OVERSIGHT OF IMPLEMENTATION OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 AND OF GOVERNMENT LENDING AND INSURANCE FACILITIES: IMPACT ON THE ECONOMY AND CREDIT AVAILABILITY

HEARING

BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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OVERSIGHT OF IMPLEMENTATION OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 AND OF GOVERNMENT LENDING AND INSURANCE FACILITIES: IMPACT ON THE ECONOMY AND CREDIT AVAILABILITY

Tuesday, November 18, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:33 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Velazquez, Watt, Ackerman, Sherman, Meeks, Moore of Kansas, Capuano, Hinojosa, Clay, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Moore of Wisconsin, Davis of Tennessee, Hodes, Ellison, Klein, Mahoney, Wilson, Perlmutter, Murphy, Donnelly, Foster, Speier; Bachus, Castle, Royce, Paul, LaTourette, Manzullo, Jones, Biggert, Shays, Hensarling, Garrett, Brown-Waite, Barrett, Gerlach, Pearce, Neugebauer, Price, Davis of Kentucky, Campbell, Putnam, Roskam, McCotter, and McCarthy of California.

The CHAIRMAN. The hearing will come to order. We will need the photographers to stop obstructing. I have a great belief in the freedom of information, but I think America is fully informed as to what these two gentlemen look like, so I don't feel like I am interfering with First Amendment rights if I ask you to let us get on with the hearing.

This hearing is called to do oversight on one of the most important pieces of legislation this current Congress has adopted and one of the most important, in many ways, that I think any Congress has ever adopted. We were asked last September by the Secretary of the Treasury, supported by the Chairman of the Federal Reserve, to pass a very extraordinary piece of legislation, putting potentially at risk, although we hope in the end not, $700 billion of public money for purposes that go beyond what government has ordinarily done and what almost everybody—myself included—believe the two gentlemen at the table think government should do. But it was a necessary response to a crisis.

Some questions have arisen about decisions that have been made with regard to the expenditure of those funds. We certainly want to hear from the Secretary and the Chairman their assessment of what has happened so far. And let me say at the outset, we do have a problem with all of us that there tends to be a focus on those areas of disagreement, and so accomplishments, areas of agreement, things which worked well tend to not get a lot of discussion. It is important, so that we can understand what has happened and evaluate what we did, that there be a full discussion today both of the successes of this program, and I believe there have been significant successes, and also of the concerns many of us have.

There are two that I hope we can address, and we have talked about these in a variety of ways, both publicly and privately, with these two officials. One, there is concern that the banks which were the recipient of capital infusions under the Capital Purchase Program have not used the funding entirely for re-lending, which many people here understood would be the purpose. There is both unhappiness at what would appear to be on the part of some financial institutions excesses in use of the money, although AIG attracted the most attention there, and that was initially not out of the $700 billion program. But even more substantively, there is concern that, and we hear this anecdotally from people we represent, that credit is still tighter than it ought to be and that the banks which received the money have not yet begun to lend it out.

The second major concern is over foreclosure prevention. And here I believe there is a very fundamental disagreement on the part of a lot of Members with the decision recently made. But we understand that decisions are subject to reexamination, etc. When the program was passed, very explicit language was included to provide for mortgage foreclosure and mortgage foreclosure diminution as one of the purposes. There is very specific language in there. And the question was, well, investment versus spending? The bill itself specifically says that we should, as we buy up mortgage assets, reduce the amount that has to be paid to a reasonable level to avoid foreclosure, so no one can argue that it was not contemplated. Indeed, it was a very important part of, frankly, the effort to get votes for this bill that we would do mortgage foreclosure reduction.

The Secretary's recent announcement was that none of these funds would go towards mortgage foreclosure reduction, although there are other programs on which we are working to do that. And I welcome recent evidence by several of the largest banks, all of whom were recipients of the capital funds and there is no direct connection, but it is true; several of the largest banks have now begun to get active. We also received an announcement by Fannie Mae and Freddie Mac of movement, although we have some concerns about how far they go and why they lag the programs that the FDIC has put in.

But the fundamental policy issue is our disappointment that funds are not being used out of the $700 billion to supplement mortgage foreclosure reduction. It is unfortunately not the case that all of our other efforts have been fully successful. I was a strong proponent of our HOPE for Homeowners bill. I now believe that if we were redoing that, we would do it differently in some ways. We learn from experience.

There is, I believe, an overwhelmingly powerful set of reasons why some of the TARP money must be used for mortgage foreclosure. First of all, mortgage foreclosures continue at an excessive pace from the standpoint of the economy. The negative effects of this cascade of foreclosures go far beyond the individuals who lose their homes. It has to do with neighborhood deterioration. It has to do with municipal inability to make their governments work. And it impacts, obviously, the macro economy.

Second, there is a matter of public confidence. A number of things need to be done to get us out of this recession, in my judgment: Fiscal stimulus; increased lending, which I talked to first; and foreclosure reduction. It may well be that further action has to be taken. I have to say at this point that public confidence in what we have done so far is lower than anybody would have wanted it to be to the point where it should be an obstacle to further steps. So because I want to keep strictly to the time for everybody, I would just reiterate that it is essential that we do something to use some of the TARP funds for the diminution of the rate of mortgage foreclosures, and the Chair of the FDIC, whom we have invited, has been very much in the lead on this. No one here is endorsing any specific plan, but the need to use TARP funds as the bill contemplates to reduce foreclosures is paramount.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman, for holding this hearing.

I welcome Secretary Paulson, Chairman Bernanke, and Chairman Bair, and I appreciate your service to the country.

There have been some reports in the press recently that the use of the TARP funds for direct injection of capital into the financial institutions is somehow contrary to the intent of Congress. I actually think that is not correct. The legislation that we passed specifically authorized direct injection of capital into the financial institutions through the purchase of equity or shares.

As I think the panel realizes, there was a debate during the entire legislative process in exactly how the situation would be addressed, and the final legislation it passed authorized both the purchase of distressed assets and capital injections. And I think what happened—I think we would all hopefully agree on this—is we simply found that it was quicker, simpler, and I think safer for the taxpayers to purchase shares of stock.

I have always had objections or at least reservations about the government purchasing what has been called troubled or toxic assets and having to manage them. So I for one, Secretary Paulson, applaud you for—and I think most economists applaud you—for actually being flexible and taking an approach which was clearly authorized by the legislation.

As the chairman said, confidence is critically important to the financial markets and to the overall economy. And it is in the best interest of not only the economy but also of the public that, as we shift and improvise on occasions, we clearly communicate the objective and the basis for what we are doing. I think we all agree on that. Conditions on the ground change. You must be agile and adjust, and I hope we all understand that.

I have a particular concern, which is that we don't appear to have an exit strategy. We continue to purchase assets and bring them onto the books of the government in the neighborhood of $1 trillion. And most of us, I think, on the Republican side have been troubled since day one about government intervention into the private markets. One of our concerns has been that we are taking capital that could be used by more efficient, more successful companies and enterprises with better business models, and we are shifting that money to companies that are less efficient and whose business models need changing. And by putting capital into those companies, we almost enable them or allow them not to confront some of the inefficiencies in their own enterprises.

Let me close by saying this: There has been a lot of discussion about the greatest economic challenge since the Great Depression. One thing that I have tried to do is go back and look at the 9 or 10 recessions we have had since World War II. What at least I find—and you may tell me that I am wrong—is that the GDP in all but the last two of those recessions dipped by as much as 5 percent in at least one quarter. In this quarter, which many people are saying is the worst quarter, we expect maybe a 4 percent dip in GDP. So, at least when you look at the history of the recessions since World War II, you find that this recession may, in fact, not be any greater, at least now. I don't know if something in the future, but at least right now, this recession as far as the loss of GDP is no greater than at least 8 of our 10 recessions since World War II.

So the question that I would ask is—and I will close with this—if we are in a recession that is, at least from a GDP standpoint, no greater than 8 of the last 10, why are we, in this recession, having so much government intervention?

Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from New York is recognized for 3 minutes. We are under the rule for Cabinet officials of two 5-minute statements and two 3-minute statements.

The gentlewoman from New York.

Mrs. MALONEY. Thank you, Mr. Chairman.

I welcome our distinguished guests and thank you for your leadership.

I particularly would like to commend Chairman Bair for her leadership in foreclosure prevention and particularly for developing a new loan modification guarantee program to refinance on a large scale, which would help us to save millions of people and help them to stay in their homes. And I would like to be associated with the comments of both the ranking member and the chairman that our intention was to use some of the TARP money to invest in our economy and to get it moving in the right direction. Certainly stabilizing housing, as Chairman Bernanke has said repeatedly, that we must fix the housing crisis before we can get the economy back on track. So whatever the model, I firmly support using TARP money to stabilize housing and our economy.

Secondly, my constituents are telling me that many of them still cannot get access to credit. Given that bank lending is still basically shut down, we need to be asking whether and when we should expect at least some fraction of TARP funds injected into banks to be lent. After all, one of the primary purposes of the TARP program was to get credit moving. I have nonbank lenders who are my constituents who lend money to small businesses and want access to the TARP to increase that activity. Today's Wall

Street Journal talks about insurance companies that are buying up banks just to get access to the TARP money. And we then read many articles that banks are using TARP money for buying other banks. So we are basically funding mergers and acquisitions, not lending.

My basic question is, why shouldn't we be giving TARP money out based on the activity it funds? Why don't we fund organizations that will lend it, whether it is a bank, an insurance company, so that we will be getting the credit out into the communities which was the purpose of the TARP program? Again, every article talks about how it is being used for capital formation, mergers, acquisitions, other activities, buying up swaps, buying other things instead of getting the credit out into the communities.

So there are many questions before us today, but those are two of my prime focuses, that we should be helping people stay in their homes, and we should be working harder to get credit out into the communities.

Thank you.

The CHAIRMAN. The gentleman from Texas is recognized for 3 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. Thank you for holding this hearing.

It is certainly better late than never. It appears that 80 percent of the funds that are currently available under the TARP program have already been committed. So I am glad we are at least holding the hearing today.

The Washington Post reported last week that, "no formal action has been taken to fill the independent oversight post established by Congress when it approved the bailout to prevent corruption and government waste." So I believe there is sufficient work for this committee at this time.

As many in this room know, I did not support the original Emergency Economic Stabilization Act. Clearly, as most, I recognize that we do have a legitimate crisis as opposed to those that occasionally get manufactured around here. I embraced an idea I thought I would never embrace, and that was a government-insured model for mortgage-backed securities. I also preferred a secured loan model.

My ideas and those of other conservatives did not carry the day. This is the law of the land. We want to make sure that it works. I had many reservations about the toxic asset purchase model, not the least of which was my belief that the Federal Government ultimately was not institutionally competent to purchase the right assets at the right price, much less manage them in a proper fiduciary fashion. But I recall being told at the time that this model had been studied at Treasury for a number of months and that the other alternatives, for a number of reasons, were discounted.

On October 3rd when the law was passed, the Dow closed at 10,325; yesterday it closed at 8,273. To the best of my knowledge, any data that has come across my desk shows that consumer confidence remains low. So, clearly, we have a ways to go.

I will be curious in this hearing to understand the reasons why the toxic asset purchase model has apparently been abandoned. If that is true, I for one applaud it and always thought the direct equity infusion model would be a preferred model, although I prefer debt as opposed to equity. I fear, though, that some view it as a bait and switch, and I am curious as to what extent regulatory and programmatic uncertainty are leading or exacerbating the economic woes that we face today as people wait to see what portion of the money they may be able to apply for.

