stronger economy today, but would have led our government to be in a stronger fiscal position.

The failures of TARP are evident in the statistics: lending today is still constrained, especially to small- and medium-sized businesses, and by the best estimates, lending is only now recovering to what it was four years ago. While the big banks were saved, the smaller and regional banks that are responsible for much of the lending to small- and medium-sized enterprises (SMEs) are in trouble. 140 went bankrupt in 2009, 157 in 2010, and 860 are on the watch list—the highest number since March 1993. But this is the tip of the iceberg, evidence of a financial system that is far from repaired. The mortgage market is still on life support; the securitization market that had dominated in the years before the crisis is still dormant; the mortgage bankers still resist assuming even as little as 5% of the risk of the mortgages that they originate. Two million more foreclosures are expected this year—on top of the nearly 7 million since the crisis began. What does it say about an economy and a society in which we have both homeless people and vacant homes?

The bottom line is simple: The financial sector was at the center of the storm that led to the devastation of our economy; but TARP has not succeeded in getting the financial sector to get America back to work. The losses resulting from the gap between our potential and actual output after TARP began dwarf even the waste of resources before the crisis for which the financial sector was responsible.

There were six critical failings of TARP. First, it did not demand *anything* in return for the provision of funds—it neither restrained the unconscionable bonuses or payouts in dividends nor demanded that they lend the money that was given to them. It didn't restrain their predatory practices, whether in credit cards or consumer loans. A system of carrots and sticks, incentives and constraints, might have redirected their attention toward the kind of activities that would have reinvigorated the economy. Instead, they were allowed to continue, much as before, reaping huge profits from speculative and trading activities, and from the monopoly power associated with the control of the payments mechanism.

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<sup>3</sup> As the FCIC's *Financial Crisis Inquiry Report* (pp. 292-293) noted: "And the word on the street—despite the assurances of Lehman CEO Dick Fuld at an April shareholder meeting that 'the worst is behind us'—was that Bear would not be the only failure."

How could the government say that the problem facing the banks was lack of adequate capital, but allow the money pouring into the banks to pour right out? Such funds were *not* contributing to recapitalization. Any economic analysis would have recognized that the interests and incentives of banks and their managers were not aligned with that of the country.

Secondly, in giving money to the banks, they should have demanded appropriate compensation for the risk borne. It is not good enough to say that we were repaid, or we will be repaid, or we will be almost repaid. If we had demanded arms-length terms—terms such as those that Warren Buffett got when he provided funds to Goldman Sachs—our national debt would be lower, and our capacity to deal with the problems ahead would be stronger. The fairness of the terms is to be judged *ex ante*, not *ex post*, taking into account the risks *at the time*.<sup>4</sup>

Thirdly, there was a lack of transparency. The Treasury through TARP was, perhaps, no worse than the Fed, their partner in many of the bailouts. Lack of transparency—off balance sheet activities deliberately designed to deceive shareholders, regulators, and the government—played a central role in the creation of the crisis and has inhibited its prompt resolution. The lack of transparency in the provision of funds has rightfully caused suspicion of favoritism. The country still has had no adequate justification for why AIG positions were closed out at 100 cents on the dollar—contrary to what happened elsewhere. We now at least know the beneficiaries, both in the United States and abroad. But we have still received no explanation for why American citizens played such a large role in bailing out foreign banks.<sup>5</sup> Shouldn't that

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<sup>4</sup> As the February, 2009 COP report, "February Oversight Report: Valuing Treasury's Acquisitions," pointed out, "review of the ten largest TARP investments the Treasury made during 2008 raises substantial doubts about whether the government received assets comparable to its expenditures." COP found that, for each \$100 spent in those investments, Treasury received assets worth approximately \$66. Extrapolating to all capital purchases in 2008 made under TARP, COP found that Treasury paid \$254 billion, for which it received assets worth approximately \$176 billion, a shortfall of \$78 billion (p. 4). Some of the later investments—arguably not made in the panic that might have dominated some of the earlier ones—were particularly egregious. For example, in the same report, the COP estimated that the \$40 billion purchase of AIG securities under TARP's Systemically Significant Failing Institutions Program was made at a 63% subsidy to the insurance corporation—the securities were worth only \$14.8 billion, the COP wrote (p.7). While there have been more recent reports that AIG might perform better than originally expected, it should be emphasized that what matters is these *ex ante* evaluations; the COP reiterated the problematic nature of Treasury's assistance to AIG in its September 2010 report, "Assessing the TARP on the Eve of Its Expiration": "[T]he value of Treasury's substantial investment in AIG and the size of any gain or loss are dependent on many external variables, and the protracted investment in AIG continues to create significant risks to taxpayers."

<sup>5</sup> While noting that it "is not easy to disentangle the cross-border flow of TARP funds," the August 2010 COP report, "The Global Context and International Effects of the TARP," stated that U.S. rescue funds may have had a disproportionate effect on foreign economies (p.76). "While the United States attempted to stabilize the system by flooding money into as many banks as possible – including those that had significant overseas operations – most other nations targeted their efforts more narrowly toward institutions that in many cases had no major U.S. operations. As a result, it appears likely that America's financial rescue had a much greater impact internationally than other nations' programs had on the United States."

be a responsibility of *their* governments? Lack of transparency has fueled suspicions, which are yet to be resolved.

Fourthly, there was a lack of concern for what kind of financial sector *should* emerge after the crisis. There was no vision. The response to any disaster can profoundly shape recovery: done wrong, alleviation of the worst immediate effects can still set the stage for a recurrence. (One should not respond to a tsunami by building new cities on the beach.) Today, we have an even more concentrated banking system, so the problem of too-big-to-fail is even bigger and the risk of anti-competitive behavior is worse. The spread between the discount rate and the prime lending rate is 25 percent higher than it was before the crisis, while lending to small- and medium-sized businesses has shrunk. The too-big-to-fail banks continue to get access to credit at favorable terms—because the market knows that they are almost risk-free.<sup>6</sup> This sets up an adverse dynamic, in which success is not based on greater efficiency but favored access to government bailouts. Our two-tier strategy—let the small and regional banks responsible for lending go, but save the big international banks—has rightly reinforced these beliefs. Resolution authority has made little difference, because few believe that the government will ever use the authority at its disposal with these too-big-to-fail banks. In short, the deficiencies in lending to SMEs that has emerged should come as no surprise. In spite of what was said in defense of TARP, it was not designed to bring back lending to SMEs quickly.

Fifthly, from the very beginning TARP was based on a false premise—that real estate markets were *temporarily* depressed. The reality was that there had been an enormous bubble, for which the financial sector was largely responsible. The breaking of that bubble — especially given the kinds of mortgages that had been issued — meant that a large fraction of the mortgages were underwater and many would not be repaid.

Many of the false starts, both in asset recovery and in homeowner programs, have been a result of building on this false premise. Particularly flawed was the PPIP, a joint public-private program designed to have the government bear a disproportionate share of the losses; the private sector, while putting up minimal money, would receive a disproportionate share of the gains. It was sold as helping the market “re-price”—but the prices that would emerge would be prices of options, not of the underlying assets. There is only one persuasive explanation for such a fundamental mistake—that in fact it was another program of hidden assistance to the financial sector. The program was a failure—no one has been able to attribute any significant macroeconomic benefit, though I am sure some of the private partners may have done well.

The standard wisdom in such a situation is summarized in a single word, *restructure*. But TARP, combined with accounting changes, *made things worse*. Banks were allowed to avoid recapitalization, if they didn’t restructure. In short, *incentives were put in place to not restructure*. The Administration programs for restructuring mortgages have made only a little dent. Now that the American government has a large stake in the vast majority of mortgages, it is inexcusable that we continue to postpone dealing with the problem.

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<sup>6</sup> In addition, the credit rating agencies now give the largest banks significant increases in their ratings because of the implicit government guarantee.



When bad loans are made, someone has to bear the cost. Part of the problem facing the country today is that no one wants to face up to those costs, which are in the hundreds of billions of dollars. The question from the start was whether it would be the banks, and their shareholders and bondholders, homeowners, or taxpayers. For more than 150 years, a basic democratic principle in America has been that individuals who get into trouble should be given a fresh start. But in America today, it is the banks that have been given a fresh start as a result of the largesse of TARP, while ordinary Americans are being saddled with debts, many of which were foisted on them by predatory actions of the banks.

The sixth critical failure of TARP was that some of the money went to resurrect securitization (under the TALF program)—without an understanding of the deeper reasons for the failure of mortgage securitization. These attempts to revive the market have failed, and, to me, this is not a surprise. Securitization means that risks are spread—no one bears the full consequences of issuing bad mortgages. The rating agencies didn't even attempt to ascertain whether the mortgages being issued were good. Instead, they used flawed statistical models—based on past data collected *before the perverse incentives to which securitization gave rise were so prevalent*—to ascertain the likelihood of adverse outcomes on pools of assets. Correlations induced by common macroeconomic shocks seemed to have been given short shrift. The problem is that even were they to return to their flawed models, using recent data would make these pools of assets highly unattractive—too unattractive to be held by pension funds.

The problems of securitization of mortgages are fundamental, and indeed, I warned about them in the early 1990s, as the securitization movement was just beginning. That the banks are so reluctant to assume even the 5% risk is disquieting; my own view is even that amount does not suffice to resolve the risks.

To be sure, critics of the perspectives that I have put forward will claim that this is Monday morning quarterbacking, that I am just conjecturing about what might have happened if an alternative strategy had been pursued. They will claim that we have been pulled back from the precipice on which we stood, and we have largely been repaid. We should be content, and this speculation of *what might have been* is beside the point. Such a view is, I think, wrong. Indeed, those who give credit to TARP for the economy having been brought back from the precipice are themselves engaged in counterfactual conjectures. They assert that were it not for TARP we would have gone over the precipice. While I agree that there was a substantial risk that that might have occurred—and we will never know for sure—we need to recognize that all such claims are judgmental; and those making these claims have a certain self-interest in attributing the successes to TARP, and ignoring its failures. And TARP's failures to deliver on what its promoters promised is not only evident, but was also predictable, and predicted. The failures are not given with 20/20 hindsight, but were clearly identified even as the program was being formulated. I suspect that it was a fundamental mistake to leave the restoration of the economy and the implementation of TARP to those who were, in a fundamental sense, responsible for its creation, failed to see the crisis coming and/or—even after the breaking of the bubble—failed to see how it would unravel. They had interests in defending past mistakes; and even if that were not the case, they were cognitively captured by perspectives that the crisis had clearly proven wrong, and by interests that were clearly at odds with the broader well-being of our economy.

We can easily describe the elements of an alternative approach that would have left our economy and our public finances in better shape. Some of the actions briefly described below could and should have been

done by TARP authorities; others would have entailed broader actions from the Administration and the Federal Reserve. Money given to the banks would have been accompanied by restrictions on the use of the money and payouts for bonuses and dividends, with oversight on the use of funds for lending, not trading or speculation. Government control would be commensurate with the capital it provided, and used to redirect banks' activities toward SME lending, and away from predatory lending and abusive credit card practices. Both the provision of funds and the use of mergers as resolution devices would have been conducted toward the end of creating a more competitive—not a more concentrated—banking system, focused more on lending, not on trading and speculation. Banks would have been forced to recognize real estate losses—not allowed to assume that the real estate market would be restored—with the government standing ready to provide additional capital, with appropriate terms and control, as needed. Banks would have been forced to restructure mortgages, as a condition of the bailout (I and others have described a variety of ways by which this can and should have been done). Finally, the terms of the deal would have been arm's length—at least comparable to those that Warren Buffett received in his investment in Goldman Sachs, adjusted for the additional risk, say, associated with the more frail financial institutions. The *minimum* terms for the government providing money that no private actor would voluntarily and rationally provide would have given the government substantial more claims on the banks than they received.