I hope going forward that, number one, we measure the program by, is it working? Number two, $700 billion is a lot of money. I haven't found anybody who doesn't want a piece of it as of yet. I hope that we look upon the program as something that the recipients will be chosen by how it could impact our macro economy and not a politically-driven process picking winners and losers. And last but not least, taxpayer accountability and transparency must be paramount.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. Mr. Secretary, let me explain to the members, we have, I believe, until noon. We will obviously not be able to accommodate all the members. I am going to hold very strictly to time limits for all of us.

Mr. Secretary.

STATEMENT OF THE HONORABLE HENRY M. PAULSON, JR., SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary PAULSON. Thank you very much, Mr. Chairman.

Mr. Chairman, Congressman Bachus, and members of the committee, thank you for the opportunity to testify this morning.

Six weeks ago, Congress took the critically important step of providing important authorities and resources to stabilize our financial system. Until that time, we faced a financial crisis without the proper tools. With these tools in hand, we took decisive action to prevent the collapse of our financial system. We have not in our lifetimes dealt with a financial crisis of this severity and unpredictability. We have seen the failures or the equivalent of failures of Bear Stearns, IndyMac, Lehman Brothers, Washington Mutual, Wachovia, Fannie Mae, Freddie Mac, and AIG, institutions with a collective $4.7 trillion in assets when this year began. By September, the financial system had seized up, presenting a systemwide crisis.

Our objectives in asking Congress for a financial rescue package were to, first, stabilize a financial system on the verge of collapse and then to get lending going again to support American consumers and businesses. Over the next few weeks, conditions worsened significantly. Confidence in the banking system continued to diminish. Industrial company access to all aspects of the bond market was dramatically curtailed. Small- and middle-sized companies with no direct connection to the financial sector were losing access to the normal credit needed to meet payrolls, pay suppliers, and buy inventory. During that same period, the FDIC acted to mitigate the failure of Washington Mutual and made clear that it would intervene to prevent Wachovia's failure.

Turmoil had developed in the European markets. In a 2-day period at the end of September, the governments of Ireland, the U.K., Germany, Belgium, France, and Iceland intervened to prevent the failure of one or more financial institutions in their countries. By the time legislation had cleared Congress, the global market crisis was so broad and severe that powerful steps were necessary to quickly stabilize our financial system.

Our response, in coordination with the Federal Reserve, the FDIC, and other banking regulators was a program to purchase equity in banks across the country. We have committed $250 billion to this effort. This action, in combination with the FDIC's guarantee of certain debt issued by financial institutions and the Fed's commercial paper program helped us to immediately stabilize the financial system.

The Capital Purchase Program for banks and thrifts has already dispersed $148 billion, and we are processing many more applications. Yesterday, Treasury announced the terms for participation for nonpublicly traded banks, another important source of credit in our economy. We have designed these terms to help provide community development financial institutions and minority depository institutions with capital for lending to low-income and minority populations. These institutions have committed to use this capital for businesses and projects that serve their communities. In addition, we are developing a matching program for possible future use by banks or nonbank financial institutions.

Capital strength enables banks to take losses as they write down or sell troubled assets. Stronger capitalization is also essential to increasing lending, which although difficult to achieve during times like this, is essential to economic recovery. We expect banks to increase their lending over time as a result of these efforts and as confidence is restored. This lending won't materialize as fast as any of us would like. But it will happen much, much faster having used the TARP to stabilize our system.

As we continue significant work on our mortgage asset purchase plan, it became clear just how much damage the crisis had done to our economy. Third quarter GDP growth showed negative three-tenths of a percent. The unemployment rate rose to a level not seen in 15 years. Home price status showed that home prices in 10 major cities had fallen 18 percent over the previous year, demonstrating that the housing correction had not abated. The slowing of European economies has been even more dramatic.

We assessed the potential use of remaining TARP funding against the backdrop of current economic and market conditions. It is clear that an effective mortgage asset purchase program would require a massive commitment of TARP funds. In September, before economic conditions worsened, $700 billion in troubled asset purchases would have had a significant impact. But half of that sum in a worse economy simply isn't enough firepower. We have therefore determined that the prudent course at this time is to conserve the remaining funds available from the TARP, providing flexibility for this and the next Administration.

Other priorities that need to be addressed include actions to restore consumer credit. Treasury has been working on a program with the Federal Reserve to improve securitization in the credit marketplace. While this would involve investing only a relatively modest share of TARP funds in the Federal Reserve liquidity facility, it could have substantial positive benefits for consumer lending.

Finally, Mr. Chairman, Treasury remains committed to continuing to work to reduce avoidable foreclosures. Congress and the Administration have made substantial progress on that front through HUD programs, the FDIC's IndyMac approach, our support and leadership of the HOPE NOW Alliance, and our work with the GSEs, including an important announcement they made last week establishing new servicer guidelines that will set a new standard for the entire industry. Our actions to stabilize and strengthen Fannie Mae and Freddie Mac have also helped mitigate the housing correction by increasing access to lower-cost mortgage lending.

As some on the committee know, I have reservations about spending TARP resources to directly subsidize foreclosure mitigation because this is different than the original investment intent. We continue to look at good proposals and are dedicated to implementing those that protect the taxpayer and work well.

Mr. Chairman, the actions of the Treasury, the Fed, and the FDIC have stabilized our financial system. The authorities in the TARP have been used to strengthen our financial system and to prevent the harm to our economy and financial system from the failure of a systemically important institution. As facts and conditions in the market and economy have changed, we have adjusted our strategy to most effectively address the urgent crisis and to preserve the flexibility of the President-elect and the new Secretary of the Treasury to address future challenges in the economy and capital markets.

Thank you again for your efforts and for the opportunity to appear today. I would like to just make one last comment in response to a question that Congressman Bachus asked because it is one I hear a lot, the distinction between the financial markets and the economy. So when we have talked about the crisis and the financial markets and being unprecedented and having to go back to the Great Depression to see anything of this magnitude and be presented with this amount of difficulty, we are talking about the financial markets. Now, when the financial markets have problems, they hurt the economy. So the reason that it was very important to get in quickly and stabilize it was to mitigate damage to the economy. When we were here before you, we saw what was happening to the economy. We talked about it. We took the steps. The economy has continued to get worse. The American people look at the worsening economy. And as your chairman said to me yesterday, in politics, you don't get much credit for what might have happened and didn't happen. What the American people see is what is happening to the economy. But again, our purpose in coming to you was to take—

The CHAIRMAN. Mr. Secretary, the gentleman will have his 5 minutes. I appreciate that.

[The prepared statement of Secretary Paulson can be found on page 190 of the appendix.]

The CHAIRMAN. Mr. Chairman.

STATEMENT OF THE HONORABLE BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you.

Chairman Frank, Ranking Member Bachus, and other members of the committee, I appreciate having this opportunity to review some of the activities to date of the Treasury's Troubled Asset Relief Program, or TARP, and to discuss recent steps taken by the Federal Reserve and other agencies to support the normalization of credit markets.

The legislation that created the TARP put in place a Financial Stability Oversight Board to review the actions of the Treasury in administering the program. That oversight board includes the Secretary of the Treasury, the Secretary of Housing and Urban Development, the Chairman of the Securities and Exchange Commission, the Director of the Federal Housing Finance Agency, and the Chairman of the Federal Reserve Board. We have met 4 times, reviewing the operational plans and policy initiatives for the TARP and discussing possible additional steps that might be taken.

Officers for the oversight board have been appointed, and the Federal Reserve and other agencies are providing staff support for the board. Minutes of each meeting are being posted to a special Web site established by the Treasury. In addition, staff members of the agencies whose heads are participating in the oversight board have met with staff from the Government Accountability Office to explore strategies for coordinating the oversight that the two bodies are required to perform under the enabling legislation.

The value of the TARP in promoting financial stability has already been demonstrated. The financial crisis intensified greatly in the latter part of September and spread to many countries that had not yet been touched by it, which led to grave concerns about the stability of the global financial system. Failure to prevent the international financial collapse would almost certainly have had dire implications for both the U.S. and world economies.

Fortunately, the existence of the TARP allowed the Treasury to act quickly by announcing a plan to inject $250 billion in capital into U.S. financial institutions. Nine large institutions received the first $125 billion, and the remainder is being made available to other banking organizations through an application process. In addition, the Federal Deposit Insurance Corporation announced that it would guarantee non-interest-bearing transaction accounts at depository institutions and certain other liabilities for depository institutions and their holding companies. And the Federal Reserve expanded its provision of backstop liquidity to the financial system.

These actions, together with similar actions in many other countries, appeared to stabilize the situation and to improve investor confidence in financial firms. Notably, spreads on credit default swaps for large U.S. banking organizations, which had widened substantially over the previous 2 weeks, declined sharply on the day of the joint announcement.

Going forward, the ability of the Treasury to use the TARP to inject capital into financial institutions and to take other steps to stabilize the financial system, including any actions that might be needed to prevent a disorderly failure of a systemically important financial institution, will be critical for restoring confidence and promoting return of credit markets to more normal functioning.

As I noted earlier, the Federal Reserve has taken a range of policy actions to provide liquidity to the financial system and thus promote the extension of credit to households and businesses. Our recent actions have focused on the market for commercial paper, which is an important source of short-term financing for many financial and nonfinancial firms. Normally, money market mutual funds are major lenders in commercial paper markets. However, in mid-September, a large fund suffered losses and heavy redemptions, causing it to suspend further redemptions and then close. In the next few weeks, investors withdrew almost $500 billion from prime money market funds.

The funds, concerned with their ability to meet further redemptions, began to reduce their purchases of commercial paper and limit the maturity of such paper to only overnight or other very short maturities. As a result, interest rate spreads paid by issuers on longer maturity commercial paper widened significantly, and the issuers were exposed to the costs and risks of having to roll over increasingly large amounts of paper each day.

The Federal Reserve has developed three programs to address these problems. The first allows money market mutual funds to sell asset-backed commercial paper to banking organizations which are then permitted to borrow against the paper on a nonrecourse basis from the Federal Reserve Bank of Boston. Usage of that facility peaked at around $150 billion. The facility contributed importantly to the ability of money funds to meet redemption pressures when they were most intense and remains available as a backstop should such pressures re-emerge.

The second program involves the funding of a special purpose vehicle that purchases highly rated commercial paper issued by financial and nonfinancial businesses at a term of 3 months. This facility has purchased about $250 billion of commercial paper, allowing many firms to extend significant amounts of funding into next year.

A third facility expected to be operational next week will provide a liquidity backstop directly to money market mutual funds. This facility is intended to give funds confidence to extend significantly the maturities of their investments and reduce over time the reliance of issuers on sales to the Federal Reserve special purpose vehicle.

All of these programs, which were created under section 13(3) of the Federal Reserve Act, must be terminated when conditions in the financial markets are determined by the Federal Reserve to no longer be unusual and exigent.

The primary objective of these and other actions we have taken is to stabilize credit markets and to improve the access of credit to businesses and households. There are some signs that credit markets, while still strained, are improving. Interbank short-term funding rates have fallen notably since mid-October, and we are seeing greater stability in money market mutual funds and in the commercial paper market. Interest rates and higher rated bonds issued by corporations and municipalities have fallen somewhat, and bond issuance for these entities rose a bit in recent weeks.

The ongoing capital injections under the TARP are continuing to bring stability to the banking system and have reduced some of the pressure on banks to deleverage, two critical first steps towards restarting flows of new credit. However, overall, credit conditions are still far from normal with risk spreads remaining very elevated and banks reporting that they continued to tighten lending standards through October. There has been little or no bond issuance by lower rated corporations or securitization of consumer loans in recent weeks.

To help address the tightness of credit, on November 12th, the Federal banking agencies issued a joint statement on meeting the needs of creditworthy borrowers. The statement took note of the recent strong policy actions designed to promote financial stability and improve banks' access to capital and funding. In light of those actions, which have increased the capacity of banks to lend, it is imperative that all banking organizations and their regulators work together to ensure that the needs of creditworthy borrowers are met in a manner consistent with safety and soundness. As capital adequacy is critical in determining a banking organization's ability and willingness to lend, the joint statement emphasizes the need for careful capital planning, including setting appropriate dividend policies. The statement also notes the agency's expectation that banking organizations should work with existing borrowers to avoid preventable foreclosures which can be costly to all involved: the borrower; the lender; and the communities in which they are located.

Steps that should be taken in this area include ensuring adequate funding and staffing of mortgage servicing operations and adopting systematic, proactive, and streamlined mortgage loan modification protocols aimed at providing long-term sustainability for borrowers.

Finally, the agencies expect banking organizations to conduct regular reviews of their management compensation policies to ensure that they encourage prudent lending and discourage excessive risk-taking.

Thank you. I would be pleased to take your questions.

[The prepared statement of Chairman Bernanke can be found on page 139 of the appendix.]

The CHAIRMAN. Chairwoman Bair.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you.

Chairman Frank, Ranking Member Bachus, and members of the committee, I appreciate the opportunity to testify on recent efforts to stabilize the Nation's financial markets and to reduce foreclosures.

Conditions in the financial markets have deeply shaken the confidence of people around the world and their financial systems. The events of the past few months are unprecedented to say the least. The government has taken a number of extraordinary steps to bolster public confidence in the U.S. banking system. The most recent were measures to recapitalize our banks and provide temporary liquidity support to unlock credit markets, especially interbank lending. These moves match similar actions taken in Europe. Working with the Treasury Department and the other bank regulators, the FDIC will do whatever it takes to preserve the public's trust in the financial system.

Despite the current challenges, the bulk of the U.S. banking industry remains well capitalized. But what we do have is a liquidity problem. This liquidity squeeze was initially caused by uncertainty about the value of mortgage-related assets. Since then, credit concerns have broadened considerably, making banks reluctant to lend to each other and to lend to consumers and businesses.

As you know, in concert with the Treasury and the Federal Reserve, we took a number of actions to bolster confidence in the banking system. These included temporarily increasing deposit insurance coverage and providing guarantees to new senior unsecured debt issued by banks, thrifts, and holding companies. The purpose of these programs is to increase bank lending and minimize the impact of deleveraging on the American economy.

As a result of these efforts, the financial system is now more stable and interest rate spreads have narrowed substantially. However, credit remains tight and this is a serious threat to the economic outlook. Regulators will be watching to make sure these emergency resources are mainly used for their intended purpose—responsible lending to consumers and businesses.

In the meantime, we must focus on the borrower side of the equation. Everyone agrees that more needs to be done for homeowners. We need to prevent unnecessary foreclosures, and we need to modify loans at a much faster pace. Foreclosure prevention is essential to helping find a bottom for home prices, to stabilizing mortgage credit markets, and to restoring economic growth.

We all know there is no single solution or magic bullet. But as foreclosures escalate, we are clearly falling behind the curve. Much more aggressive intervention is needed if we are to curb the damage to our neighborhoods and to the broader economy.

Last Friday, we released the details of our plan to help 1.5 million homeowners avoid foreclosure. Our program would require a total of about $24 billion in Federal financing. The plan is based on our practical experience in modifying thousands of mortgages at IndyMac Federal Bank. As we have done at IndyMac, we would convert unaffordable mortgages into loans that are sustainable over the long term. The plan would set loan modification standards. Eligible borrowers would get lower interest rates and, in some cases, longer loan terms and principal forbearance to make their monthly payments affordable.

To encourage the lending industry to participate, the program would create a loan guarantee program that would absorb up to half the losses if the borrower defaults on the modified loan. While we applaud recent announcements by the GSEs and major servicers to adopt more streamlined approaches to loan modifications along the lines we have employed at IndyMac, the stakes are too high and time is too short to rely exclusively on voluntary efforts. Moreover, these recent announcements do not reach mortgages held in private label securitizations.

We need a national solution for a national problem. We need a fast-track Federal program that has the potential to reach all homeowners regardless of who owns their mortgages. What we are proposing is a major investment program that can yield significant returns by attacking the self-reinforcing cycle of unnecessary foreclosures that is placing downward pressure on home prices. Average U.S. home prices have declined by more than 20 percent from their peak and are still spiraling down. If this program can keep home prices from falling by just 3 percentage points less than would otherwise be the case, over half a trillion dollars would remain in homeowners' pockets. Even a conservative estimate of the wealth effect this could have on consumer spending would exceed $40 billion. That would be a big stimulus for the economy and nearly double our investment.

In conclusion, the FDIC is fully engaged in preserving trust and stability in the banking system. The FDIC stands committed to achieving what has been our core mission since we were created 75 years ago in the wake of the Great Depression—protecting depositors and maintaining public confidence in the financial system.

Thank you.

[The prepared statement of Chairwoman Bair can be found on page 100 of the appendix.]

The CHAIRMAN. Thank you.

Before I begin my questioning, I want to just put into the record: A very thoughtful letter from our colleague Mr. Kucinich, who was chair of a Subcommittee on Government Reform, strongly arguing for help on foreclosures; a letter that was sent to me and a letter was also sent to the Secretary from Michael Fryzel, the Presidential appointee to head the National Credit Union Administration, objecting strenuously on behalf of the health of the credit union industry to the decision not to buy up any assets; and also, a statement from the National Association of Realtors.

I will now begin my 5 minutes, and I am going to hold everybody to the 5 minutes.

First, I welcome the two Chairs to the interagency statement on meeting the needs of creditworthy borrowers. It is a very good statement. It will be an even better statement if somebody gets whacked for not following it. There has to be some teeth. And it does talk about compensation, about dividends, and it is a very good statement. I can't imagine that a month from now everybody will have complied, and so, therefore, frankly, evidence that it meant something will be if there were at least some letters issued or some penalties.

Secondly, I just want to report on the oversight board, and the gentleman from Texas referred to it. My understanding is that the Senate Majority Leader and the Speaker have appointed their members. The minority leaders have not appointed their members yet, so the board is not yet functional. Earlier this week, or last week, three members were appointed, as called for under the statute, by the Majority Leader of the Senate and the Speaker.

Now I want to get to the issue of mortgage foreclosure.

First, Mr. Secretary, I am going to also put into the record a 4-page memo of sections of the law that we passed which mandate that if you buy assets, you do mortgage foreclosure.

And make it very clear, when you say spending—first, I have to say this: We obviously all appreciate the concern for the taxpayers' money. But the Chair of the FDIC talks about $24 billion. That is, what, 40 percent of what we just gave to AIG out of this program. And you say this is for an investment and not spending. I don't know what investment counselor, absent macro economics conditions, would have advised you to invest in AIG. I suspect it does not rate highly as an investment these days. I hope it goes well going forward. And there is no question that this will be helpful to it. But $40 billion for AIG, and then we can't find $24 billion on the mortgage foreclosure, is part of the reason we have the real problem with the country.

But let me just say, it is 4 pages of specific authorization to buy up mortgages and write them down. Section 109(c): "Upon any request arising under existing investment contracts, the Secretary shall consent, where appropriate in considering net present value to the taxpayer, to reasonable requests for lost mitigation measures."

In section 110, homeowner assistance by agencies: "To the extent that the Federal property manager holds onto, controls mortgages, they shall implement a plan that seeks to maximize assistance for homeowners."

The bill is replete with authorization to you not simply to buy up mortgages but in effect to do some spending because we are talking about writing them down. So the argument that—frankly, of all the changes that have come in the program, this wouldn't be a change. This was the program. And my colleague from California, whom you will be hearing from shortly, made a big point of this on the Floor. So the argument that this is not part of the program simply doesn't work.

Would you agree, Mr. Secretary, that in fact the bill does authorize aggressive action not simply to buy up mortgages but, in buying them up, take some action to reduce in some ways the amount owed so we diminish foreclosures?

Secretary PAULSON. Mr. Chairman, two things.

First, I need to just say a word about AIG, because the primary purpose of the bill was to protect our system from collapse. AIG was a situation, a company that would have failed had the Fed not stepped in. Had we had the TARP at that time, this is right down the middle of the plate for what we would have used the TARP for. As it turned out—because it should have had preferred and a Fed facility. And as it turned out, we needed to come in, again, to stabilize that situation and maximize the chances that the government would get money back. So I just wanted—

The CHAIRMAN. I am not objecting to the AIG. I am just saying, though, that the standards of what we do—and obviously foreclosure is also a serious problem for the economy.

Secretary PAULSON. I agree with you on the bill. There is no doubt—and so don't misunderstand what I say—that we came to Congress with the intent to get at the capital program that banks were facing and the system was facing through purchasing large amounts of illiquid assets. So the bill—and it was to purchase those assets and then resell them. And our whole discussion—because that is what we were talking about, was how to use them and use this investment position to make a difference and mitigate foreclosures.

My only point is, now that we haven't bought those assets, illiquid assets, that the intent, as I had seen it, at least all the discussions we had went to buying assets and reselling them; it didn't go to a direct subsidy. But—

The CHAIRMAN. No, Mr. Secretary, I have to interrupt you. You are talking legitimately about your intent. But we had to get the votes for the bill. Our intent was also relevant, and I read you sections of the bill which says, write it down; give them assistance. So the bill couldn't have been clearer that one of the purposes—and by the way, we are talking about, what, $24 billion out of $700 billion; you are talking about 4 percent of the total amount. But the point is that clearly part of this was not just to stabilize but to reduce the number of foreclosures for good macroeconomic reasons. So, again, the intent couldn't be clearer from what I read.

Secretary PAULSON. Let me then, Mr. Chairman, say what you have heard me say a number of times before, that, going back many, many months, before it was as topical as it is now, we have been working very, very aggressively at the individual—helping the individual. As recently as last week—

The CHAIRMAN. Mr. Chairman, I am sorry—Mr. Secretary. We don't have a lot of time. I don't usually do this, but the question is the language in the TARP. We understand that there are other activities going on. I don't accept them as a substitute for using the authority that we very specifically and carefully wrote into the TARP and that was essential to it getting passed.

Secretary PAULSON. Well, what you have heard from me and what you heard from me last night and which I will say again, that I am going to keep working on this and looking for ways to use the taxpayer money as they expect me to here with regard to foreclosure mitigation. We have been, you know, as recently as last week, taking a step, which I think will have—

The CHAIRMAN. No, I am sorry, Mr. Secretary. Those are not substitutable, because I will tell you, and I apologize for taking the time, it is nobody's view that we have been as successful as we need to be for the sake of the economy in reducing foreclosures. We have a very large pot that was intended to be part of that effort that is going untapped.

The gentleman from Alabama.

Mr. BACHUS. He was responding to you.

The CHAIRMAN. We are out of time. He can respond to you.

Mr. BACHUS. Thank you, Mr. Chairman.

You have just been told, if you don't give assistance or lend to folks, you will be waxed. It is sort of a continuation of what we have been hearing since the 1970's by Federal policy and the GSEs, is, lend and meet the needs of folks and assist them. I think, as a result of that, the financial system and the economy has been waxed by lending to people who weren't creditworthy. And I hope—and I appreciate that your intergovernment statement stressed creditworthy borrowers.

Secretary Paulson, I very much appreciate something that you did in your opening statement. I think you distinguished between the economy and the financial system, because people did question some of the actions by saying, well, the economy is strong. But the financial system, chaos or distress there will affect the economy. It has that effect. I think we have heard good news here. There is stability returning to the financial system. And I think the good news is, just like the instability in the financial system affected the economy, going forward, and it may take a while to do, but the stability that has returned to the system will in the long term strengthen the economy. I think that is good news for all of us.