We might say all of this is water over the dam. But it's not, for two reasons. First, we have not repaired our banking system. Dodd-Frank did not go far enough; it was riddled with exceptions and exemptions. It did not adequately deal with the too-big-to fail banks and the over-the-counter derivatives. The likelihood is that we will have another crisis.<sup>7</sup> I hope that in that next crisis—perhaps even more costly than the last—we will have learned the lessons from the failures in this one. But as I wrote at the beginning of the crisis, I fear that we will experience a repeat of what occurred this time, and has occurred in similar crises all over the world. Powerful interest groups, and especially financial institutions, use the turmoil in the midst of the crisis to protect and even enrich themselves at the expense of the rest of society, all in the name of maintaining the economy.

Secondly, our economy is not back to health, and will not be until and unless lending is restored, especially to small and medium enterprises. This means that we need a more competitive financial sector, and one more focused on its core mission of lending. There is a wide array of important activities performed by the financial sector, but not all of them should be undertaken by government-insured banks. Too-big-to-fail

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<sup>7</sup> Even if it is inevitable that there occasionally is a crisis, the rules of the game can affect their depth and frequency. This crisis was, in particular, manmade; it was not like an earthquake, something that "just" happens. JP Morgan Chase CEO Jamie Dimon said in recent testimony: "It's not a surprise that we know we have crises every five or ten years. My daughter came home from school one day and said, 'daddy, what's a financial crisis?' And without trying to be funny, I said, 'it's the type of thing that happens every five, ten, seven, years.'" (First Public Hearing of the FCIC, Panel 1: Financial Institution Representatives, January 13, 2010, viewable online at <http://www.fcic.gov/videos/view/17>). We have crises so frequently because of the lack of adequate regulations, because of the moral hazard that our bailout procedures have created, because of problems in corporate governance, etc.

institutions are a problem, whether they be mortgage companies, insurance houses, commercial or investment banks. They pose an ongoing risk to our economy and the soundness of government finances. Banks won't focus on lending if they can continue to make more money by publicly-underwritten speculation and trading, or by exploiting market power in the credit and debit card markets.

I want to conclude with two more general comments. First, we should not forget the process by which TARP—and this Oversight Panel—was created. That political process does not represent one of the country's finest moments. At first, a short, three-page bill was presented, giving enormous discretion to the Secretary of Treasury, without Congressional oversight and judicial review. Given the lack of transparency and potential abuses to which I have already referred—which occurred even with full knowledge that there was to be oversight—one could only imagine what might have occurred had the original bill been passed. Fortunately, Congress decided that such a delegation of responsibility was incompatible with democratic processes. On the other hand, the political deals required to get TARP passed, with an estimated \$150 billion in largely unjustified and unjustifiable tax breaks, do not speak well for our democracy. When we think of the cost of TARP, surely the price tag associated with the tax breaks should be included in the tally.

Finally, I want to extend a compliment to TARP. In difficult circumstances, as ideas that had seemed so persuasive showed themselves to be so flawed, there was a willingness to try different approaches and to change course. The original idea of buying what were euphemistically called "troubled assets" was fundamentally flawed, for reasons that I loudly articulated at the time. What was needed was more capital. That was necessary, but not sufficient. Capital that comes in and goes out almost simultaneously does not recapitalize banks. *How* capital is provided—preferred shares versus common shares—and with what control and with what constraints makes a great deal of difference. Any economist could have told those running TARP that, and could have told them that the approach taken was deeply flawed. Incentives matter, and incentives were not aligned.

For these, and the other failings of TARP, our economy, and our society, have paid—and will continue to pay—a very high price.

The CHAIRMAN. Thank you.  
Mr. Meltzer.

**STATEMENT OF ALLAN H. MELTZER, ALLAN H. MELTZER UNIVERSITY PROFESSOR OF POLITICAL ECONOMY AT CARNEGIE MELLON UNIVERSITY**

Dr. MELTZER. Mr. Chairman, members, gentlemen.

The invitation to this hearing, like most discussions of the TARP program asked whether TARP succeeded in preventing major financial failures. My answer is yes, TARP avoided a potential financial disaster.

My concern is with a question. Congress should not start with a crisis that followed Lehman Brother's failure, instead it must ask and demand answers to some other questions. Why was it necessary to issue about a trillion dollars of public money to prevent financial collapse? What, if anything, has been done to reduce to insignificance the prospect that another TARP will follow at some unknown time in the future?

Like many other bad decisions, the use of public funds to prevent failures began small. In the 1970's the Federal Reserve began the policy that became Too Big to Fail, by preventing the failure of First Pennsylvania Bank. That was followed by other bailouts. Soon bankers and financial firms recognized that becoming large was a way to reduce risk. Some recognized that they could take more risk. This is known as moral hazard.

The process works like this. I've been present for some of these. Bankers and Treasury or Federal Reserve staff warn the principal policymaker that the failure invites a domestic or world financial crisis. Sometimes they say, "Mr. Secretary, your name will be on that crisis in the history books." I've never found any way of overcoming that warning when the crisis occurs or seems imminent.

It doesn't help to point out that on the few occasions when there was no bailout, financial failures occurred but no crisis followed. One example is the failure of Penn Central Railroad in June, 1970. Penn Central Railroad was a major issuer of commercial paper. The commercial paper market closed to most issuers. Federal Reserve Chairman Arthur Burns was anxious to protect the commercial paper market by bailing out Penn Central. Budget Director George Schultz opposed. President Nixon made the mistake of appointing an outside counsel from his old Nixon law firm. Congressional leaders, led by Congressman Wright Patman, viewed that as an effort to assist the Republican Party. That ended the bailout.

The taxpayers were lucky that time, there was no crisis. The commercial paper market declined but borrowers got the accommodation at banks. No crisis occurred. After a few months the commercial paper revived—market revived.

Drexel Burnham Lambert, the major issuer of non-investment grade debt at the time, went bankrupt. No bailout and no crisis. Other financial firms took over the business that Drexel had done and Drexel went into bankruptcy.

The main reason that policymakers resort to Too Big to Fail in ever larger amounts is regulatory failure. Regulators do not require financial firms to hold enough capital. In the 1920's large banks had capital—held capital equal to 15 to 20 percent of their assets.

Many small banks, but no large banks, failed. Even in the early years of the Great Depression, very few large banks failed. Stockholders, not the general public, bore those losses. That is as it should be, in my opinion.

After the recent crisis Congress passed the Dodd-Frank bill. Dodd-Frank did nothing to increase capital requirements. The international regulators at Basel did better, but did not increase capital enough. Further, Dodd-Frank put the Secretary of the Treasury at the head of the committee to decide on Too Big to Fail. That decision embeds two errors in the law. First, the time to prevent bailouts is not when the crisis occurs, it has to be established policy, not a judgment made when failure threatens the international financial market. We profess to believe in the rule of law, we need a law that embeds a rule and a policy that applies it.

Second, the Secretary of the Treasury is very often the principal person who favors Too Big to Fail. Nothing in Dodd-Frank changes these incentives, it continues bailouts, it even provides money for them.

I will repeat the proposal I've made in several previous hearings, that some minimum size to protect community banks, Congress should require banks to increase capital relative to their assets as asset size increases. Instead of subsidizing large banks we should make them pay for the cost that they impose. If a bank increases assets by ten percent, capital must increase by more than ten percent.

The proposal has three major benefits. First, stockholders and managers bear the losses, not the taxpayers and the public. Second, the rule encourages prudence and eliminates the imprudent by replacing owners of failed banks. Third, Congress can eliminate many of the regulations included in Dodd-Frank. Regulation will not strengthen financial institutions, more capital will.

In the most recent crisis Bear Stearns was the first big failure. Instead of letting it fail the Federal Reserve took some of the worst assets on to its balance sheet, shifting many losses to the public. The market read the decision as a sign that Too Big to Fail remained the policy. They got a big shock when without much warning, in the midst of a recession, Lehman Brothers was allowed to fail. This sudden policy change without warning in the midst of a recession created massive uncertainty. I believe Secretary Paulson and Chairman Bernanke were wrong to change policy without warning, but I praise the prompt response called TARP that provided liquidity to all parts of the market after making a huge error. TARP avoided compounding the error.

Notice, however, what has happened. Chairman Bernanke told us that the top funds were short term, they would run off in due course, thereby shrinking the Federal Reserve balance sheet. But instead of shrinking the Fed, at the pressure from the Treasury, bought mortgages more than offsetting the original TARP funds. Again, Chairman Bernanke told us that the mortgages would start—would be repaid so the balance sheet would shrink. Again, that didn't happen. QE-2 purchased more than—purchases more than offset the reduction in mortgages.

I don't believe that the Federal Reserve has a credible strategy to reduce its balance sheet. We face the prospect, in future years, of high inflation.

Three last remarks. First, how can Congress continue to justify a system that makes the public pay for bankers' mistakes? Second, remember that capitalism without failure is like religion without sin, it doesn't work. Third, Congress should demand a detailed statement of how the Federal Reserve plans to shrink its balance sheet, including an estimate of how high market interest rates will have to rise.

[The prepared statement of Dr. Meltzer follows:]

**Testimony of Allan H. Meltzer,  
The Allan H. Meltzer University Professor of Political Economy,  
Carnegie Mellon University,  
Before the Congressional Oversight Panel  
Washington, D.C.  
March 4, 2011**

The invitation to this hearing like most discussion of the TARP program asks whether TARP succeeded in preventing major financial failures. My answer is, Yes. TARP avoided a potential financial disaster.

My concern is with the question. Congress should not start with the crisis that followed Lehman Brothers failure. Instead it must ask and demand answers to two other questions. Why was it necessary to issue about \$1 trillion of public money to prevent financial collapse? What, if anything, has been done to reduce to insignificance the prospect that another TARP will follow at some unknown time in the future.

Like many other bad decisions, the use of public funds to prevent failures began small. In the 1970s, the Federal Reserve began the policy that became too-big-to-fail (TBTf) by preventing the failure of First Pennsylvania Bank. That was followed by other bailouts. Soon bankers and financial firms recognized that becoming large was a way to reduce risk. Some recognized that they could take more risk. This is known as moral hazard.

The process works like this: Bankers and Treasury or Federal Reserve staff warn the principal policymakers that permitting the failure invites a domestic or world financial crisis. I have never found any way of overcoming that warning when the crisis occurs or seems imminent. It did not help to point out that on the few occasions when there was no bailout, financial failure occurred, but no crisis followed.

One example is the failure of the Penn Central Railroad in June 1970. Penn Central was a major issuer of commercial paper. The commercial paper market closed to most issuers. Federal Reserve Chairman Arthur Burns was anxious to protect the commercial paper market by bailing out Penn Central. Budget director George Shultz opposed. President Nixon made the mistake of appointing an outside counsel from his old law firm. Congressional leaders, led by Congressman Wright Patman, viewed that as an effort to assist the Republican party. That ended the bailout. The taxpayers were lucky that time.

The commercial paper market declined, but borrowers got accommodation at banks. No crisis occurred. After a few months, the commercial paper market revived.

Drexel Burnham Lambert, the major issuer of non-investment grade debt became bankrupt. No bailout and no crisis. Other financial firms took over the business that Drexel had done.

The main reason that policymakers resort to TBTF in ever larger amounts is regulatory failure. Regulators do not require financial firms to hold enough capital. In the 1920s large banks held capital equal to 15 to 20% of their assets. Many small banks, but no large banks failed. Even in the early years of the Great Depression, very few large banks failed. Stockholders, not the general public, bore the losses that occurred. That is as it should be.

After the recent crisis, Congress passed the Dodd-Frank bill. Dodd-Frank did nothing to increase capital requirements. The international regulators at Basel did better, but did not increase capital enough. Further, Dodd-Frank put the Secretary of the Treasury at the head of a committee to decide on TBTF. That decision embeds two errors in the law. First, the time to prevent bailouts is not when the crisis occurs. It has to be established policy, not a judgment made when failure threatens. We profess to believe in the rule of law. We need a law that embeds a rule and a policy that applies it. Second, the Secretary of the Treasury is very often the person who favors TBTF. Nothing in Dodd-Frank changes his incentives. It continues bailouts.

I will repeat the proposal I have made in several previous hearings. After some minimum size to protect community banks, Congress should require banks to increase capital relative to their assets as asset size increases. For example, if a bank increases assets by 10 percent, capital must increase by more than 10 percent.