The TARP program, the capital purchase program, all of them had as a design two things. One was restoring the stability to the financial markets. And I think that we are well on our way to achieving that. And as you said, you don't get credit for something that you avoid, and that would be a collapse of the financial system.

The second objective was to strengthen the economy by restoring lending to companies and borrowers. And on that score, it hasn't worked as well. Would you comment on, do you think we are on the right track in restoring lending?

Secretary PAULSON. Yes, Congressman Bachus, I think we are on the right track. Remember, this is early days. In terms of the capital, it has just gone out, and a lot of it still hasn't gone out to the banks. The way I look at where we are today is, I think we have turned the corner in terms of stabilizing the system, preventing a collapse.

I think there is a lot of work that still needs to be done in terms of recovery of the financial system, getting it working again, getting credit flowing again. I think this is going to be key to getting the economy going. And it is going to take a lot of work and time.

I agree with what the chairman said about bank lending. And I just want to say, one, to get to your point on foreclosure prevention, I understand the chairman's point. And he expects and wants to see something in the TARP, specifically in the TARP to deal with that. We are continuing to work on that.

I did want to say, though, that because I was so aware of what the American people expected and what Congress expected and because I cared so much about this, that I believe that the actions we took outside of the TARP with regard to the GSEs and the national standard they set has the potential to touch more and do more than we might have achieved if we had used all $700 billion to buy illiquid assets. So we are working. I understand the point. I know what you would like to see us do, but I just wanted to make that point there.

Mr. BACHUS. Thank you.

Let me say this. There have been quite a lot of things, Chairman Bernanke, over $2 trillion of emergency loans to institutions, and the identity of those assets that you have taken back. You have always advocated—as the Secretary has—committee transparency. I know you are refusing to disclose the names of those institutions or the composition of those assets. Is that a short-term—I will call it a refusal to disclose? Or when do you anticipate letting the public know?

Mr. BERNANKE. Congressman, I think there has been some confusion about what this involves.

Mr. BACHUS. Sure.

Mr. BERNANKE. The Federal Reserve, like all other central banks, has short-term collateralized lending programs to financial institutions. We have always had that. The main difference is we have extended it to primary dealers as well as depository institutions. It is open to any bank that comes to our window. We take collateral. We haircut it. It is a short-term loan. It is very safe. We have never lost a penny in these lending programs.

Now, some have asked us to reveal the names of banks that are borrowing, how much they are borrowing, what collateral they are posting. We think that is counterproductive for two reasons: First, the success of this depends on banks being willing to come and borrow when they need short-term cash. There is a concern that if the name is put in the newspaper that such and such bank came to the Fed to borrow overnight, even for a perfectly good reason, that others might begin to worry, is this bank creditworthy? And that might create a stigma, a problem, and it might cause banks to be unwilling to borrow. That would be counterproductive for the whole—

Mr. BACHUS. So these are banks which have good sound CAMELS ratings?

Mr. BERNANKE. Yes. We only lend to good quality banks. We lend on a recourse basis, that is post, post, post collateral, and if the collateral were to be insufficient, then the bank itself is still responsible. We have never lost a penny doing this. I think it is a totally standard practice for central banks around the world, and it is very constructive to provide liquidity to the financial system.

Mr. BACHUS. Thank you.

The CHAIRMAN. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Secretary, I heard you use the comment in a response to a question just a little while ago, "turning the corner." It is a quotable phrase, I think. It reminds me of another famous phrase, "return to normalcy." And it sort of scares me if you look at the context of when "return to normalcy" was used.

I think there is a crisis of confidence that is in the general public and within this body of the Congress. We are trying to figure out, those of us who extended ourselves on the vote for the bailout and the 180-degree change that you made in policy from buying bad assets to injecting investments of equity in banking institutions. I do not fault you for it. It just was an extreme change and rather shocking. And it wasn't your idea. It was the idea of the drafters of the legislation that you set up in the form of a 3½ page draft and we converted after several weeks to 400 pages. And part of those 400 pages gave you the authority to make that 180-degree change.

Now, my problem is, that has happened once. And now suddenly I see other things occurring where you make 180-degree changes in policy. One example is this thing we are struggling with this week, the potential bankruptcy or collapse of our auto industry in the country. And it seems that there is a dual idea, either at Treasury or at the White House, that if you take the $25 billion out of certain qualified funds, then it is necessary and should be used and obviously would avoid systemic risk. The underlying principle: We shouldn't do it unless there is systemic risk. But if you were to use money from the TARP fund, that is unacceptable to the White House and Treasury and should not be done.

Now it seems to me, when you are treating the disease, you don't decide where the disease came from. You decide, what is the prognosis, the likely prognosis, and then you take action. So there is a lack of confidence it seems to me, both in this body and in the general population. They want to get some idea, do we have a plan? Where are we going? To say "turning the corner" really is not terribly significant. It is no different than what Herbert Hoover said, "return to normalcy." And it is causing fright to the people. Why can this Treasury and this White House not lay out a plan that takes into consideration all the contingencies that will happen or may happen and what our potential response will be, knowing full well mistakes will be made, money will be unreasonably or foolishly expended, but we all tend to agree that if, in fact, we are on the precipice of a disaster or a meltdown, we are willing to take those opportunities. But we do not want to walk into a room of darkness. We really want you to shed as much light in that room before we take the leap over the threshold.

So I am sort of calling upon you, can you now give us some indication, do you consider the loss of the American auto industry a significant and systemic risk? Or do you not? If we lose 3 million jobs, what would it cost to make it up? What would be the loss of revenue? And would it be worth spending $25 billion initially to stop that from occurring? And if we do not do that, what is our backup plan, and what do we tend to do?

It seems to me that if we are going to build confidence among our constituents, the American people, and confidence within this institution to respond to your requests and the White House's requests just over the next 60 days and then the next Administration, it seems to me we have to be a little more forthcoming.

Secretary PAULSON. Well, then let me be very, very forthcoming to you. Because the intent of the TARP, when we came here, was to stabilize the system to prevent a collapse. That is what we talked about; we talked about the financial system. And what I have said today here, I was very careful when I said what turning the corner meant. I said I believe that meant that we have stabilized the financial system and prevented a collapse. I was also very clear in saying we have a lot of work ahead of us, and the recovery of the financial system is a lot of work to get the markets going again.

So now let's look at the TARP. When we came here, the purpose was that: getting capital in the financial system. We came forward with—the strategy was buying illiquid assets. That was the strategy. The purpose was clear. We worked with Congress, and we wanted those additional authorities. Don't forever believe that we did not want—we were working to maximize the authorities we have and the tools we have. And when the facts changed and the circumstances changed, we changed the strategy. We didn't implement a flawed strategy; we implemented a strategy that worked.

Now, to get to your question—and I think what the American people need, in terms of confidence, is a realistic assessment of where we are, sticking with what our objective was to begin with.

Now, look at the autos. Again, you haven't seen any lack of consistency on my part with regard to the autos. The TARP was aimed at the financial system. That is what the purpose is. That is what we talked about with the TARP. Okay, now, in terms of autos, I have said repeatedly I think it would be not a good thing, it would be something to be avoided, having one of the auto companies fail, particularly during this period of time.

We have asked Congress—you know, and Congress has worked to deal with this. But I believe that any solution must be a solution that leads to long-term viability, sustainable viability here.

And so, again, I don't see this as the purpose of the TARP. Congress passed legislation that dealt with the financial system's stability. And, again, you know, there are other ways. And, you know, you also appropriated money for the auto industry and the Department of Energy bill. Another alternative may be to modify that.

The CHAIRMAN. The gentleman from—who is next? The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Secretary, I think I would like to follow up on that line of questioning. I think what I hear you saying today and what I think I have heard you say is that, as a matter of policy, you do not believe that the TARP funds should be allocated to the big three automakers.

But, to be specific, do you believe, under the definition of "financial institution" in the underlying legislation, that you are authorized to expend these sums, if you so choose?

Secretary PAULSON. Congressman, I think I will just leave it where I left it. I don't think this is the purpose of the legislation.

Mr. HENSARLING. Well, I understand that, Mr. Secretary. Then let me follow up by asking, what is your understanding of what qualifies for a financial institution under the legislation?

For example, I read press reports recently that a group of plumbing contractors were applying for portions of the TARP funds in order to refurbish some foreclosed properties, making their case that doing so qualifies them as a financial institution.

So, in your mind, since you are essentially in charge of disbursing the funds, can you give me a clearer, black-and-white definition of what a financial institution is?

Secretary PAULSON. Congressman, I cannot. We have a broad definition. We got very broad authorities and powers. And I think that is appropriate.

But we certainly are not going to give money to plumbing contractors, and we are not going to give money to a lot of other people and institutions that are applying. We have had a very clear focus here right now.

And, again, I feel a great responsibility, even though the powers may be very broad, and appropriately so, I feel a great possibility to stick with what the purpose is. The purpose is stabilizing and strengthening our financial system. And I have said to you very clearly that I believe that the auto companies fall outside of that purpose.

Mr. HENSARLING. Chairman Bernanke, the Federal Reserve has been very aggressive in developing new credit facilities, expanded facilities, reducing collateral standards for troubled financial services companies. But, by some estimates, we now have an exposure somewhere in the neighborhood of $2 trillion of commitments by the Federal Reserve.

Can you tell us exactly how much exposure is out there, how much money has been lent?

Mr. BERNANKE. Well, our balance sheet is about $2 trillion, of which—I am guessing now—$600 billion is Treasury's and agencies'. The rest is some kind of credit extension of some type.

The overwhelming amount, however, is of two classes. It is either collateralized lending to financial institutions. I described earlier, those are loans made with recourse and on haircut collateral. They are short-term loans, and they are quite safe. We have never lost a penny on one of those.

The other type of lending we have been doing is we have been doing currency swaps with some major central banks in order to try to address dollar funding problems in other jurisdictions. There the credit risk is of the Foreign Central Bank, like the European Central Bank, and we consider that to be zero risk, essentially.

So the overwhelming majority of our lending is at very low credit risk.

Mr. HENSARLING. Well, you appear to be going where perhaps no Federal Reserve Chairman has gone before. And this may be a very good thing, given the crisis at hand. But just how much more are you prepared to commit and expose present and future taxpayers' liability to?

Mr. BERNANKE. Well, I think we need to do what we need to do to keep the U.S. credit system working and to try to create a recovery in the financial system.

By law, our lending has to be against fully collateralized, secure backing. We are actually making money in some of our programs. I don't see us as having a substantial exposure. It is a liquidity provisioning process, not a credit or a fiscal process.

Mr. HENSARLING. At what point do you believe that these activities could undermine your ability to actually, on a prospective basis, impact monetary policies? And at what point might it adversely affect the credit rating of the United States?

Mr. BERNANKE. Well, the size of the balance sheet has affected, to some extent, the amount of reserves in the banking system, which makes it more difficult to control the Federal funds rate. It was a productive and useful feature of this same bill that we are discussing that included the right for the Federal Reserve to pay interest on reserves to banks, which has been helpful in keeping the Federal funds rate, you know, closer to the target that it otherwise would be. But that is still an issue that we are working on.

Again, I see no significant credit risk in what we are doing, and I don't think it will have any benefit or any effect, one way or the other, on U.S. credit rating. That is my assessment. I haven't heard anyone give me a view to the contrary.

The CHAIRMAN. I thank the gentleman.

I do have to note, Mr. Secretary, there was a general response which I heard from several of the members after your last comment that the 15 minutes of fame for the plumbing industry appears to have ended.

The gentlewoman from California.

Mr. BACHUS. Joe has had a rough month, I will tell you that.

Ms. WATERS. Thank you very much, Mr. Chairman, for this hearing. It is very much needed.

And I welcome the representatives from the three agencies who are here today.

I come here very troubled about the direction that Secretary Paulson has taken, as it relates to the $700 billion that we made available to him to help stabilize our economy. It is very clear, no matter how the Secretary describes it, that we gave him the authority that you identified when you talked with him, Mr. Chairman, to deal with foreclosure mitigation efforts. As a matter of fact, the purchase of toxic assets was at the centerpiece of this program, because everybody agreed, at that time, that the subprime meltdown was at the epicenter of the dislocation that we were experiencing in our economy.

So the fact that you, Mr. Paulson, took it upon yourself to absolutely ignore the authority and the direction that this Congress had given you just amazes me. I just could not believe it when I heard that somehow you had abandoned the whole foreclosure mitigation effort.

Now, in addition to that, I want you to know that I and some others worked very, very hard to pass this. As a matter of fact, I was looked at with great suspicion by members of my caucus and the Congressional Black Caucus, in particular, as I sold them this program and told them about my faith in your ability to carry out this program. I was asked over and over again, will the homeowners be helped? What are we going to do about Main Street, not just Wall Street? We spent, and I spent, considerable time selling this program to those who were suspicious and did not want to do it.

Now, having said that, again, I am disappointed that you have not utilized the authority and you have just divorced yourself from dealing with that. On the other hand, in your testimony today, you say, "And we need to continue our efforts to use a variety of authorities to reduce avoidable foreclosures. The government has made substantial progress on that front through HUD programs, through the FDIC's program with IndyMac, through our support and leadership of the HOPE NOW Alliance, and through the new GSE servicing guidelines announced last week that will set a new standard for the industry."

Let me just relate to this statement. First of all, the HUD programs working under HOPE NOW have not been successful. It is a terrible failure. I convened in my office all of the HUD-backed counseling programs when we went on break, and I sat down and I talked with them to find out what kind of success were they having working with the HOPE NOW program. And, to a person, they have not been able to get in touch with the servicers, in many cases. When they get in touch with them, many of the servicers are inexperienced. They don't have the ability to make good decisions. Nobody knows what formulas they are using in order to make decisions about a homeowner's ability to get a loan modification. And so, they all work under HOPE NOW.

So HOPE NOW has been a failure. And even though you identify it as a success, I am not going to challenge you, but I would dare say that you could not cite for this committee the number of modifications that have come through HOPE NOW because you don't know. You probably are not tracking them. And, secondly, if you were, you would know that it is not working.

Secondly, the GSE proposal that was recently released you referred to, but it really hasn't gotten underway yet, and it only deals with a small portion of the market.

You do refer to FDIC, and you are right, you are right about FDIC's program and what has happened with IndyMac and Chairman Sheila Bair. She has been able to come up with a way by which we could do credible loan modifications, and it has been ignored. Barney Frank and I sent a letter to you and everybody else asking that you just give her the program and let her run with it, because she has discovered how you can do these loan modifications. You can't do them one by one, Mr. Secretary, and get it done.

I spent time—I have 26 of them that I am working on in my office right now—and I spend time, and I get a release from the homeowner, and I get on the line with the servicer, and it is absolutely ridiculous. I have had to go all the way to the chairman, for example, of one of the banks, Mr. Stump over at Wells Fargo, to tell him about what his servicing company is and is not doing. They own America's servicing company. I stayed on the line for 1 hour just trying to get to a servicer. They are understaffed; they don't take this seriously. And then when you talk to the servicers, they don't even know enough to be able to evaluate the income of those persons who are trying to get some help.

With that, I would like, Mr. Chairman, to go to Sheila Bair and ask her to please unveil for this committee what she is doing and what she has shown can be done with IndyMac modifications that have been so successful.

The CHAIRMAN. I thank the gentlewoman, but that is going to have to wait until the next round, if someone will ask for it.

Briefly, Mr. Secretary.

Secretary PAULSON. I will be brief, because there is no one whose disappointment—

The CHAIRMAN. Mr. Chairman, briefly and substantively.

Secretary PAULSON. I will just simply say that I know how hard the Congresswoman worked on this legislation and was critical to getting it done, and this has been critical to saving the system.

Let me just say specifically to you, Congresswoman, that I have not said no to doing something here in the TARP aimed at foreclosure mitigation. We did not buy illiquid assets for a very good reason. We are going to continue to evaluate and look for programs that protect the taxpayer and are effective.

And I just would make one last point here. In designing programs, in broad-based programs, there is a balance to getting money to those who need it as opposed to those who don't need it. And there is also a balance to, you know, not providing a windfall to the banks, and we are working hard on that.

The CHAIRMAN. Thank you, Mr. Secretary.

The gentleman from Alabama has proposed that, if we have unanimous consent, we will ask the Chair of the FDIC if she would respond in a couple of minutes.

Is there any objection?

Hearing none, I will recognize the Chair of the FDIC to respond.

Ms. BAIR. Thank you very much.

At IndyMac, we became conservator in mid-July, and they had a fairly sizable servicing portfolio with a number of delinquent loans. So we developed a systematic protocol for modifying them. Basically, we use a debt-to-income ratio in the 31 to 38 percent range. We verify income, and if the borrower's income can support a modified loan that includes their principal, interest, taxes, and insurance at 31 to 38 percent of pretaxed income, they get that loan modification. And we lower their mortgage payment through, first, interest rate reductions, then extended amortization and, in some cases, we do principal forbearance as well.

We do it on a systematic basis. We run all these loan modifications through a net present value analysis, so we must demonstrate that the net present value of the modified loan exceeds the foreclosure value. And, generally, where there is reasonable income to support a modified loan, these loans will pass the test.

These modifications are within the authorities we have under the pooling and servicing agreements that govern IndyMac's servicing obligations. We have been able to do modifications both for IndyMac-owned loans, as well as for IndyMac-serviced loans, including private label securitization. After some strenuous talking and advocacy, we were able to get the investors on board. Even though the modifications were permissible under the pooling or servicing, we briefed the investors and they support the program. I would note that this loan modification protocol was designed to work within the framework of securitization trusts.

Our modification plan has been heavily relied upon. The GSEs and some of the other larger originators are also announcing they will conduct systematic loan modifications now as opposed to a loan by loan approach.

We have suggested making this program national by providing a financial incentive for servicers and investors to adopt it, along with some loss-sharing. We found, in engaging in dialogue with the investors, that the biggest pushback or the biggest uncertainty for getting these loans modified is uncertainty about the redefault risk. Specifically, what happens if you modify the loan and the borrower still, down the road, redefaults, and then you have to go to foreclosure later as the home prices are going down and the losses are exacerbated? This is a big concern and uncertainty.

To address this, some loss-sharing by the government is appropriate. We have suggested that if servicers would agree and investors would agree to support servicers in modifying these loans to the IndyMac protocol, that, if there was a subsequent redefault, up to 50 percent of the losses would be shared by the government.

We would exclude early payment defaults, so the loan would have to perform for 6 months before it would be eligible for this loss-sharing program. And very high loan-to-value loans also would have a declining loss-sharing.

We also would provide for administrative expenses of $1,000 per modification for servicers. This addresses another impediment to systematic loan modifications. The pooling and servicing agreements generally do not provide for compensation for administrative expenses associated with loan mods, while they do provide it for foreclosures. And even with the systematic approach, you need to go through and verify incomes, so there is some administrative expense involved. An additional incentive of $1,000 per loan mod would be appropriate.

The combination of these steps could reduce foreclosures for loans that would be going delinquent through 2009 by about 1.5 million, which is significant. We think it is about a 30 percent reduction in foreclosure rates that we would otherwise see.

It is not a silver bullet, but it would be a huge reduction in the foreclosures we are seeing, which are creating significant downward pressure on home prices and adding to broader economic problems.

And these measures together promote homeownership. The modifications are available only for owner-occupied properties, and where borrowers have documented income. For that category, there should be a concerted effort to preserve homeownership, which will help our broader economy.

The CHAIRMAN. Thank you, Madam Chairwoman.

I would note that, in the TARP, there is explicit authorization to provide funding for servicers in appropriate context. So we think it is embraced.

The gentleman from California, Mr. McCarthy.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman. If I could just follow up one moment with the chairwoman.

How many loans did you provide in the IndyMac situation, and what was the value overall?

Ms. BAIR. We had about 40,000 delinquent loans that were eligible. There were 60,000 delinquent loans total, but about 20,000 of those either were investor-owned or had been abandoned or were just too far gone. They were in bankruptcy or the homeowners had given up. So about 40,000 eligible.

As I indicated in my written testimony, we will do loan modification proposals for about 30,000 of those 40,000. The letters are still going out. We have completed modifications of about 5,000, with several thousand more in process. We do verify income—

Mr. MCCARTHY OF CALIFORNIA. And how long does that take you? What is the timeframe from start to finish?

Ms. BAIR. We started in late August with the first mailing of 7,000 and have made mailings throughout the months since.

When the loan modification proposal goes out, it specifically says, "This is your current mortgage payment. We are going to reduce your mortgage payment by 'X' amount." The average is about $380 a month. The proposal will go on to say, "If you want this loan modification, send us a check for your first month's payment, and sign this form that allows us to document income through looking at your tax return." It is a very simple, streamlined procedure. It is easy for borrowers to understand. It is not a general, you know, "Call us, we are here to help you." Instead, it says, this is the loan modification that you will get.

We have had a very strong response rate. Of the first mailing we did in late August, over 70 percent of the borrowers have responded.

But it still takes time. You still have to document income. You still have to go and look at the tax return, and you have to establish that borrower contact. The income verification takes the most time.

Mr. MCCARTHY OF CALIFORNIA. Mr. Secretary, I understand you have to modify, things change, and the latest is: no longer planning to purchase troubled assets.

Have you taken a look since the last 6 weeks about part of the plan in there, the insurance program? Have you pursued that in any further way?

Secretary PAULSON. Yes. We have a responsibility to develop an insurance program for implementation. We have gone out for public comment, got a number of proposals and comments, and we are in the process of developing a program there.

Mr. MCCARTHY OF CALIFORNIA. When do you think that will come back?

Secretary PAULSON. I can't tell you when it will be completed, but we are working to complete it. And then when it is completed, it will be evaluated.

Mr. MCCARTHY OF CALIFORNIA. In listening to your statement, you said toward the end part that you found at the beginning $700 billion you thought would be a sufficient amount. Now, within the troubled assets, you don't think that is a sufficient amount of what you have left to pursue going further.

And then also, listening to your speech, I think it was November 12th, where you talked about maybe bringing in, attracting private capital, which would create some synergy, which I thought would be very positive, maybe if you could expand on that, if that would be helpful, using the private capital—how it would work, who would receive it, how could you do the matching funding.

Secretary PAULSON. Well, what I said in my remarks on November 12th was that we needed to evaluate this capital program once it is completed and look at the markets and then be prepared to use another capital program if it is appropriate, and that we were working to develop other programs.

A matching program would work along the lines of, if an institution, whatever the scope of the program is, whichever institutions might be eligible for this program, to the extent they can raise a dollar of equity, let's say common stock, then it might be matched by a dollar of preferred. And so this would have the advantages of making the capital of the TARP go further. And it also has the advantages of being a filter, so those healthy institutions that are able to raise money get a match.

Now, the disadvantage of a program like that is it doesn't work in a market where capital is not generally available. So that is why we didn't start that way. So there are some advantages and some disadvantages.