This proposal has three major benefits. First, stockholders and managers bear the losses, not taxpayers and the public. Second, the rule encourages prudence and eliminates the imprudent by replacing owners of failed banks. Third, Congress can eliminate many of the regulations included in Dodd-Frank. Regulation will not strengthen financial institutions. More capital will.

In the most recent crisis, Bear Stearns was the first big failure, instead of letting it fail, the Federal Reserve took some of the worst assets onto its balance sheet, shifting many losses to the public. The market read the decision as a sign that TBTF remained the policy. They got a big shock when, without much warning, Lehman Bros. was allowed to fail. This sudden policy change without warning in the midst of a recession created massive uncertainty. I believe Secretary Paulson and Chairman Bernanke were wrong to change policy without warning. But I praise the prompt response called TARP that provided liquidity to all parts of the market. After making a huge error, TARP avoided compounding it.



Notice however what has happened. Chairman Bernanke told us that the TARP funds were short-term. They would run off in due course thereby shrinking the Federal Reserve balance sheet. But instead of shrinking the Fed bought mortgages more than offsetting the original TARP funds. Again, chairman Bernanke told us that the mortgages would start to be repaid, so the balance sheet would shrink. Again, that didn't happen. QE 2 purchase more than offset the reduction in mortgages.

I do not believe the Federal Reserve has a credible strategy to reduce its balance sheet. We face the prospect of high inflation, not immediately but in the next few years. The best estimates we have imply that it takes as much as two years from the time the Fed starts to slow money growth until inflation falls.

Three last remarks. First, how can Congress justify a system that makes the public pay for bankers' mistakes? Second, remember that capitalism without failure is like religion without sin. It doesn't work. Third, Congress should demand a detailed statement of how the Fed plans to prevent inflation including an estimate of how high market interest rates will have to rise.

The CHAIRMAN. Thank you.  
Mr. Johnson.

**STATEMENT OF SIMON H. JOHNSON, RONALD A. KURTZ (1954)  
PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL  
OF MANAGEMENT AND SENIOR FELLOW, PETERSON INSTI-  
TUTE FOR INTERNATIONAL ECONOMICS**

Dr. JOHNSON. Thank you, Senator Kaufman.

I completely agree with and would like to endorse the views of both Professor Stiglitz and Professor Meltzer. And let me frame my agreement in the form of the following question. Does anyone here think that Goldman Sachs could fail? If Goldman Sachs hits a rock, a hypothetical rock, I'm not saying they have and I'm not saying they will, but if they were to hit a rock, does anybody here believe that it would be allowed to collapse, fail, go bankrupt, unencumbered by any kind of bailout now or in the near future? I've asked this question around the country and across the world for the past two years, I've yet to find anyone who realistically thinks it could fail. I found some people who wish it could fail, but that's a different question.

Goldman Sachs is too big. Goldman Sachs has a balance sheet around \$900 billion in the latest data. It was a \$1.1 trillion bank when it came close to failing in September 2008 and it was rescued by being allowed to convert into a bank holding company. It is too highly leveraged. Those debts are held in a complex manner around the world, including through its derivative positions. And it is too inherently cross border. We—I would remind you, and I would ask you to reinforce with everyone you meet, we do not have a cross border resolution authority. Whatever you think of Dodd-Frank, and I share many of the reservations already expressed, there is, there can be no cross border resolution authority in U.S. legislation. You need a cross border agreement.

Among other things, I'm the former chief economist of the International Monetary Fund, I know well the technical people, the G20, the G10, various bodies responsible in the alphabet soup of international regulation and macro-prudential supervision, I know these people, I talk to them, there will not be a cross border resolution in our lifetimes. No mechanism, no authority. You cannot handle, in an orderly fashion, the failure of a bank like Goldman Sachs or JP Morgan Chase or Citigroup which operate in 50, 100, 120 countries. You can let them collapse but then you face another Lehman, or you can bail them out with some form of conservatorship where you protect the credit, and that's the key point, and then you have all of the complications Professor Stiglitz and Professor Meltzer put forward.

Or it gets worse. You enter another phase of what the Bank of England now calls a "doom loop" where repeated boom, bust, bail-out cycles lead you not just to some unfortunate situation where there's always a transfer from the public to the bankers, it leads you to fiscal ruin. And if you don't believe me look carefully at the experience of Ireland, where three big banks became two times the size of the Irish economy and they blew themselves up at enormous cost. That is where this leads. It leads to fiscal ruin.

What we should have done along with TARP or in addition to it, quickly on its heels, is implement a form of size cap, a form of leverage cap relative to GDP, just as was proposed in the Brown-Kaufman Amendment to Dodd-Frank, which unfortunately failed on the floor of the Senate, I believe 33 to 61.

We should also have implemented a cross border resolution framework, although as I said, that will always prove elusive. Given that those measures have failed and that water is now under the bridge, we should do exactly what Professor Meltzer and Professor Stiglitz have suggested. We should have much higher capital in these banks.

It is astonishing, but unfortunately true, that Basel III supplemented with all the supplementary cushions and all of the implementation that we will see for systemically important financial institutions, the so-called SIFIs, will I believe leave us with a Tier I capital requirement below that which Lehman Brothers had the day before it failed. Lehman Brothers had 11.6 percent Tier 1 capital. We will end up between 10 and 11 percent.

How can this make any sense? The Swiss national bank is requiring 19 percent capital requirements, although I would suggest they go with pure equity for all 19 percent. The Bank of England is actively pursuing and trying to implement capital requirements closer to 20 percent.

Raising capital requirements in this form is not socially costly. I know that the bankers claim vehemently to the contrary, but they are wrong. And if you don't believe me you should consult the research of Anat Admati and her colleagues at Stanford and other leading universities. These are the top people in finance who are not captured by the financial industry and they say we need more capital, it's not costly and we need a version, I would suggest, of exactly what Professor Meltzer just laid out for you most articulately. We are not going to do it.

In conclusion, let me quote Larry Summers. His 2000 Ely Lecture to the American Economic Association where he reviewed the experience of financial crisis around the world to that point, particularly in the 1990s when he was at the U.S. Treasury. And Mr. Summers said, "It is certain that a healthy financial system cannot be built on the expectation of bailouts."

[The prepared statement of Dr. Johnson follows:]

March 3, 2011

**Testimony submitted to the Congressional Oversight Panel, “Hearing on the TARP’s Impact on Financial Stability” Friday, March 4, 2011 (embargoed until start of the hearing).**

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of <http://BaselineScenario.com>.<sup>1</sup>

#### **I. Summary**

- 1) The financial crisis is not over, in the sense that its impact persists and even continues to spread. Employment remains more than 5 percent below its pre-crisis peak, millions of homeowners are still underwater on their mortgages, and the negative fiscal consequences – at national, state, and local level – remain profound.
- 2) To the extent that a full evaluation is possible today, the financial crisis produced a pattern of rapid economic decline and slow employment recovery quite unlike any post-war recession – it looks much more like a mini-depression of the kind the US economy used to experience in the 19<sup>th</sup> century. In addition, the fiscal costs of the disaster in our banking system so far amount to roughly a 40 percentage point increase in net federal government debt held by the private sector, i.e., roughly a doubling of outstanding debt.
- 3) In this context, TARP played a significant role preventing the mini-depression from becoming a full-blown Great Depression, primarily by providing capital to financial institutions that were close to insolvency or otherwise under market pressure.
- 4) But part of the cost is to distort further incentives at the heart of Wall Street. Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program put it well in his [latest quarterly report](#), which appeared in late January, emphasizing: “perhaps TARP’s most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are ‘too big to fail.’”
- 5) Adjustments to our regulatory framework, including the Dodd-Frank financial reform legislation, have not fixed the core problems that brought us to bring of complete catastrophe in fall 2008. Powerful people at the heart of our financial system still have the incentive and ability to take on large amounts of reckless risk – through borrowing large amounts relative to their equity. When things go well, a few CEOs and a small number of others get huge upside.
- 6) When things go badly, society, ordinary citizens, and taxpayers get the downside. This is a classic recipe for financial instability.

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<sup>1</sup> This testimony draws on joint work with Peter Boone, particularly “[The Next Financial Crisis: It’s Coming and We Just Made It Worse](#)” (*The New Republic*, September 8, 2009), and James Kwak, particularly “[The Quiet Coup](#)” (*The Atlantic*, April, 2009) and [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at <http://BaselineScenario.com>, where we also provide daily updates and detailed policy assessments for the global economy.

- 7) Our six largest bank holding companies currently have assets valued at just over 63 percent of GDP (end of Q4, 2010). This is up from around 55% of GDP before the crisis (e.g., 2006) and no more than 17% of GDP in 1995.
- 8) With assets ranging from around \$800 billion to nearly \$2.5 trillion, these bank holding companies are perceived by the market as “too big to fail,” meaning that they are implicitly backed by the full faith and credit of the US government. They can borrow more cheaply than their competitors and hence become larger.
- 9) In public statements, top executives in these very large banks discuss their plans for further global expansion – presumably increasing their assets further while continuing to be highly leveraged.
- 10) There is nothing in the Basel III accord on capital requirements that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially raising capital requirements would not be costly from a social point of view (e.g., see [the work of Anat Admati of Stanford University and her colleagues](#)).
- 11) But the financial sector’s view has prevailed – they argue that raising capital requirements will slow economic growth. This argument is supported by some misleading so-called “research” provided by the Institute for International Finance (a lobby group). The publicly-available analytical work of the official sector on this issue (from the Bank for International Settlements and the New York Fed) is very weak – if this is the basis for policymaking decisions, there is serious trouble ahead.
- 12) Even more disappointing is the failure of the official sector to engage with its expert critics on the issue of capital requirements. This certainly conveys the impression that the regulatory capture of the past 30 years (as documented, for example, in [13 Bankers](#)) continues today – and may even have become more entrenched.
- 13) There is an insularity and arrogance to policymakers around capital requirements that is distinctly reminiscent of the Treasury-Fed-Wall Street consensus regarding derivatives in the late 1990s – i.e., officials are so convinced by the arguments of big banks that they dismiss out of hand any attempt to even open a serious debate.
- 14) Next time, when our largest banks get into trouble, they may be beyond “too big to fail”. As seen recently in Ireland, banks that are very big relative to an economy can become “too big to save” – meaning that while senior creditors may still receive full protection (so far in the Irish case), the fiscal costs overwhelm the government and push it to the brink of default.
- 15) The fiscal damage to the United States in that scenario would be immense, including through the effect of much higher long term real interest rates. It remains to be seen if the dollar could continue to be the world’s major reserve currency under such circumstances. The loss to our prestige, national security, and ability to influence the world in any positive way would presumably be commensurate.
- 16) In 2007-08, our largest banks – with the structures they had lobbied for and built – brought us to the verge of disaster. TARP and other government actions helped avert the worst possible outcome, but only by providing unlimited and unconditional implicit guarantees to the core of our financial system. This can only lead to further instability in what the Bank of England refers to as a “[doom loop](#)”.