Another advantage might be that, if we chose to go beyond institutions where there are Federal regulators, and we don't have regulatory capability here at the Federal level or capability of Treasury to make the sorts of judgments that the regulators are making for us now with the banks, that the private market could be a filter. In other words, those institutions that are able to raise capital in the private market would have an ability to get matching funds.

But no decision has been made. It is just a matter of programs that we are working to develop.

Mr. MCCARTHY OF CALIFORNIA. Has anyone approached you about coming forward, outside of the financial industry, being able to do the matching money? I mean, is there capital out there willing to make this investment?

Secretary PAULSON. Well, there is definitely capital available now for certain institutions and certain industries, no doubt about it. And so we stay close to the market.

But, again, you should take away, the biggest part of what I was saying is, given where we are now, capital is more powerful. And you can get more bang for a dollar of capital investment than you could buying a dollar of illiquid assets. And so that is where the focus is.

But I think it is premature to be starting another capital program while the current one is not even yet complete.

Mr. MCCARTHY OF CALIFORNIA. But there would be more capital out there—

The CHAIRMAN. I am sorry. We are out of time.

The gentlewoman from New York.

Mrs. MALONEY. Thank you, Mr. Chairman.

First, I would like to thank all the panelists for your leadership in stabilizing our financial markets.

And I congratulate Chairman Bair on an innovative program to help people stay in their homes, if it was expanded. She testified that 1.5 million people could be kept in their homes without a financial loss to this Nation, therefore helping to stabilize our economy, which is now our major concern.

Chairman Bernanke, would you favor her program? Would you use TARP funds to expand FDIC's loan modification program to help stabilize our economy and help people stay in their homes?

Mr. BERNANKE. Well, first let me say that I agree that we need to do a lot more on foreclosure prevention. It is very important for communities, and it is important for our economy and for our financial system. So I very much commend Chairman Bair and the FDIC for the work they have done, and I think we need to build on these ideas.

There are a few points I would like to make.

First, I think a very strong point of the FDIC program is that it is simple. And it is run by the servicers rather than by the government, and that is a plus, certainly.

There are a couple of design issues that we would need to talk about, I think, in the context of the Congress. Let me mention two.

The first is that the FDIC program is focused on affordability, which is understandable, getting the payment down to 31 percent of income. The Congress recently passed HOPE for Homeowners, which takes a different philosophy, which is about principal writedown and getting mortgages out from underwater. Those are two different philosophies, and they depend on different views of what it is that keeps people in their homes. So an alternative approach would be to strengthen the HOPE for Homeowners approach, just to give one option there.

The second comment I would make is that—and we have discussed this extensively with the FDIC—addressing the issue of what is the best way to induce servicers to actually undertake these modifications. The suggestion by the FDIC is that the government would ensure some portion of the loss if the mortgage redefaults after it has been modified. And a concern that we have had about that is that, in some cases, that would be a very high cost. If a borrower had a large capital loss in their home, and they paid for 6 months but then moved or left for whatever reason, the government might be liable for $100,000, depending on how much the loss had been. So an alternative would be to consider other ways of subsidizing.

But, just in general, I want to say this is a very promising approach, and I think there is lots of interesting things to talk about here.

Mrs. MALONEY. Thank you.

Secretary Paulson and Chairman Bernanke, a large portion of the TARP money has been used to pay off the AIG counterparties in the new AIG deal. And since the government is now running AIG, we should have full disclosure of what they are doing with the TARP money so Congress can appropriately manage our oversight.

Will you make public who those counterparties are and how much they received?

Mr. BERNANKE. Well, I think that information can be made available. AIG had many, many counterparties, banks and other institutions, which they essentially wrote insurance on—

Mrs. MALONEY. Thank you. And if we can make it available, if you could get that to the committee, we would appreciate it.

Mr. BERNANKE. We will see what we have.

Mrs. MALONEY. That would be wonderful. Thank you.

And on the credit default swaps, it is my understanding, following up on your statement, that they were originally like a form of insurance taken out by an investor to insure against loss on securities owned by that investor, sort of like insuring one's home against a fire; the homeowner deserves to get paid by the insurer, should his house burn down.

It is also my understanding that a great number of investors in hedge funds bought swaps from AIG when they did not own the securities and were just betting on a default, like taking out an insurance policy on your neighbor's house and hoping that it will burn down so you can get paid.

My question with respect to AIG is whether we are using taxpayers' funds to cover AIG's obligations to investors who have suffered real losses, or are we using some of the taxpayer funds to pay the investors who are basically gamblers the billions of winnings that they earned at AIG's expense. I personally do not think that taxpayers' money should be used to help investors who are gamblers to collect their profits rather than taxpayers' funds. They should be used to help those who stand to suffer real economic losses.

And, Mr. Bernanke, Chairman Bernanke, can we differentiate now between those two classes of swap purchases? Can we see where they are? Are we paying the gambling type or only those that are real losses?

Mr. BERNANKE. Congresswoman, I don't think you can really differentiate. People use credit default swaps to hedge all kinds of positions. Even if you don't own the underlying credit, you might be hedging against the stock or some other thing that you own, or maybe you have taken a position in that particular industry.

And, moreover, these are legal contracts. If they are not paid, then the company is in default, and there is a bankruptcy process. And the entire purpose here is not to pay off the creditors per se, it is not to save AIG per se. It is to avoid the contagion of losses and crisis that would occur if this huge financial institution with large exposures across the world were to fail and not to make good on its financial contracts.

The CHAIRMAN. The gentleman from Texas.

Dr. PAUL. Thank you, Mr. Chairman.

My question is directed to Chairman Bernanke.

You know, for many years, the Austrian free market economists have predicted all these problems would come, and they were certainly correct in everything that they said. Of course, they are not very satisfied, including myself, with the so-called solutions, because it looks like we are spending a lot of energy and a lot of money trying to patch a system together that is unworkable. So we have Congress spending a lot of money; we have Treasury very much involved in trying to pick and choose which worthless asset that we are going to buy. And, of course, the Federal Reserve is involved in injecting trillions of dollars that nobody seems to be keeping track of.

But what we are failing to do, I think, is to recognize that the system no longer works. But I can understand why we do this. Because, you know, if Congress couldn't do this and if the Fed couldn't do this and the Treasury couldn't do this, it would make us all irrelevant. And instead of looking at the causes of this and then realizing that the solutions aren't going to be found here, we have to make ourselves feel pretty important.

But I think there is another reason why we think we are pretty important. It is because, in a way, our interference in the market corrections that tried to come about since 1971 seemed to work. I mean, the failure started in 1971 with a system that had no way of automatically correcting the balance of payment in the current account deficits. And that is where the problem has been.

The economists, whether they were left, right, or middle over the last several decades, have always said this current account deficit is a big problem. Now it is totally out of hand. So here we are, struggling with all these rules and shifting back and forth and really getting nowhere.

But my question is: When we come to the full realization that the system is unworkable, what are we going to do? What have you thought about doing?

Already we see talk in the newspapers, we see articles about a new international world reserve currency. And, to me, that is pretty important, because the fiat dollar reserve system is not going to work anymore. And that is the information that we have to accept and decide what we are going to do with in the future.

This is not new in history. Currencies have failed, financial systems have failed. And, generally, to restore the confidence that everybody is talking about, they usually have to go back to a currency with integrity to it rather than just fiat money.

And, you know, the stage is there; it is not impossible. Already the central banks of the world still own 15 percent of all the gold that was ever mined in all of history. So they hold on to this gold for some reason. And, therefore, something has to give, or are we going to keep trying to waste more money and time patching this system together?

Just last week, there was a report that Iran purchased $75 billion worth of gold, took their reserves out of Europe, bought gold, and put it in Asia. So is that a sign of the times, and is that moving on?

Now, my question is, in your meetings, and you had a meeting just recently with other central bankers, does this thought come up, about a new international world reserve currency? And, if so, does the subject of gold ever come up? How do you restore the confidence? Have you recently had conversation with any central banker? And is there a move on to replace the dollar system?

Because the dollar system is essentially declared dead because it is not working. But this, indeed, was predictable because of these tremendous imbalances that were never allowed to be corrected, and they were always patched up. We always came in. We would spend, we would inflate, we would run up deficits. And, since 1971, we have been able to correct these problems.

Could you tell me what kind of conversations you have had regarding a new reserve currency?

Mr. BERNANKE. Yes, Congressman. I don't think the dollar system is dead. I think the dollar remains the premier international currency. We have seen a good bit of appreciation in the dollar recently during the crisis precisely because there has been a lot of interest in the safe haven and the liquidity of dollar markets. And the Federal Reserve has been engaged in swap agreements to make sure there is enough dollar liquidity in other countries because the need for dollars is so strong. So I think the dollar system remains quite strong.

I do agree with you very much on one point, which is about the current accounts. The current account imbalances have proven to be a very serious problem. It was, in fact, the large capital inflows from those current accounts which created a lot of the financial imbalances we saw and have led to some of the problems we are seeing. And one of the silver linings in this huge great cloud is that we are seeing some improvement in greater balance in our current account deficits.

Dr. PAUL. But does the subject of a new regime ever come up?

Mr. BERNANKE. No, it doesn't.

Dr. PAUL. And does the subject of gold ever come up in any of your conversations?

Mr. BERNANKE. Only in terms of the sales that the central banks are planning.

The CHAIRMAN. The gentlewoman from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Gentlemen and gentlewoman, while we now spend more than $1 trillion on the bailout, a recent report shows that foreclosures increased 5 percent last month. We also know that 3 million more are likely to face foreclosure in the very near future.

In light of the Fed's extensive options on taxpayers' expense, can you tell us why foreclosures are still increasing?

Secretary PAULSON. Okay, I will—the question is, why are foreclosures still increasing?

Ms. VELAZQUEZ. Yes, sir.

Secretary PAULSON. I will say to you that it is hard to imagine, no matter what program we have, that we are not going to have a good number of foreclosures when you look at what we have gone through here and look at the excesses and look at the shoddy lending practices.

Foreclosures take place for a number of reasons. Some of them take place because speculators no longer want to stay in their home.

But I think the question to really ask, which is one that we are all asking, is, why are foreclosures taking place when people, homeowners want to stay in their home and they are willing to make an effort to stay in their home and they can afford to stay in their home?

And this is, I will tell you, a—

Ms. VELAZQUEZ. Sir, I am the one asking the questions here.

Secretary PAULSON. Well, I thought you asked me a question. I was trying to answer it.

Ms. VELAZQUEZ. So let me ask you, to what extent are foreclosures causing our continuing economic instability?

What is the relationship, Mr. Bernanke?

Mr. BERNANKE. Well, they are both a symptom and a cause. Now that the house prices are falling and that the economy is weakening, people don't have the income to make their payments, the house foreclosures are going up. So that is a symptom of the downturn.

But it is also a cause, because it is weakening house prices, it is hurting the value of mortgages, which hurts financial institutions. So it is part of the mechanism which is causing the economy to weaken.

Ms. VELAZQUEZ. So can you tell me how much of the more than $1 trillion spent by the Treasury and Fed in the bailout has gone to prevent individual foreclosures?

Mr. BERNANKE. Where do you get the $1 trillion from? There has been $250 billion by the Treasury, and the Fed hasn't spent any money. We only lend money.

Ms. VELAZQUEZ. Okay. So, of the money that has been lent, how many foreclosures have been prevented, individuals?

Mr. BERNANKE. Well, as the Secretary has described, there has been a whole number of programs, including HOPE for Homeowners and so on. But I also agreed with an earlier questioner that I think we need to do more.

Ms. VELAZQUEZ. You know, the trouble here, sir, is I supported the bailout package. I agonized with that vote. Still, Main Street America, the people who are watching this debate here or this discussion, they are still waiting to hear an answer as to how this is benefitting them, how this is benefitting Main Street America.