## II. TARP Compared

- 1) In the immediate policy response to any major financial crisis – involving a generalized loss of confidence in major lending institutions – there are three main goals:
  - a. To stabilize the core banking system,
  - b. To prevent the overall level of spending (aggregate demand) from collapsing,
  - c. To lay the groundwork for a sustainable recovery.
- 2) IMF programs are routinely designed with these criteria in mind and are evaluated on the basis of: the depth of the recession and speed of the recovery, relative to the initial shock; the side-effects of the macroeconomic policy response, including inflation; and whether the underlying problems that created the vulnerability to panic are addressed over a 12-24 month horizon.
- 3) This same analytical framework can be applied to the United States since the inception of the Troubled Asset Relief Program (TARP). While there were unique features to the US experience (as is the case in all countries), the broad pattern of financial and economic collapse, followed by a struggle to recover, is quite familiar.
- 4) The overall US policy response did well in terms of preventing spending from collapsing. Monetary policy responded quickly and appropriately. After some initial and unfortunate hesitation on the fiscal front, the stimulus of 2009 helped to keep domestic spending relatively buoyant, despite the contraction in credit and large increase in unemployment. It was also consistent with parallel countercyclical fiscal moves in other countries. This was in the face of a massive global financial shock – arguably the largest the world has ever seen – and the consequences, in terms of persistently high unemployment, remain severe. But it could have been much worse.
- 5) There is no question that passing the TARP was the right thing to do. In some countries, the government has the authority to provide fiscal resources directly to the banking system on a huge scale, but in the United States this requires congressional approval. In other countries, foreign loans can be used to bridge any shortfall in domestic financing for the banking system, but the U.S. is too large to ever contemplate borrowing from the IMF or anyone else.
- 6) Best practice, vis-à-vis saving the banking system in the face of a generalized panic involves three closely connected pieces (see chapter 2 of *13 Bankers* and the references provided there):
  - a. Preventing banks from collapsing in an uncontrolled manner. This often involves at least temporary blanket guarantees for bank liabilities, backed by credible fiscal resources. The government's balance sheet stands behind the financial system. In the canonical emerging market crises of the 1990s – Korea, Indonesia, and Thailand – where the panic was centered on the private sector and its financing arrangements, this commitment of government resources was necessary (but not sufficient) to stop the panic and begin a recovery.
  - b. Taking over and implementing orderly resolution for banks that are insolvent. In major system crises, this typically involves government interventions that include

revoking banking licenses, firing top management, bringing in new teams to handle orderly unwinding, and – importantly – downsizing banks and other failing corporate entities that have become too big to manage. In Korea, nearly half of the top 30 pre-crisis chaebol were broken up through various versions of an insolvency process (including Daewoo, one of the biggest groups). In Indonesia, leading banks were stripped from the industrial groups that owned them and substantially restructured. In Thailand, not only were more than 50 secondary banks (“Finance Houses”) closed, but around 1/3 of the leading banks were also put through a tough clean-up and downsizing process managed by the government.

- c. Addressing immediately underlying weaknesses in corporate governance that created potential vulnerability to crisis. In Korea, the central issue was the governance of nonfinancial chaebol and their relationship to the state-owned banks; in Indonesia, it was the functioning of family-owned groups, which owned banks directly; and in Thailand it was the close connections between firms, banks, and politicians. Of the three, Korea made the most progress and was rewarded with the fastest economic recovery.
- 7) If any country pursues (a) unlimited government financial support, while not implementing (b) orderly resolution for troubled large institutions, and refusing to take on (c) serious governance reform, it would be castigated by the United States and come under pressure from the IMF. Providing unlimited implicit guarantees does not help underpin financial stability.
  - 8) At the heart of any banking crisis is a political problem – powerful people, and the firms they control, have gotten out of hand. Unless this is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-term recovery, but it creates major problems for the sustainability of the recovery and for the medium-term. Serious countries do not do this.
  - 9) As Larry Summers put it, in his 2000 Ely Lecture to the American Economic Association, “[I]t is certain that a healthy financial system cannot be built on the expectation of bailouts” (*American Economic Review*, vol. 90, no. 2, p.13).
  - 10) Seen in this context, TARP was badly mismanaged. In its initial implementation, the signals were mixed – particularly as the Bush administration sought to provide support to essentially insolvent banks without taking them over. Standard FDIC-type procedures, which are best practice internationally, were applied to small- and medium-banks, but studiously avoided for large banks. As a result, there was a great deal of confusion in financial markets about what exactly was the Bush/Paulson policy that lay behind various ad hoc deals.
  - 11) The Obama administration, after some initial hesitation, used “stress tests” to signal unconditional support for the largest financial institutions. By determining officially that these firms did not lack capital – on a forward looking basis – the administration effectively communicated that it was pursuing a strategy of “regulatory forbearance” (much as the US did after the Latin American debt crisis of 1982). The existence of TARP, in that context, made the approach credible – but the availability of unconditional loans from the Federal Reserve remains the bedrock of the strategy.

- 12) The downside scenario in the stress tests was overly optimistic, with regard to credit losses in real estate (residential and commercial), credit cards, auto loans, and in terms of the assumed time path for unemployment. As a result, our largest banks remain undercapitalized, given the likely trajectory of the US and global economy. This is a serious impediment to a sustained rebound in the real economy – already reflected in continued tight credit for small- and medium-sized business.
- 13) Even more problematic is the underlying incentive to take excessive risk in the financial sector. With downside limited by government guarantees of various kinds, Andrew Haldane of the Bank of England bluntly characterizes our repeated boom-bailout-bust cycle as a “doom loop.”
- 14) Exacerbating this issue, TARP funds supported not only troubled banks, but also the executives who ran those institutions into the ground. The banking system had to be saved, but specific banks could have wound down and leading bankers could and should have lost their jobs. Keeping these people and their management systems in place serious trouble for the future.
- 15) The implementation of TARP exacerbated the perception (and the reality) that some financial institutions are “Too Big to Fail.” This lowers their funding costs, probably by around 50 basis points (0.5 percentage points), enabling them to borrow more and to take more risk with higher leverage.
- 16) The Obama administration argues that regulatory reforms, including the Dodd-Frank Act and associated new rules, will rein in the financial sector and make it safer. Unfortunately, this assessment is not widely shared.
- 17) There was an opportunity to cap the size of our largest banks and limit their leverage, relative to the size of the economy. Unfortunately, the Brown-Kaufman to that effect was defeated on the floor of the Senate, 33-61, primarily because it was opposed by the US Treasury.<sup>2</sup>
- 18) Regulation remains weak and many regulators are still captured by the ideology that big banks are good for the rest of the economy. Capital requirements will increase but are likely to remain below the level that Lehman had in the days before it failed (11.6 percent tier one capital). There will be no effective cap on the size of our biggest banks. They have an incentive to take on a great deal of leverage. This confers private benefits but great social costs – lowering economic growth, increasingly volatility, and making severe crises more likely.

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<sup>2</sup> See <http://baselinescenario.com/2010/05/26/wall-street-ceos-are-nuts/>, which contains this quote from an interview in New York Magazine: “If enacted, Brown-Kaufman would have broken up the six biggest banks in America,” says the senior Treasury official. ‘If we’d been for it, it probably would have happened. But we weren’t, so it didn’t.’”



The CHAIRMAN. Mr. Zingales.

**STATEMENT OF LUIGI ZINGALES, ROBERT C. McCORMACK  
PROFESSOR OF ENTREPRENEURSHIP AND FINANCE AND  
THE DAVID G. BOOTH FACULTY FELLOW, UNIVERSITY OF  
CHICAGO BOOTH SCHOOL OF BUSINESS**

Dr. ZINGALES. Thank you, Chairman Kaufman and members of the Congressional Oversight Panel. Thank you for inviting me.

In providing—TARP and the financial sector economy it's important to establish what is a counter factor, what will happen in the absence of TARP. Chairman Bernanke and then Treasury Secretary Paulson repeatedly presented their choice as an alternative between TARP and the collapse of the entire financial system. If the alternative was indeed the abyss, TARP is clearly an unqualified success. We have escaped the abyss.

Even if the alternative was between TARP and some chance of falling into the abyss, we have to conclude that TARP was a success. The cost of TARP, however big, is small with comparison to the possibility of a second Great Depression.

Pietro Veronesi and I estimated the bankruptcy of the ten largest banks would have wiped out 22 percent of their value for a total of 2.4 trillion, a number that doesn't consider the cost imposed on the rest of the U.S. economy which could be a multiple of that. The financial system was at risk and some intervention was needed. Yet, it is both false and misleading to say there were no other alternatives. False because there were feasible and in fact superior alternatives. Misleading because it made TARP appear inevitable forcing people not to question its cost.

By stating clearly why an intervention was needed, ie. where the market failed, it would have been possible to design plans more effective and less expensive. This is not just hindsight. On September 19, 2008 I wrote a proposal to address the instability of the financial system through an emergency reform of the bankruptcy code that could have transformed the long term debt of shaking financial institutions into equity. The feasibility of this idea is proven by the fact that the Credit Suisse has not advanced a similar proposal to deal with future bailouts. The same is true for alternative plan to deal with home foreclosure and with the bankruptcy of GM and Chrysler.

I didn't write a plan for AIG because I never understood what the real goal of bailing out AIG was, to save European banks, Goldman Sachs or the policyholder. We have to rely on Wall Street for claims that the failure would have completely roiled markets.

If we agree that other feasible alternatives did exist, then we have to consider the cost and benefits of TARP, vis a vis these alternatives. Veronesi and I estimated that the capital purchase program increased the value of banks' debt by 120 billion at a cost of 32 billion for the taxpayers. Though in spite of the enormous value created by the government intervention, taxpayers ended up with a large loss. In the auto companies' case, creditor were now the winner, the autoworkers union was with a gain of 16 billion. There is, however, a consistent loser, the taxpayers who lost 59 billion in the rescue.

TARP was the largest welfare program for corporations and their investors ever created in the history of humankind. That some of the crumbs have been donated to the autoworkers unions doesn't make it any better. It makes it worse. It shows that that redistribution was no accident, it was a premeditated pillage of defenseless taxpayers by powerful lobbyists. TARP is not just a triumph of Wall Street over Main Street, it is the triumph of K Street over the rest of America.

Yet, the worst long term effect of TARP is not the burden imposed on taxpayers but the distortion to incentives it generated. First, its excessively lenient terms of the bailout ensure that the legitimate assistance recapitalized in smaller banks and at market terms became more difficult.

Second, the way subsidies were distributed under TARP show that the enormous return to lobby. A member of the Bush Treasury admitted that during the summer of 2008 any phone call from the 212 area code had one message, "Have the government buy the toxic assets." Eventually this constant request became government policy.

Third, the way the bailout was conducted destroyed the faith that the Americans have in the financial system and in the government. In a survey they conducted in 2008, 80 percent of the American people stated that the government intervention made them less confident to invest in the financial market.

Last but not least, it entrenched the view the large financial institutions cannot fail and their creditors cannot lose. This expectation leads investors, such as a CFO I know, to invest their money in the banks most politically collected, not in the most financially sound.

This is the end of the credit analysis and the beginning of political analysis.

[The prepared statement of Dr. Zingales follows:]

Oral Testimony of

Luigi Zingales

on

"Overall Impact of TARP on Financial Stability"

Before the  
Congressional Oversight Panel

United States House of Representatives  
March 4, 2011

Chairman Kaufman, members of the Congressional Oversight Panel, thank you for inviting me.

In providing an opinion on the impact of the Troubled Asset Relief Program (TARP) on the financial sector and the US economy it is important to establish what is the counterfactual: what would have happened in the absence of TARP. Chairman Bernanke and then Treasury Secretary Paulson repeatedly presented their choice as an alternative between TARP and a collapse of the entire financial system. If the alternative was indeed the abyss, TARP is clearly an unqualified success: we have escaped the abyss. Even if the alternative was between TARP and some chance of falling into the abyss, we have to conclude that TARP was a success. The cost of TARP, however big, is small with comparison to the possibility of a Second Great Depression. Pietro Veronesi and I estimate that the bankruptcy of the ten largest banks would have wiped out 22% of their value, for a total of \$2.4 trillion, a number that does not consider the cost imposed on the rest of the U.S. economy, which could be a multiple of that.

The financial system was at risk and some intervention was needed. Yet, it is both false and misleading to say that there were no other alternatives. False because there were feasible, and in fact superior, alternatives. Misleading because it made TARP appear inevitable, forcing people not to question its costs.

By stating clearly why an intervention was needed (i.e., where the market failed), it would have been possible to design plans more effective and less expensive. This is not just hindsight. On September 19 2008, I wrote a proposal to address the instability of the financial system through an emergency reform of the bankruptcy code that could have transformed the

long-term debt of shaky financial institutions into equity. The feasibility of this idea is proven by the fact that Credit Suisse has now advanced a similar proposal to deal with future bailouts. The same is true for an alternative plan to deal with home foreclosures and with the bankruptcy of GM and Chrysler. I did not write a plan for AIG because I never understood what the real goal of bailing out AIG was: to save European banks, Goldman Sacks, or the policyholders. We have to rely on Wall Street for claims that a failure would have completely roiled markets.

If we agree that other feasible alternatives did exist, then we have to consider the costs and benefits of TARP vis-à-vis these alternatives. Veronesi and I estimated that the Capital Purchase Program increased the value of bank's debt by \$120 billion at the cost of \$32 billion for the taxpayers. Thus, in spite of the enormous value created by the government intervention, taxpayers ended up with a large loss. In the auto companies' case creditors were not the winners: the autoworkers' union was, with a gain of \$16 billion. There is, however, a consistent loser: the taxpayers, who lost \$59 billion in the rescue.

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Yet, the worst long-term effect of TARP is not the burden it imposed on taxpayers, but the distortions to incentives it generated. First, the

excessively lenient terms of the bailout ensured that legitimate assistance – e.g., recapitalizing smaller banks at market terms --became more difficult.

Second, the way subsidies were distributed under TARP showed the enormous return to lobbying. A member of the Bush Treasury admitted that during the summer of 2008 any phone call from the 212 area code had one message: have the government buy the toxic assets. Eventually, this constant request became government policy.

Third, the way the bailout was conducted destroyed the faith that Americans have in the financial system and in the government. In a survey conducted in December 2008, 80% of the American people stated that government intervention made them less confident to invest in the financial market.

Last but not least, it entrenched the view that large financial institutions cannot fail and their creditors cannot lose. This expectation leads investors, such as a CFO I know, to invest their money in the banks most politically connected, not in the most financially sound. This is the end of credit analysis and the beginning of political analysis!

Table 1  
Winners and Losers from TARP

List of the winners and losers of the major programs under TARP on an ex-ante basis (when program announced). The second column is from Treasury.gov. The third and fourth columns are from the SIGTARP Quarterly Report to Congress (January 2011), except for row 5, which comes from CBO (June 2009) for the Treasury and CBO (May 2010) for NYFRB. The fifth column is computed as follows: For 1) it is equal to funds committed, since it is a transfer. For 2) is obtained from Veronesi and Zingales (2010). For 3) it is extrapolated applying to small banks the Veronesi and Zingales (2010) estimates for large banks. For 4) it is taken from CBO (June 2009). For 5) it is taken from CBO (June 2009) for the Treasury and CBO (May 2010) for NYFRB. For 6) it is the CBO “The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009”, applied to the full program. For 7) it is the March 2010 CBO report. The sixth column is based on the author’s judgment. The seventh column is computed as follows: For 1) it is equal to funds committed, since it is a transfer. For 2) is obtained from Veronesi and Zingales (2010). For 6) it is an author’s calculation based on the CBO “The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009” valuations.

Program	Goal	Funds Committed	Funds		Major beneficiary	Amount Benefit
			Spent to 12/2010	Ex Ante Cost to Taxpayers		
1 <i>Making Home Affordable</i>	To promote stability for both the housing market and homeowners.	45.6	1	45.6	Homeowners, servicers	
2 <i>Capital Purchase Program Large</i>	To inject much-needed capital into the system in the fastest way.	125	125	32	Debtholders	120
3 <i>Capital Purchase Program Small</i>		79.9	79.9	20.5	Debtholders	
4 <i>Targeted Investment Program</i>	A case-by-case assistance basis to stabilize systemic institutions	40	40	7	Debtholders	
5 <i>American International Group</i>	To avoid a catastrophic failure (?)				Debtholders, policyholders ?	
		<i>Treasury*</i>	70	48	35	
		<i>NYFRB**</i>	175	175	2	
6 <i>Automotive Industry Financing Program</i>	To prevent a significant disruption of the American automotive industry.	81.8	80.7	58.9	Unions	16
7 <i>Public-Private Investment Program</i>	To support market functioning and facilitate price discovery in CMBS and non-agency RMBS.	22.4	15.6	1	Investment banks	
			639.7	565.2	202.0	

\* AIG Treasury investment. Sources: CBO (June 2009). It is comprehensive of SSFI and Equity Capital Commitment Facility.

\*\* NYFRB investment in AIG consists of revolving credit facility and Maiden Lane II and III

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The CHAIRMAN. Thank you.

Now we'll begin the questions. And the first question I have is moral hazard. The panel, one of the things that has been incredible about the way this panel's functioned since I've been here is, and not because of me, because of the other panelists, is how bipartisan, non-partisan things have been. And I think moral hazard has been raised in every one of our discussions, just about everything that TARP's done and our concerns about that.

Could each one kind of—this is kind of the history of TARP. Can each one kind of talk about how you think TARP impacted on moral hazard?

Mr. Stiglitz.

Dr. STIGLITZ. You know, I think the point has been made by all four of us, and we didn't coordinate our testimony.

The CHAIRMAN. Right.

Dr. STIGLITZ. And I think this is reflecting where the broad span of the economics profession is from a whole spectrum. We don't agree about a lot of things, but one of the things we do agree is, incentives matter. And that if you know that you're going to get bailed out no matter what your losses are, then you have an incentive to take on more risk. The market gets distorted because the Too Big to Fail banks get capital at a lower cost. So that money doesn't flow on the basis of efficiency, but on the basis of this connectedness, is the way Professor Zingales put it.

So it's manifested in absolutely every way. It also gets manifested at a higher level, it's not quite moral hazard in the usual way, but the banks have gotten much higher returns out of their political investments than any other form of investment. And you might say, from the point of view of a firm obligated to maximize your returns to your shareholders, "Where is the best place to put your money? It's on K Street."

The CHAIRMAN. Mr. Meltzer.

Dr. MELTZER. I agree completely with Joe. [Laughter.]

He's absolutely right. There has to be incentive. Those incentives will never come if you say to the Secretary of the Treasury, "Look, there's this crisis and we have to do something about it now. We have to do something about it before. We have to have capital in the banks. We have to give an incentive to the bankers to be prudent in the risks that they take." No set of regulations is going to do that.

You know, I've given this talk to lots of places, including the Council on Foreign Relations, where I said regulations are made by bureaucrats and regulators and is circumvented by lawyers and markets. First question was a man got up and said, a large Wall Street audience, first question came from a man who said, "I'm a Wall Street lawyer, who do you think shows them how to circumvent them?" [Laughter.]

We need to have capital so that the incentives are on the banker and stockholders to avoid TARP. We started small with First Pennsylvania. Before the 1970's we didn't bailout large banks. It's only something that has been growing and growing and growing. And it's time for Congress to put an end to it.

The CHAIRMAN. Mr. Johnson.

Dr. JOHNSON. Gene Farmer, the father of the efficient markets view of finance, said on CNBC recently, “Too Big to Fail is not a market, it’s a government subsidy scheme.” And it’s an abomination and it should end. The new GSEs, the government sponsored enterprises of today are—include, most prominently, the largest six bank holding companies in the country: Bank of America, JP Morgan Chase, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley. These firms can borrow more cheaply because they are backed by the government.

The estimates—responsible, realistic estimates are they have a funding advantage about 50 basis points, .5 of a percentage point. They can get bigger, they want to get bigger, they want to become more global. These are all exactly the things we can’t deal with when they fail. It’s all the things that make it harder for any secretary of the Treasury to refuse them a bailout.

Gene Farmer suggests, and I actually agree with him, we should be looking at capital requirements closer to 40 or 50 percent. This isn’t—this is just the percent of their assets financed with equity. I know it’s anathema to the modern bankers, because they’re excessively focused on return on equity.

And also they’re not doing the analysis right. They’re not following the principles of basic finance.

And again, I refer you to the website of the analysis of Anat Admati and her colleagues who have written extensively about this for a broad audience and explained it to the newspapers repeatedly in op eds and letters. The technical people get this, the bankers refuse because they want to be paid on a risk—on a return on equity basis that’s not risk adjusted. That way they can get a lot of cash out in the boom and they walk away a long time before society bears these horrible ultimate costs.

The CHAIRMAN. Mr. Johnson, let me just follow up on that and then I’ll get to Mr. Zingales.

The plan of major banks to increase their dividends. How does that fit into capital requirements and stockholders’ equity?

Dr. JOHNSON. Senator Kaufman, it makes no sense at all. The Federal Reserve and the other responsible authorities have not yet determined—you know, so even within their own framework it makes no sense. They’ve not yet determined what a systemically important financial institution should hold. There are exactly the issues you were discussing with the previous panel, in terms of additional losses coming through from major lawsuits, various kinds of put-backs and so on. We don’t know how much capital they’re going to need to weather the next stage of the global cycle. And the Federal Reserve has not yet determined that. So why you would allow them to pay out any of this capital as dividends? This is just reducing their equity, it is allowing them to have more leverage in their business.

The bankers, again, want it because they get paid on a return on equity basis. But this is just letting them leverage up. And there’s a put option. We write the put option, we bear the cost of that. You’re increasing the put option, which is not scored in anyone’s budget, by allowing them to pay these dividends. It’s unconscionable, it’s irresponsible and the Federal Reserve should back off

from allowing this increase in dividends, which is apparently where they're currently headed.

The CHAIRMAN. Thank you. And I'll take this time off my next thing, Mr. Zingales, so we can have everyone comment.

Dr. ZINGALES. Thank you.

In terms of—I agree with most of—what everybody else has said. Let me point out one aspect of moral hazard that people generally don't think of, because they always think about sort of shareholders doing crazy stuff.

But moral hazard arises also on the size of investors. What I was mentioning in my testimony is during the crisis I was talking with a CFO who had to park his liquidity, it was in Europe. And he had like very large liquidity in this company and was worried and he said, "I need to invest in a safe place. Where is a safe place, and not the banks with more capital, other banks who are more politically connected."

And so this creates the incentives for lenders to actually lend more to the banks that are politically connected, independently of their safety. And bankers who find this—that extremely cheap, find it irresistible to take back. And sometimes they take back because they really sort of want to speculate, sometimes it's because they just don't see the end in sight. I think that in the case of Lehman, probably at the end, Dick Fuld was a fool, was not excited playing on some strategic risk taking, was simply not seeing that—the mistakes he was doing. But the credit market was not there to stop him because the credit market felt ensured by the Too Big to Fail policy.

Let me add another couple things that are slightly different to my colleagues here. Number one, I would like, like Professor Meltzer, stop the Too Big to Fail by legislation. I don't think this is feasible. I think that it's like trying to stop a parent from saving a child when the child is in danger. I think that we should not bail-out our children, it's not educationally good, but when their life is in danger we can't resist. And even if we promise before not to do it, eventually we're going to do it.

So the very way to address sort of this problem is not by legislating out an intervention, it is by adding a system of intervention in place. Because the real problem of the regulator is they intervene too late. It's not that they don't have the instruments.

Let's take a case where they did have the instrument, like in savings and loans or in the case of Washington Mutual, the regulator had the—all the instruments to intervene. You know when they intervene? When the credit default swap price was 3,305. It means 33 percent spread over the risk free rate.

And in spite of this, if you Googled Washington Mutual and shareholders, you find that there are some shareholders sued because the shareholders are complaining that the regulators are—intervene too early. I always say, if you are a turkey Thanksgiving always comes too early. And if you are sort of a shareholder of a bank that is really out of the money, the regulator always intervenes too early and you exert an enormous political pressure for them to intervene.

So we need to have the market-based signal to force the regulator to intervene early on and give a choice, either you recapitalize

or you are liquidated. And in a sense, what the gentleman earlier was saying, from the Treasury, the stress test was exactly that, was an out and out choice. Either you sort of recapitalize or we take you over. And all of a sudden all the problems in raising capital disappeared.

The CHAIRMAN. Thank you very much. I just lost my second round.

Mr. McWatters.

Mr. MCWATTERS. Thank you. That's a hard act to follow.

When I read your testimony last evening, it was well after midnight, I'd just flow in and I was thumbing through the pages and I thought, "Okay, there's four minds here thinking pretty much the same way." And I happen to agree with most everything I was reading, which was delightful.

It raises a question though. If we go back to September of 2008, okay, September, 2008 if President Bush and Secretary Paulson had called you and said, "We're in a jam, we're in a really bad jam here. What should we do," what would you have said?

Mr. Stiglitz.