You have the silver bullet, it seems to me, that just by giving a blank check to financial institutions—this is a partnership, this is taxpayers' money that is providing capital infusion to financial institutions. But we expect from the banks to do more to help families keep their homes.

And so we are giving this money or lending this money without any strings attached to it.

Secretary PAULSON. Let me just say three things here.

First of all, the key to turning around the housing situation and avoiding foreclosures is going to be to keep lending going. If the financial system collapsed, we would have many more foreclosures, number one.

Number two, you are seeing a number of big banks take extraordinary actions, and they have announced them, and you could just tick them off, announcing actions they are taking. So they are doing things, number one.

And number two, I would say that I believe that our actions to stabilize Fannie Mae and Freddie Mac, who are the biggest source of home financing in America today, have been critical.

So there have been real steps that have been taken that make a difference. More needs to be done. I hear your frustration; more needs to be done. And we are going to keep working on it.

Ms. VELAZQUEZ. Yes, you hear my frustration. And I hope that you understand the pain and the suffering of so many homeowners in this country who are losing their homes.

So it is just not enough to say to the banks, "Here is the money. And, by the way, I trust you." Because they are not lending; they are not lending to small businesses. They are not working on a loan modification strategy.

You just told Mr. Frank here that you are examining strategy to mitigate foreclosures. You don't have the strategy to mitigate foreclosures; you are examining. Chairwoman Bair does. Are you willing to support her plan?

Secretary PAULSON. What I have said very clearly is that the IndyMac protocol is an excellent protocol. We, as a matter of fact, with the GSEs, if GSEs, with their whole guidelines, endorsed the plan, what they have done, which I think will become the national model, is based upon that plan. And I said that I am looking very hard to find programs to put into the TARP that I think strike the right balance between protecting the taxpayer and are effective.

The CHAIRMAN. Without objection, I would ask for unanimous consent for 1 minute.

Mr. Bernanke, you said HOPE for Homeowners, which this Congress passed, has some problems, and we were taking a first cut at it. I just want to advocate what the chairwoman has done and IndyMac has been superb. And the leadership elsewhere is important. They were different models. As interest rate reduction, as pension reduction—let 100 flowers bloom, there are different motivations and different impacts.

And there were some things about HOPE for Homeowners which you have told us and we agree need to be modified, some of which can only be done statutorily. But the TARP lets you do that. So I would recommend, Mr. Secretary, work together on another model, not in competition with, but give the modifications in HOPE for Homeowners through the TARP that help work that out. Because these are not competitive; they are additive.

I thank the members.

The gentleman from Ohio.

Mr. LATOURETTE. Thank you, Mr. Chairman.

Mr. Secretary, I am going to let my colleagues be global and I am going to be very parochial and talk about one bank in particular. And that is that my frustration and, I guess, anger that the TARP money has been used to—about to be used to purchase National City Bank in Cleveland, Ohio, by PNC in Pittsburgh, Pennsylvania. It was never my understanding that the TARP program was designed to pick winners and losers.

I was struck by Chairman Bernanke's observation that his window is open to everyone. I am going to detail for you in hopefully 4 minutes and leave a minute to respond.

While the Treasury window was never open to National City Bank, I wrote to you on the 30th of October; you were kind enough to send me a letter back yesterday. The last graph basically says—the letter says you haven't received an application from National City Bank. The last graph says, and, by the way, the documents that you want are in the possession of OCC, so please talk to OCC. We talked to the OCC staff. They said, since you sent a letter to the Secretary, we really don't have time to respond to your request for documents.

But it is funny because, on October the 28th, I did get a letter from the Comptroller of the Currency, Mr. Dugan, who expressed umbrage that I would dare suggest that he was a lawyer for PNC in private life before he became the Comptroller of the Currency. But he says that you make the decision on these applications, not him. And, by the way, he wished he could tell me about these communications in this transaction, but it is a secret.

National City Bank is one of the only—I think the only top-25 bank in the country that is not permitted now to participate in the TARP program. It is my understanding that it is the only bank in the country that is being purchased with TARP money.

And if you look at PNC's potential merger and acquisition agreement, they are not only going to get their share, which is about $4 billion, but they have been told by the regulator they are also going to get National City's share, about $4 billion. If you combine that with the tax changes that were made on September the 30th as to how losses are treated by acquiring banks, they are going to get an additional $5 billion.

And so, basically, they are going to be able to purchase the 7th-largest bank in the country for free, a bank that has existed since the American Civil War, survived the Great Depression, can't survive 8 weeks of the TARP.

I just want to go through with you the timeline that was in the Wall Street Journal. I ask unanimous consent that it be included in the record.

The CHAIRMAN. Without objection, it is so ordered.

Mr. LATOURETTE. Peter Raskind, the CEO of National City Bank, talked to Mr. Dugan, and said he wanted to apply for TARP. He said, "Well, I am happy to do that, but first I want you to explore all M&A avenues." He says, "Well, we have been doing that, but I want to apply for TARP." He said, "Just keep doing it. Trust me."

Minutes later, as Mr. Raskind was to go into a meeting with his board of directors, he gets a telephone call from Richard Davis, who is the CEO of U.S. Bancorp. Mr. Davis says, "After talking with the

OCC and other Federal regulators, we have a new interest in buying your bank. And the regulators have indicated to us, have assured us that the government would provide U.S. Bancorp with capital to finance a takeover. And we will buy you for $1.10 a share," which was less than half of what it was trading for on that particular day.

Mr. Dugan remained a constant presence, and his tone became increasingly assertive with National City Bank. "An M&A deal is your only alternative," he told Mr. Raskind on more than one occasion. Mr. Dugan warned National City Bank not to expect to take advantage of any new government programs. When Mr. Raskind said, "Wait, I thought this was open to everybody," he said, "That is all discretionary, and right now you shouldn't be comfortable that it is available to you." He said, "I thought it was available to all banks." "No, it is discretionary."

That evening, the board met. They felt that they were being bullied. Talks continued with U.S. Bank under Mr. Dugan's supervision. And then, all of a sudden, PNC comes in at this moment in time when they are aware that they can get free money from the TARP to buy another bank.

And just a couple of analysts, I ask that these be submitted for the record, as well. A guy named Mike Mayo, who is a pretty renowned analyst of banks and their values, writes for Deutsche Bank that, "National City Bank maintained a peer-leading Tier 1 ratio of 11 percent. PNC was substantially less than that."

Another fellow, writing for Citibank, indicates under the section, "Why Sell?" on October 24th, he says, "So on face value there was no immediate catalyst that would force them to sell, since National City had sufficient capital and liquidity. In our view, it is possible that there was a change in management's outlook or a push from the government."

Well, the change in management's outlook is also in an October the 25th article in the Cleveland Plain Dealer that said that Peter Raskind went to his board, and he laid out a scenario that, when he wasn't even able to apply, not even able to apply for TARP, the board was presented with a downside scenario of deteriorating viability so horrifying that the bank was almost forced to act now; and not only to act, but to sell its very solid, well-capitalized business at a significant discount.

Mr. Chairman, I would ask for just 1 additional minute.

The CHAIRMAN. We would ask for 2 additional minutes. The committee has been accommodating. This is very important to the gentleman. So if the gentleman can wrap up the question, and we will have time for an answer.

Mr. LATOURETTE. I am going to wrap up the question.

And so the question is—there are two questions that I want to ask you and give you time to answer.

This isn't WaMu, and this isn't Wachovia. As I indicated, National City's Tier 1 capital ratio of 11 percent was amongst the highest of any bank in the United States. They had $18 billion of cash, more than their cash requirements. PNC was at 8.2 percent.

My question is, why did you deny assistance to National City Bank, affecting 29,000 employees in 9 States?

But first, I would like to ask and make a request of you that the legislation—there is only one place that the OCC is in that 300 pages, and it said that you are going to act in consultation with the OCC. In my mind, you don't have an application because the OCC wouldn't send you one, wouldn't take one from National City Bank.

And so I am asking you, Mr. Secretary, on behalf of those 29,000 people and the City of Cleveland and 9 other States, will you look at this under the authority that you have, not Mr. Dugan, and reconsider that decision? And, if not, why did you do it?

Secretary PAULSON. Okay. Let me—you took a long time for the question; it is important. I would like a little bit of time—

The CHAIRMAN. This is of sufficient importance that we will not be constrained here.

I will announce to all the members, this panel has to leave at noon. At noon, we will take the next panel, and we will begin the questioning on our side where we left off. So we won't go back to the beginning.

Mr. Secretary?

Secretary PAULSON. Now, let me, before getting into the specifics, let me just say that, in my experience, that I have seen institutions that have capital, that it meets certain ratios, but where the market loses confidence in them and they fail or are about to fail because there are questions about the quality of the assets and the quality of the mortgages they hold.

And so now I am going to get to the program and the way it is designed and get to your question.

We do have a program—and you saw it with AIG—we have a program to make investments if there is a systemic issue. If there is an impending failure, we can step in. But this program, which we designed under our authority, this program was designed for healthy banks. And what we did is we set out criteria, but the first criteria was that banks needed to apply to their regulator and applications needed to come from the regulator with a recommendation. We don't have regulatory capabilities at Treasury, but we have outstanding Federal regulators.

Mr. LATOURETTE. Mr. Secretary, I know you are answering my question, but here is the problem. If the OCC tells the CEO not to file an application, you never get to that point.

And let me just say one other thing. I mean, I get the fact that there can be other factors. But the fact of the matter is the regulator told National City Bank to raise $3.5 billion of private capital. They raised $7 billion. They are one of the best-capitalized banks in the country, and you guys wouldn't even take an application.

Secretary PAULSON. Let me then make two other points here, because you are dealing with consolidations. I have heard a lot about using capital from the TARP for mergers. And, again—and I am just not going to deal with this—I will make the general point that, if there is a bank that is in distress and it is acquired by a well-capitalized bank, there is more capital in the system, more available for lending, better for communities, better for everyone. No doubt about that in my mind.

And so, when we get—and the applications which come to Treasury, when it will come to Treasury—we have not received an application for capital from either of the banks you have mentioned—when it comes to Treasury, we will look at it and act on it.

But, again, I just can't emphasize enough that this program, to me, it was very, very important on this program that—this is general; I am not speaking—that it not be used to prop up failing banks or banks that might fail, that this be used for healthy banks.

And I looked to the regulators. As a matter of fact, we designed a process with the regulators. They would look at the applications as they would come in. And there is even a peer-review board with the regulators. And they submit them to us, and we make a decision.

Mr. LATOURETTE. Mr. Secretary—and thank you, Mr. Chairman—the analyst that I referred to from Citicorp indicates that TARP changed the landscape. Because National City Bank was able to survive, but because it was not on the list, it was leaving itself open to possible unfavorable outcome, to market perception that it was not a survivor.

And my question was—I appreciate your general answer—will you personally look at the National City Bank situation and discuss it with Mr. Dugan?

Secretary PAULSON. Well, I will tell you I have great confidence in John Dugan, and I am very happy to discuss it with him. I have regular conversations with him. I have great confidence in his judgment. And I believe, based upon generally what I know, that he made the right decision. But I am perfectly happy to talk about it with him some more.

Mr. LATOURETTE. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

I am not going to go down the same path, but I would just express to the Secretary that there is a strong feeling out in the public that a number of the decisions that have been made have had the effect of not only picking winners and losers, but influencing who is a winner and is a loser.

And that is something that we have to deal with every day. I am dealing with it in my own community, not in the sequential fashion that Mr. LaTourette is, but there are a number of people in my community who believe that, had a different set of decisions been made regarding Wachovia, Wachovia would still be a viable institution today.