Dr. STIGLITZ. Well, I think it is clear that there had to be some government action. I think it's also clear that we've all said the real mistake was letting things get to that position and also the case that given what we know now, the Fed knew that there was a lot of turmoil in the financial markets well before. Everybody knew; the Financial Inquiry Commission pointed this out, that after Bear Stearns it was known that Lehman Brothers was very likely—this argument that they didn't have authority is a little bit nonsense, because if they really believed that, they should have gone and asked for the authority. So they needed to do something.

The real problem that I had, and I tried to emphasize in my remarks, was the way they gave money to the banks was wrong. Now, interesting, when TARP was passed, they said they were going to buy the troubled assets. Everybody pointed out that that was a flawed approach and to their credit Paulson changed the strategy after several weeks. And it would have been an even worse disaster had he not changed that strategy. But the way the money was put in, as I said before, without conditions, without thinking about the structure of where you wanted to go, and most importantly without thinking about the mortgage market which was the source of the—the underlying source of the problem. It seemed to me that they went in without any vision, without any understanding of how to get re-lending started, what to do with the mortgage market. And they'd had plenty of time to think about that. So it's not the intervention, it's how the intervention was done.

Mr. MCWATTERS. Okay. Mr. Meltzer.

Dr. MELTZER. I'm in a good position to answer your question, Mr. McWatters, because I appeared on the Lehrer Program when the program was first announced and I said, "I'm against it. He hasn't explained how it's going to work, he hasn't explained why it should work, he doesn't have a coherent plan. We need a coherent plan."

I've got—I've been on TV, such programs, many times. I received an overwhelming response from the public. Nobody that I knew, it went 149 to 1 on my side.

I got a call from the Treasury, they said, not in so many words, but the message was clear, the message was, “Okay, wise guy, what would you do?” So I went to the Treasury and I told them what I would do. I said, “Call the banks in, raise capital in the market. If you can raise—if you need \$20 billion, raise \$10 billion in the marketplace and we’ll give you \$10 billion at subsidized rates. If they can’t do that they’re done.” The Treasury eventually did something like that, close to that but at the time they didn’t want to hear it.

Capital, that’s spelled in capital letters, is what protects the public and incentivizes the management and the stockholders.

Mr. MCWATERS. Okay. Thank you.

Mr. Johnson.

Dr. JOHNSON. If you give me the choice between global calamity and unsavory bailout, I’m going to suggest unsavory bailout, along the lines of Mr. Meltzer recommending the capital injection, that is best practice if you find yourself with that choice.

But I think all of the suggestions we’re making are with regard to how do you learn the lesson and reduce the chance of a global calamity scenario going forward. And I completely agree, that given the options now on the table, capital is the answer. We need a lot more capital and it needs to be pure capital, real capital, not funky capital, not hybrid capital, not contingent capital. It needs to be real equity capital in our financial system.

This is not costly, from a social point of view. The bankers don’t want it. They hate it. They’re fighting against it. All the arguments they brought forward against it are pure lobbying. They have no research on their side. They have no analysis on their side. It is complete public relations exercise. We need a lot more capital in the financial system here. And we need to persuade anybody who wants to do banking business or financial sector related business in the United States from another country needs to have, whatever they do in the United States be just as well capitalized as our financial institutions. And hopefully that will be a lot more capital than we have today.

Dr. ZINGALES. Also in my case the question is not so hypothetical. I am a member of the Committee on Capital Market Regulation and while I didn’t speak directly to Treasury, I did speak with the chairman of our committee who spoke with Paulson. And I had a very clear proposal that I articulated in two pieces that I reference in my testimony.

One with a very subtle title, “Why Paulson is Wrong” and the second, “Plan B” where I would say it’s very simple, you basically require a bank to do a debt for equity swap. There is enough long term debt that can absorb those losses. And if you think that this requirement is coercive, you give the option to shareholders to buy back their shares through a scheme that is known in the literature as a batch scheme, which is very fair.

So it would not have been coercive at all, it would have been immediate. And even—the only objection that people could raise to the Meltzer idea, which is a very good idea, is the market is not ready to provide that capital. In that particular case there wasn’t even that objection. So the plan was feasible.

And, as I said in my testimony, now the Credit Suisse is proposing it as the law of the land in Switzerland. Why? Because banks in Switzerland know that they are too big to be saved. And so they are concerned about what is going to happen in the future. In the United States they're not concerned about that so they lobby in a different direction.

Mr. MCWATTERS. Okay. Thank you.

I'll ask one more question. This will be my second round. If you fast forward to today and look at the other end of the bookend, March 4, 2011, you've all described problems we have now. The chair has described moral hazard and the like, we've all written and talked about moral hazard. What do you do today? I can anticipate your answers as I think you've given them, but just to make it very clear on the record, what would your recommendation be on March 4, 2011?

Dr. STIGLITZ. Okay, very briefly. You know, first I want to emphasize the two things that we've already said. One, that you need more capital and that you need—the magnitude of more—increasing capital has to be commensurate with the size of the banks, the risk of the Too Big to Fail distortion has to be eliminated.

But secondly, if you have a problem, I think Professor Zingales is right, you ought to play by the ordinary rules of capitalism which says when you go into bankruptcy you convert debt to equity. I mean it's really just a version of the standard rules of capitalism. And you look at the numbers, say back in Citibank, they had enough long-term capital that it was more than enough to manage them, it was actually more than we actually put in. So the answer, you know, that we need to have the resolution authority, ought to be nothing more than basically the rules of capitalism.

But I do feel that because there are what we call agency problems, that the owners of the bank—the managers of the banks do not necessarily act in the interest of the owners. This is, you know, we have a kind of managerial capitalism, that you have to go beyond that to have regulations and restrictions on risk-taking. And in particular, for instance, that it should not be allowed for government-insured institutions or very large institutions to be writing these kinds of risky derivatives and under other very high risk activities.

So I think we do need additional regulations and more transparency that would circumscribe excessive risk taking by either government insured institutions or large institutions, because they're implicitly government-insured, because I don't think the capital is enough, is a full solution.

Mr. MCWATTERS. Thank you.

Dr. MELTZER. At the risk of sounding as though Simon Johnson and I collaborated, I would say, I'll change the word capital to equity and picking up what he had said. And what would I would do? I would raise the requirement to say that for every—that after a minimum size, to protect community banks, you start to phase in capital requirements which start at 10, 10 percent and increase as the size of the bank increases so that it's 11, 12, 13 going up toward 20. So that the largest banks will be paying what they were paying in the 1920's.

And I would phase that in beginning now, because the big banks are reporting substantial profits. And I would give them three years to get to the required capital.

And as far as other regulation is concerned, I'm a believer that regulation only works when it incentivizes the regulated. That is, if you compare drug regulation where you say, "Well, we'll give you a monopoly and you produce this drug," then you have someone who wants to protect his right. We have to go the same thing. Capital is one way to do it. There are other ways to incentivize the bankers. If we just give them prohibitions what we'll get, you can see it happening, you can see the number of lobbyists, bankers that are in Washington every day trying to write the rules that were passed in Dodd-Frank. That isn't the way we're going to restrict future risks.

Mr. MCWATTERS. Okay. Thank you.

Dr. JOHNSON. Don't allow them to pay dividends today. Nobody knows—we're all agreeing you need more capital. Nobody knows how much capital is necessary. The—even the bankers will concede that the easiest way to increase equity in the business is to retain earnings. They have profits now. That money stays in the bank, it belongs to the shareholders.

Paying out equity under these circumstances makes no sense in economic terms. It's irresponsible. It encourages risk taking of these banks, high leverage bets and it's completely contrary to the state of policy, both in the broad of the administration, Mr. Geithner says, "We need capital, capital, capital," that's what he says all the time. But they're not pushing for enough capital.

And it's completely against the process. The federal Reserve process stress test and the determination of how Basel III will apply to systemically important financial institutions is not done, so why would you let them pay capital under these circumstances? It makes no sense and they shouldn't do it.

Mr. MCWATTERS. Okay. Thank you.

Dr. ZINGALES. I agree with most of what has been said, with one qualification. I think the definition of capital, especially if it is done in accounting terms, is not particularly useful because Washington Mutual did not violate any capital requirement before it failed. As was reminded earlier, Lehman at 11 percent of capital just the day before it went bust. So I don't think that this accounting based measure of capital are particularly useful.

What we need to do is a market base. And Oliver Hart and I have a proposal based on credit default swap, you can have other proposals based on other indicators.

But I think the notion is we don't want to treat everybody the same, because there are virtuous banks, there are sort of people who behaved properly. Why should they be subject to the same rules? I think that the rule should be if your CDS is above a certain level you cannot pay dividends and you cannot pay cash bonus. You have to transform all the bonus you want into equity and that will likely play a bigger role in recapitalizing banks than even stopping dividends.

Mr. MCWATTERS. Thank you gentlemen.

The CHAIRMAN. Mr. Silvers.

Mr. SILVERS. Well, if I've learned one thing from this panel, it's not to ask all of you the same question. [Laughter.]

Actually I have several questions I would like to get answered, and so although I enjoyed listening to you I'm going to be specific in whom I'm asking.

First, when Secretary Massad spoke one of the things that I took away from his testimony was the argument that while we have a lot of problems in our economy, those problems aren't really related to TARP. Unemployment, foreclosures, so forth, that they didn't really—perhaps even in credit provision are not really the fault of TARP or shouldn't be—TARP shouldn't be held responsible for it.

Professor Stiglitz, I think I take your testimony to be of the view that you don't agree with that. Can you explain what it is, in relation to those macroeconomic matters, that are related to TARP?

Dr. STIGLITZ. Well, they're related in the short run and in the long run. In the short run what I was trying to argue is that if you—they had given money to the banks in ways—in other ways, they could have induced more lending and induced more restructuring. So for instance, by the time we bailed out Citibank and Bank America, we were very large shareholders. We could have been even larger shareholders if we got shares—

Mr. SILVERS. If we got the value for the money, so to speak?

Dr. STIGLITZ. Yeah, if we had gotten voice relative to the money we put in. If we used that shareholder voice to say, you can't go make your profits out of speculation, you can't go paying these bonuses, this goes back to the point paying out bonuses and dividends is decapitalizing the banks and what was needed was recapitalization. And we allowed the decapitalization of the banks through the payouts of bonuses and dividends. We didn't put any pressure, any constraints on the behavior of the banks, so there were—including the restructuring of the mortgages.

So given the amount of money that, you know you're putting in—if you're putting in hundreds of billions of dollars you should have some voice in what happens. And the result of that is that we didn't get what we wanted, which was a restarting of the economy.

The long run are the more—are the even worse problems, because we have a more concentrated banking system, that means interest rates will be higher, spreads will be higher. And the result of that is not only are there the long risks that we've been talking about but in the short run the—because the market is less competitive the flow of money will, in the long run, not be what it should be.

Mr. SILVERS. Okay. Professor Johnson, Treasury seems convinced that the banks are healthy, sound or something like that. I wonder if you would comment on two things. One is, is that right? And two, how can anyone know that's right and given the state—we've talked a lot about the capital side of the balance sheet, the liability side, given the state of what we know or don't know about the asset side of the balance sheet.

Dr. JOHNSON. Yes, that's exactly right. There's a great deal of uncertainty around asset values. And of course, the correct way to assess the state of any banks is to do the stress test. Now there needs to be tough stress tests, the downside scenario needs to be much more rigorous or negative, pessimistic than the one they used in



2009. And I fear that the stress tests that they're doing now, although they haven't disclosed anything really about them, I fear that those tests are even more gentle.

So my answer is, we don't know. There's a lot of bad things that can happen. We're certainly not out of the recession, as my colleagues have mentioned, in many dimensions, and you have emphasized. So the sensible, prudent thing to do is to require that the banks retain the earnings and build up bigger equity buffers against potential future losses.

And that's irrespective of whether or not you accept my view; Gene Farmer's view; Professor Meltzer's view and Admati's view that going forward we should have 20, 30, 40, Adair Turner's view from the UK, the FSA there, Financial Supervisors; Mervyn King's view, the head of the Bank of England; Philipp Hildebrand's view, the head of the Swiss National Bank, even if you don't agree with the views of those people, just today, and if you're just in learning Basel III the only thing that makes sense is to have them retain the earnings right now and not pay out dividends, given what we know and the many things we don't know, many things we fear about the economy going forward.

Mr. SILVERS. Professor Meltzer, your suggestion that we have size adjusted capital requirements is, as I noted in the prior panel, it was one of the recommendations of this panel, in our regulatory reform report to Congress.

Dr. MELTZER. Good for you. [Laughter.]

Mr. SILVERS. Thank you.

It seems to me, just the most sort of obvious idea and I'm heartened to see some one of your experience having recommended it.

Dr. MELTZER. Senator Vitter introduced a bill to do it.

Mr. SILVERS. Now I've also been involved in the arguments on The Hill that essentially prevented it from being mandated in Dodd-Frank and I find that in general it is treated as though you were suggesting the creation of a perpetual motion machine or something of that nature in our politic processes. Can you explain to me why something so sort of straightforward can't seem to be taken seriously?

Dr. MELTZER. Yes. The bankers don't want it and they come down with their lobbyists in hordes to tell them—tell the congressmen, you know, "That's just disaster. You're facing disaster. There won't be loans for the public. There won't be capital to build industry," all that stuff.

Mr. SILVERS. Can I just ask and then I'm going to stop.

Dr. MELTZER. We got through the 1920's with capital requirements.

Mr. SILVERS. But since we're talking about size-weighted capital requirements, would that not just mean that it would be a powerful incentive for institutions to be smaller and then they would lend more when they were smaller? I mean would not rational actors move to basically step away from the Too Big to Fail structures and the amount of credit provision would not be affected.

Dr. MELTZER. We would remove the incentive which pushes them to be bigger and bigger all the time. And that would be good. I don't think they would be small, but I do think they were be smaller.

Mr. SILVERS. Smaller, right.

Dr. MELTZER. There isn't any evidence that I know that says that there are economies of scale at that size which makes them want to be bigger.

Mr. SILVERS. Yeah.

Dr. MELTZER. And I would like to add one other thing. In 1991 I believe Congress passed FDICIA. Are you familiar with FDICIA? Yes. Did they use it at all? No, they didn't use it at all. What did it call for? It called for early intervention. Just completely ignored. And they gave reasons. They said it didn't apply to holding companies, such things as that. You know, given all the things that they were doing they could have made FDICIA work and closed them down early or make them raise more capital. They didn't do that. So we have to legislate it.

Mr. SILVERS. Thank you. I'm allowed to keep going, I'm told.

Various people want to speak. Mr. Johnson?

Dr. JOHNSON. My understanding of the literature, just to reinforce Professor Meltzer's point, is there's no economies—no evidence for economies of scale or scope in banking over about \$50 billion in total assets. You might see \$100 billion dollars if you wanted to be generous. All the benefits above that are private benefits, not social benefits.

Mr. SILVERS. I guess one—

Dr. STIGLITZ. Can I just make one more point—

Mr. SILVERS. Yeah, sure.

Dr. STIGLITZ [continuing]. Just to emphasize the theoretical point here, that the requirements of leverage, there's a basic idea in economics called the Modigliani-Miller Theorem—

Mr. SILVERS. Yes.

Dr. STIGLITZ [continuing]. That says that leverage doesn't buy you anything except higher probabilities of default. And that—and so that the argument that they're making that it would interfere with the efficiency of the economy has no support in the economics profession.

Mr. SILVERS. But there is one more argument I'd like to dispose of, because there is this—there is the notion that—I mean you all suggested various levels of capital be required. But setting the question of how much capital should be required at any given size, just the notion of a sliding—the notion of a sliding scale, right, does not—is there any basis for the argument that a sliding scale would bring on a credit crunch?

Dr. MELTZER. No.

Dr. STIGLITZ. No.

Dr. ZINGALES. Can I dissent on this? I think that—

Mr. SILVERS. I've found a point of agreement. I feel proud. [Laughter.]

Dr. ZINGALES. I have to say I have great respect for Professor Stiglitz. I think that since Modigliani and Miller we have a large literature in corporate finance saying that actually it's sort of—the level of that is not irrelevant. And actually he contributed in part to that literature. So I'm surprised to say—to see now that he says that it's completely irrelevant. I don't think it's irrelevant, I think that there are some costs of having too much or too little debt depending on the situation. And I think that in the current situation,

if you were to dabble in the capital requirement to banks tomorrow, you will have a credit crunch. I think that it will definitely be a consequence.

Why? Because the managers don't want to raise more equity, regardless of whether this is in the interest or not of the shareholders, but they don't want to raise more equity. And so the alternative of raising more equity is to lend less. So I think there will be consequences and I think that the argument they're going to use to say why the sliding scale is bad is that it's going to unfairly affect the large banks. I completely disagree with this argument. I think that now we unfairly favor large banks so the sliding scale will only bring sort of a level playing field, but that's how to argue they would make.

Mr. SILVERS. Right. Your point about the credit crunch is kind of an institutionalist argument.

Dr. MELTZER. But, the main change would be——

Dr. ZINGALES. Why institutional? I'm sorry.

Dr. MELTZER [continuing]. You get more collective form of lending. That is if a bank—one argument that's made is that the corporations are so big that they need to have——

Mr. SILVERS. Big banks, right.

Dr. MELTZER [continuing]. Big banks. But they can syndicate the loans, they've done that for hundreds of years. They can syndicate the loans and service the banks—the customers.

Dr. JOHNSON. Sorry, I see a straw man slipping into the conversation. And no one is proposing that you immediately double capital requirements and tell them to hit that number tomorrow. Yes, the one way you could achieve that is by dumping assets or reducing loans as Luigi said. But, if you can look, for example, at the plans brought forward by or proposed by Jeremy Stein and David Scharfstein, for example, who are both very experienced, both worked in the Treasury under this administration, and now have proposals out there for ways in which you can time the shift in capital requirements to phase in these kinds of either a higher level overall or a step level as Professor Meltzer's suggesting. This, if implemented properly, would not be contractionary.

Dr. STIGLITZ. Let me just go back to——

Mr. SILVERS. I don't think—my chair has told me that this must come to an end. [Laughter.]

The CHAIRMAN. Dr. Troske.

Dr. TROSKE. Thank you. This has been a fascinating conversation and I'm certainly not going to try to compete with you on your field, so I'm going to pull you over to mine as a mere labor economist and start talking about executive compensation, which is—has received a certain amount of attention.

But my own view of this issue and combined with the current crisis sort of has evolved over time and to one in which it seems to me that when you have a Too Big to Fail financial institution it's the case that shareholders very much value risk and are going to move towards more leverage. And they're actually going to compensate executives in a way that would have them shift the risk profile of the investments that they make out to a more risky environment. So you don't need to take a very strong stand, in terms of whether you think, you know, executive pay is set, you know, op-

timally or not, but in the presence of Too Big to Fail, both shareholders and executives are willing to move towards more risky forms of investment and are going to be compensated in that fashion.

I guess I'd like your thoughts on my hypothesis. And I'll start with you, Professor Stiglitz.

Dr. STIGLITZ. Well, let me just say, the important point that you're emphasizing is that the decisions made by the banks are made by managers, not by the shareholders, and that there can often be misalignment of interest between the two. And that's why I remarked before, I think that there need to be regulations affecting shareholder compensation, regulations in general, including regulations affecting shareholder incentives. Because those incentive structures can lead them to want to undertake excessive risk and there may be limited ability of shareholders to constrain the ability of managers in that way.

So—and there's a second problem in managerial compensation that you didn't mention that I think is important to realize. That when you get shareholder stock option kind of compensation, it provides an incentive for you to distort the information that you're providing. So it encourages nontransparent accounting and there's always going to be a lot of discretion. A lot of the issues that—we've ignored the mistakes that have been associated with the ability to not—to keep on bad mortgages at full value and that whole distortion in the assessing of the asset structure. But the point is that if you have compensation that is related to the seeming performance of the share market, you—sharers, you have an incentive to distort the information provided by the market and to the regulators.

Dr. TROSKE. Does anybody have anything different to add?

Dr. JOHNSON. Yes.

Dr. TROSKE. Okay.

Dr. JOHNSON. If I may. I agree with you that theoretically if the Too Big to Fail guarantee holds, then the interest of the investor and interest of management, in this regard, are—can be aligned. So the investors want the management to leverage up, they want them to take a lot of risk. However, as a practical matter, I think the kinds of concerns Professor Stiglitz was mentioning come into play.

And I would refer you to a paper by Sanjai Bhagat and Brian Bolton who went carefully through the compensation received by the top 14—by executives of the top 14 financial institutions in the United States between 2000 and 2008. They found that those executives took out, in cash bonus and through stock sales, \$2.6 billion in cash. In fact the top five executives took out around \$2 billion in cash. And the shareholders, at the same time, if you were a buy and hold shareholder over that period, you did pretty badly.

So that suggests that as a practical matter, maybe it's because of misrepresentation, actually I think that's quite a plausible explanation, or maybe it's for some other reason, the shareholders do not do well when the managers leverage up, take a great deal of risk and get paid on a more or less immediate return basis, which is linked to your return on equity basis, not properly risk adjusted.

Dr. TROSKE. Yeah. Thanks. Can I—

Dr. MELTZER. Dr. Troske, I worried about this program a lot as a practical thing because I was a chairman of an audit and compensation committee for a Fortune 500 company. And so I faced the problem of how do you reward the chief executive and subsidiary executives. I don't think there's an easy answer to this problem. Dodd-Frank came up with a proposal which says that you have a nonbinding vote of the shareholders. So far I believe the evidence is the shareholders don't care much. That should be evidence that, leave it alone.

Dr. TROSKE. Professor Zingales—

Dr. MELTZER. Except in the case where you're failing.

Dr. TROSKE [continuing]. I'd like to ask you a little, somewhat different question more related to your recent paper, "Paulson's Gift," and I like your title. I wish I were that creative, or editors let me be that creative in my titles.

You estimate that TARP preferred equity infusions and the FDIC debt guarantee cost taxpayers between 21 and 44 billion. You talk about an alternative plan. The government could have charged more for both the equity infusion and the debt guarantee, as Warren Buffett did when he invested in Goldman Sachs three weeks before the Paulson plan. Could you kind of—could you elaborate on the difference between private party transactions undertaken at the time of TARP on the one hand and the actual TARP transactions as well as the FDIC's extension of deposit insurance?

Dr. ZINGALES. Yes. I think that there are two aspects. First of all, the capital infusion that was done was done, not in market terms by any stretch of the imagination, was definitely worse than the one that Warren Buffett got in terms of return. And the same is true for the debt guarantee. Now, what is interesting is we observe when this debt guarantee was the standard that the overall cost of insuring these institutions dropped.

So—but even if we take the value of this cost after the announcement, so let's think about there is a systemic effect and there is an individual effect, even if we sort of take anyway the systemic effect, the cost of insuring this institution was too cheap and that was not really varying according to the type of institution. So for JP Morgan this was not very convenient, for Citigroup or Goldman was tremendously convenient.

So what the accurate number you reported doesn't give a good sort of picture of is sort of the cross section. There was an important redistribution also within banks. JP Morgan was heavily penalized by the plan, probably because the market expected them to buy on the cheap the assets the other people were selling. And Citigroup was—Citigroup, Morgan Stanley and Goldman were tremendously helped by the plan.

So there is sort of also this cross sectional aspect which I think is important because it distorts the market incentives. By treating everybody the same the good managers are not rewarded and the bad managers are not penalized.

Dr. TROSKE. So let me ask one final question. As a profession we're often characterized as unable to reach consensus on any issue. And I would argue that the five independent PhD economists in the room, and I'm going to be arrogant enough to put myself in your group, agree about the importance of incentives and the ef-

facts that these distorted incentives had throughout this problem and continue to have today. This is a point I've made repeatedly since being on this panel.

I can understand why folks ignore me, but I struggle to understand why they ignore you. And I guess I'm kind of curious on your thoughts, what are we doing wrong as a profession because I do think these issues are something that economists do agree about. And so I guess I'd like your thoughts on, you know, on—because I'm kind of tired of shouting into the wind. I don't know about you. [Laughter.]

Professor Stiglitz, I'll let you lead off.

Dr. STIGLITZ. Okay. Well, I think the—what is interesting about this particular case is that there is a broad spectrum of support from the Left and the Right in the economics profession. But this goes back to the particular groups who are big beneficiaries of this particular system. And they have a lot of money to invest in both trying to shape public opinion and to get what they want.

So I don't find it that mysterious in a way, that there is a lot of money at stake. I mean he's talked about some of it, but a lot of money and that the money on the other side of trying to create a more efficient, fairer system, the point that a number of people have always made, Becker, for instance, that those are lots of people. And you have concentrated beneficiaries and the alternatives are much more diffuse. It's very hard to get a fair battle when you have that—this much money at stake.

Dr. TROSKE. Professor Meltzer, you've been doing this for a long time. What are your thoughts?

Dr. MELTZER. Well, I'm a strong believer in what is now called “political economy,” that is making policy; the first four letters of policy and politics are the same and the money is very important. So you know, we're fighting a battle that I—well, I agree with my old friend, the late Milton Friedman who said, “Our job as economists is to come up with proposals and when the crisis comes it will be better than the proposals that will occur at that time.” And he and we have had a record of getting things done that way in crises.

In the ordinary course of events you're fighting a tough political battle in which, as Joe just said, there's much at stake and there's a lot of money that goes into campaigns coming from Wall Street and that makes, you know, a big, big hurdle to get over. So when Senator Vitter introduced my bill to scale up the thing, you know, there just wasn't a lot of support in the Senate Banking Committee for it.

Dr. JOHNSON. It's a fascinating question that the bankers, when confronted by these proposals in the United States say, “We're going to move to the UK,” and when confronted by these proposals in the UK they say, “Well, we're going to move to New York.” You don't have to get the G20 together on this, you need to have the world's leading financials and New York and London would span most of it. And the Swiss are already pointing in exactly the same direction.

And there are people within the Federal Reserve system, for example, Thomas Hoenig, within the other regulatory agencies, including Sheila Bair, who I think totally get this. I'm not saying

that we convinced them, I think that they figured this out by themselves.

There are other people, such as Treasury and important elements within the New York Fed and within the Board of Governors of the Fed who are absolutely adamantly opposed to applying the logic that we've been discussing here today. They say—well, I don't know what they say. They don't come out and discuss it enough and clearly enough and I think, you know, ultimately a lot of the reasons they put forward make no sense at all.

And I think it was Mark Hanna, the legendary Republican Senator at the turn of the—beginning of the 20th century, the organizer of the Republican Party in the Senate around the country who said, "There are two things that matter in American politics. The first is money and I don't remember what the second one is."

Dr. TROSKE. Mr. Zingales.

Dr. ZINGALES. I think there are a couple of reasons. First of all, I think we know, as Stiglitz reminded, that there is a capture by the sort of people who are well organized and have a lot of money at stake. I actually believe in democracy enough that I think that on some topics this sort of strength can be overcome, but it requires that the topic is sufficiently interesting and sufficiently sort of easy to explain in the media that it generates sort of a public outrage.

So I think that in terms of environmental issues, people are much more sensitive because you can explain that more easily to the ordinary human being. I think that excessive compensation really attracts the interest of voters. When it comes to how to properly regulate capital requirements, I think that would put asleep like 99.9 percent of the people. And so it's very hard to be successful in explaining or pushing on—with the political agenda, against the entrenched interest.

But I have to say that there is also a responsibility of the economic profession in that. I think that you preach to the choir and it says, here this is not a selected sample, I think there are people that have been actively engaged in public speaking and I don't think that you can say the thing about most economists. I think that most economists don't write in newspapers, don't sort of actively sort of take their positions, they're not public figures. It's not what you are awarded for academically. The type of policy advice you give is not sort of very strong in your vitae and I think that they don't care.

Dr. TROSKE. Thank you.

The CHAIRMAN. Thank you.

Superintendent Neiman.

Mr. NEIMAN. Thank you.

The CHAIRMAN. We saved the best for last.

Mr. NEIMAN. Oh, okay. Thank you.

You know, in addition to the global calls and efforts to increase bank capital, we also know that liquidity is a driver to a firm's failure. Lehman is a good example with reference to the capital position at the time, the impact of short sellers, and of the fact that short term funding can dry up at any point in time.

I'd be interested in your views on the relationship between capital and liquidity. And also your views on the proposals out there,

particularly Basel III; the proposals with respect to increases in liquidity practices and requirements.

Dr. ZINGALES. Can I start?

Mr. NEIMAN. Sure.

Dr. ZINGALES. I think that the risk that short term debt presents is very large because short term debt can run very quickly. If I lend somebody overnight, I don't want to take any risk that the counterparty will fail overnight. Whatever high interest rate you offer over a day is not large enough to compensate for the risk. And that's the reason why when the market sentiment shifts and when there is a fear that the counterparty is insolvent or—then the short term lenders stops lending.

So that's the reason why I think it's important to have a cushion of long term debt. And so the Basel requirement for having a significant amount of long term debt I think is important. And paradoxically I think that part of what made the crisis worse are two pieces of—two facts. One is the Fed policy that kept sort of interest rates, especially short term on the curve, very low favored people—favored the short term borrowing by part of financial institutions, made it very convenient. And of course they don't internalize this externality of sort of the systemic aspect.

The second paradoxically is sort of the bankruptcy reform done in 2005. By making sort of—by exempting derivative and repurchase agreements from bankruptcy, they made them much cheaper than everything else, basically inducing institutions to take more of it and then making them more fragile. So, I'm definitely in favor for some sort of requirement in terms of compositional liabilities.

Mr. NEIMAN. Any other?

Dr. STIGLITZ. The—I think the issue that you raise focuses particularly on the question of the shadow banking system and that this is a really very serious problem that a lot of the discussion will be focusing on in the banking system. But you know, the point where Lehman Brothers really showed up was the collapse of reserve—the reserve fund. And people thought that they could use the shadow banking system as a substitute for the banking system.

I think what we now know we have to regulate both the shadow and the regular banking system. We have to see them as an integrated whole and that we shouldn't view the shadow banking system as a way of circumventing the banking system. So I think that is one of the important aspects.

I do want to agree with Professor Zingales that the incentive structures that are often built very subtly into the whole structure, like the bankruptcy provision, is really an example of something that's a major distortion that got very little attention at the time that it was adopted, but is obviously—it is an example of the kind of concern.

Another example is when you have incentives where some of the things are—some of the CDSs are done in a transparent market and some are done over the counter. That is an incentive to move things into the dark areas and to engage in things where nobody—it's difficult to regulate.

So, we are now, in the way we're going forward right now are creating new opportunities and new incentives to move things away from where we can see what's going on and to where we can't



and where these kinds of liquidity issues become all the more important.

Mr. NEIMAN. I'm glad you raised the issue of shadow banking because I did want to ask about the regulatory reform efforts about riskier activities, proprietary trading, swap activities and different proposals. For example, the Volcker Rule requires moving those activities, the proprietary trading, hedge fund activities out of the holding company all together as opposed to certain swap activities being moved out of the bank into the holding company.

I'd be interested in your views as are you shifting those activities into a less regulated area or would you prefer to see them within the bank holding company structure with a higher level of oversight and capital requirement?

Dr. STIGLITZ. Well, my view, there are two separate issues. I think we have to deal with very strongly with the Too Big to Fail banks and financial institutions, whether they're banks or non-banks and with the Too Correlated. We haven't talked about the Too Correlated to Fail, because that's another set of problems that represent systemic risk. But—so that's one set of issues. And when you have them still connected in a holding company you haven't really solved the Too Big to Fail.

But the other issue is, wherever they are there needs to be transparency. And the movements to allowing large segments of transactions to be in a nontransparent venue seems to me a real invitation to problems.

Mr. NEIMAN. Any other?

Dr. MELTZER. Yes. I'd like to say that on the money market funds, the biggest part of the off banking system, how did that crisis come about? Well, they got a rule, they had to mark their markets—their assets to market until they got to the point where they no longer could do that and pay a dollar or pay their face value. So they got the SEC to change the rule so they didn't have to mark their market—their assets to market. And when there was a run, after Lehman, that caused them. If they had been forced to mark their market—their assets to market that would have been the normal course of events. That was just a bad ruling.

We ought to reverse that ruling and say that when your liabilities are only worth 95 cents, they're worth 95 cents.

Mr. NEIMAN. Thank you, Mr. Meltzer.

Dr. MELTZER. That was a mistake. I agree with a comment that you made quickly and I think it is a major problem that you have to think about. If we regulate too much, and we may well be doing that, we're just going to shift—somebody has to bear the risks of the forward movement of the American economy. If we shift those risks out of the banks, the most regulated part of the system, and into other agencies, perhaps some not yet born, that's not going to be in the public interest or in the long run interest of the country.

So we have to be concerned with what we do to keep the risks where we can at least see them.

Mr. NEIMAN. Well the most descriptive is to avoid playing “whack-a-mole” I live near an amusement park and—

Dr. MELTZER. Right. So that's another reason why capital requirements are much more desirable than regulation.

Mr. NEIMAN. Appreciate that.

Mr. Johnson.

Dr. JOHNSON. I agree completely. The—many of these shadow structures were constructed as a way to get around capital requirements, to so called economize on capital which means to take more highly leveraged bets and to take on more risk. And while I recognize your points about liquidity, and I agree that we have constructed incentives for too much short term funding of longer term assets and assets that should be actually funded with equity, because of the nature of the risks there, I would emphasize we need high capital requirements across the board.

We can't rely on the market to do this by itself, because as we've discussed it's an incentive for the management, for sure, and in many cases management and shareholders to get big enough so they can fail.

And I would end by quoting somebody I know in the hedge fund sector, in a very large hedge fund, household name. He said to me, "Simon, let's face it, on the Too Big to Fail debate you lost. And now our question is, or what we're working on in the hedge fund is, how do we become Too Big to Fail."

Dr. ZINGALES. Can I sort of endorse strongly what Professor Meltzer said? I think that the single most evil rule that is still in place is exactly that one of the SEC that provides an appearance of safety on money market funds and help them market themselves as complete substantive deposits when they are not. And it's ironic that we had 2,000 pages of legislation and we could have changed that rule sort of very easily, I don't think it's subject to congressional approval, it's just a rule of the SEC, but nobody wants to do it and nobody even is discussing doing it.

Mr. NEIMAN. All right. Thank you.

The CHAIRMAN. Well, I've been around this place for almost 40 years, I've never seen a panel and a group of witnesses more in agreement in my entire life. [Laughter.]

So I—and let me tell you something, I know you know about the disparity in the political ideas of the witness, let me tell you, there's some pretty different views about just about everything up here on the panel, but I think there's one thing that we're all in agreement on and I think that Dr. Troske raised a good point, that I have felt the—I have the scars from, and that is the difficulty, of not just economists of trying to get some of these ideas that have been raised here that seem to be pretty simple, pretty straightforward and pretty widely held by people that have spent time thinking about it, to get it into legislation and get it into the Securities Exchange Commission and get it into CFTC.

So anyway, I really, really want to thank you all for taking time out of your day to come down here and do this. We really do appreciate it.

The record for the hearing will be kept open for one week so the panel may submit questions to the record of witnesses.

I want to finally say, just thank some folks. And I want to thank my fellow panelists. I mean you know, I came into this late and the welcomeness, the ability, the—I've never seen a group that is so easy to get along with and are so interested in trying to come to a common ground, even though there are very basic differences on the issues. So I really want to help my fellow panelists.

The other thing, having been a staff person, when you show up at this point with a staff that's in existence, you show up and you're a little scared because you know what you want in a staff and the rest of it. And I want to tell you, this has been a—absolutely—this COP staff is absolutely incredible and Naomi Baum does an incredible job to monitor the—Elizabeth and the whole group has just done an incredible job and I think the record shows that.

So I want to thank everybody from here. And with that we will close the hearing.

[Whereupon, at 1:44 p.m., the hearing was adjourned.]