But I am going to leave that alone. It is a perception problem that, unless we are provided the kind of information and assurance that people are looking at it and looking at it with integrity, we can't reassure the public about.

That is not a question, Mr. Paulson.

Secretary PAULSON. I would just say with that—

Mr. WATT. That is not a question, Mr. Paulson, because I don't even know how to frame a question that will get to—but I think you all need to deal with the reality that the perception is out there and that we are having to defend these decisions. So I hope you will make the decisions.

$24 billion is the figure that I have heard used to do the FDIC foreclosure prevention program. How is that figure calculated? What does that figure consist of, Ms. Bair?

Ms. BAIR. That is based on a no-greater-than-50-percent loss share for loans that are modified to a specific affordability metric and then end up redefaulting later on. We are assuming a 33 percent redefault rate, which we think is a fairly conservative assumption. The government would take 50 percent of the loss between the net present value of the modified mortgage versus whatever the recoveries were at resolution. The mortgage might end up going into foreclosure as a short sale, or it might be that it would be remodified or refinanced.

Mr. WATT. Okay, who would get—I mean, where is that money?

Ms. BAIR. That money would go to the—

Mr. WATT. Is it an expenditure?

Ms. BAIR. It is.

Mr. WATT. Does it go to somebody?

I guess what I am trying to figure out is Mr. Paulson, Secretary Paulson, apparently doesn't think that is part of stabilizing the financial system, as he reads the language. And I have the bill right here in front of me. That is what it says, "stabilizing the financial system." How does that stabilize the financial system if we put up $24 billion?

Ms. BAIR. It provides financial incentives to get loans modified that are not being modified now that are going into unnecessary foreclosures. That is the bottom line.

Mr. WATT. Okay.

And how is that less important, Secretary Paulson, than basically telling some banks, you will take an equity investment, some of whom, really, didn't even have any interest in doing that and certainly didn't have the need for it, according to their own public statements?

You have $24 billion, as I see this list here, almost coming into banks in North Carolina, at least some of whom said, I don't need this money.

How is that more important than what we have described here about helping stop the cascade of foreclosures?

Secretary PAULSON. I think I have been pretty clear. I believe it is important to stop the cascade of foreclosures, and I think the key—

Mr. WATT. Let me rephrase the question. How does that stabilize the financial system more than stopping the cascading of foreclosures under a program that is projected to cost $24 billion?

Secretary PAULSON. I would say that these are—you are dealing with apples and oranges here, and the apple is a very, very big apple. Because the step that was taken to stabilize the system—

Mr. WATT. The question I am asking is, is the apple more important than the orange, or is the orange more important than the apple?

Secretary PAULSON. I would say that the forest through the trees here was—the important step was the step that was taken to stabilize the banking system, and the combined step taken by—

Mr. WATT. And how does putting money in a bank that didn't ask for it help to stabilize the banking system?

Secretary PAULSON. Well, okay, to answer that question, there are no banks, when the system is under pressure, unless they are ready to fail, that are going to raise their hand and say, please, I need capital; give me some capital.

What happens when an economy turns down and when there is a crisis, they pull in their horns. They say, I don't need help. They don't deal with other banks. They don't lend, and the system gets ready to collapse.

So the step that we took was very, very critical, and to be able to go out and go out to the healthy banks and go out before they became unhealthy and to increase confidence in the banks and of the banks so that they lend and that they do business with each other, that was absolutely what we were about. And when we came here to—

The CHAIRMAN. Mr. Secretary, we need to wrap it up. I won't say we got a little metaphorically confused there, but I think the summary is that our accusation is that you can't see the orange grove for the apple trees.

The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

First of all, I would like to associate myself with the remarks of Ms. Waters as to the problems of the loan modifications.

But I would really like to turn to another subject that the gentleman from California, Mr. McCarthy, addressed briefly and that is that section 102 of the TARP authorized the Treasury to set up an insurance program, and this is similar to the program that I think that many members of this committee and Members of the Congress really felt that the self-funded insurance program would be a better alternative to the purchase of the assets and the recoupment, because I think that this alternative minimizes the risk to taxpayers, and it charges premiums to the financial institutions and begins to determine a value for those toxic assets that are on the books of the financial institutions.

So, Secretary Paulson, you said that you have had the comment period. I would like to know, how many staff do you have dedicated to setting up an insurance program and evaluating the public comments that you recently received?

Secretary PAULSON. I will have to get back to you on that, because I don't have, offhand, how many staff.

We have, not a large staff, an overworked, hard-working staff, and I can tell you that we will develop a plan, because the legislation asked us to develop a plan, and we will develop a plan.

Mrs. BIGGERT. Okay.

Then, have you received the Aon proposal? We have someone testifying for the Council of Insurance Agents and Brokers in the second panel, Mr. Findlay.

Have you reviewed that proposal, which was submitted, I think, in the comment period?

Secretary PAULSON. Yes. I would say my staff currently is, as I am sure we have either reviewed or are reviewing the proposal. I have not personally reviewed the proposal.

Mrs. BIGGERT. How, then, do you propose that we determine the value of these toxic assets or the mortgage-backed securities or their potential future mortgage foreclosures? Do you think that this insurance program would help to do that?

Secretary PAULSON. Well, an insurance program—there are a number of programs that have the potential to help determine value. And the insurance program would be, a properly designed insurance program has the potential to do that. Clearly, the illiquid asset purchase program has the potential to do that.

We have a—I might also add, that as banks are well capitalized and they are able to write down and sell assets, and the marketplace, market forces can also help determine the value.

Mrs. BIGGERT. Well, it seems like we haven't gotten anywhere.

And yesterday, Chairman Frank, who talked to you, said yesterday that the insurance program is unlikely to be implemented because it would do little to restore the liquidity to cash-starved banks.

But have you considered, then, the actuarial valuation markets, models, proposed for the insurance program? Isn't that one way to do it?

Secretary PAULSON. This is going to be a big part of what we are going to need to do the develop the program, and we are doing a lot of work developing a number of programs, and this will be one that deserves careful consideration, and we need to develop the best program possible.

Mrs. BIGGERT. Do you agree with Chairman Frank that it is unlikely that this program will be implemented?

Secretary PAULSON. I am not going to speculate about what is likely to be implemented in the future until we understand the program. And if we can develop a program that is a good, workable program, then we will comment on it at that time.

Mrs. BIGGERT. Have you considered any of the proposals by the credit bureaus to drill down into those toxic assets to determine likely mortgage loan default rates?

Secretary PAULSON. I have not personally done that, no. But, again, we have a group of people who have been working very hard analyzing many of these issues.

Mrs. BIGGERT. All right.

Then, Chairman Bair, do you think that if there is a compulsory loan modification provision in an insurance program, that this would help to make sure that the loan modifications are effective and are made?

Ms. BAIR. That is something I would want to take a look at. We have based our program on the section 109 authority, outside the section 102 insurance program. But I would happy to talk with the Secretary about what they may be contemplating. There may be some synergy between the two.

Mrs. BIGGERT. Thank you.

I yield back.

The CHAIRMAN. The gentleman from New York.

Mr. ACKERMAN. Thank you, Mr. Chairman.

During times of a national crisis, and we seem to be deeply in the midst of one, people look for leadership in which they can place confidence. Unfortunately, I think, our President is not in the position to provide that right now.

And people are looking more strongly in the direction of yourself, Mr. Chairman, Mr. Secretary, Madam Chairman, and to the Congress.

It seems to me that with what has been going on very recently, we seem to have a crisis in confidence.

You came to us with a plan and made a strong case for over $700 billion based on a particular premise, and we, in turn, listened and asked some questions and, in turn, were asked questions by our constituents. And we answered those questions and basically sold them the plan. Not everybody agreed that we were doing the right thing. Some of us here voted for it not sure if it was the right thing but confident that it was the direction we had to go, and then suddenly woke up one day to find out that $700 billion was going to be used for a different plan.

It appears that you seem to be flying a $700 billion plane by the seat of your pants. It seems to be that this is, at least to me, and maybe it is the right direction to go, but it seems to be the second largest bait-and-switch scheme that history has ever seen, second only to the reasons given us to vote for the invasion of Iraq.

I would like to know what the considerations are that you might have had in other ways to spend the $700 billion. Is there a plan "C" or "D" that you considered and set aside because now plan "B" is better than plan "A," and what those plans might be so that we might have some input into them? And what is your impression of the authority you have with regard to those other plans?

Also, I would like to know, because choices are being made, what would be the impact on the economy if the automobile industry was allowed to fail? Certainly choices were made back a month or so ago when a decision was made to allow Lehman Brothers to fail, and perhaps there is some regret that that decision was made.

I am sure, if we allow General Motors and the auto industry to fail, that there will be a lot of concern afterwards as to why we allowed that to happen.

And if the airline industry, for example, would be teetering on the verge of failure, would we allow that to fail as well?

Secretary PAULSON. Okay.

Let me, first of all, take your questions or comments one at a time. First of all, when we came to Congress, we came to Congress saying the financial system was on the verge of collapse, and there was clearly a need to recapitalize the system. The strategy we laid out to do that was a strategy to buy illiquid assets.

During the 2 weeks—and I commend Congress, this is not a complaint on my part, giving us the authority as quickly as they did.

But during the 2 weeks, the situation changed materially during that 2-week period. And I went through that in my—

Mr. ACKERMAN. What was it that changed again?

Secretary PAULSON. I went through that in my testimony. We had the situation worsen in the United States, and we had a couple of banks fail or approximately fail.

We had a whole series of banks in Europe go down. We had the credit spreads widen further and further. The situation froze up to the point that there was a market, serious change.

Mr. ACKERMAN. And did we not anticipate that might happen?

Secretary PAULSON. We certainly did not anticipate everything that was going to happen.

But, what we did anticipate, we got legislation that was broad enough in the authority, so that what we came out—I think the way you should be looking at it is we gave, we came and we said there is a real crisis; there was a real crisis. We got the authorities we needed, and we went to the heart of the problem. And the heart of the problem was the financial system and capital, and we used a strategy that would work more effectively, and it has worked, number one, in stabilizing the system.

Now, you have asked, what were the other things that we were considering or have considered, plan "B" or "C" or "D?" And there are only—to deal with something in the magnitude we are dealing with, there has only been one trade-off we have made. And the trade-off we have made is between capital, which goes farther per dollar of TARP investment, and purchasing illiquid assets, which we would have to do in big size.

We are also looking at a variety of other programs but don't involve that big trade-off. I have talked about a program to use a small amount of TARP assets to make it possible for the Fed to provide liquidity to consumer credit. We have talked about the future capital programs.

Now, with regard to the automotive industry—

The CHAIRMAN. Quickly, Mr. Secretary, please.

Secretary PAULSON. Okay.

Let me also say, for the record, strongly, there was no authority, there was no law that would have let us save Lehman Brothers. We did not have the TARP then. The Fed did not have any authority to lend if it was not properly secured.

So, now, with regard to the automotive industry, this Administration has made it clear that, through modifications to the Department of Energy bill, 136, we believe that there is a path that leads towards a viability in the auto industry. And we think these funds should be tapped only if they lead to a long-term viable solution. And, no, we do not believe that it is desirable to have an auto company fail with the economy in its current situation.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Secretary Paulson, under the TARP plan, would captive finance companies be eligible for TARP funds, particularly for the automobile industry?

Secretary PAULSON. Well, there are broad powers under the TARP to make captive finance companies eligible under the TARP. Under the current plan we have outlined, the only capital plan we have in place, they are not eligible.

If we were to implement the program we are working on with the Fed, where we put a small amount of money into a Fed liquidity facility, that facility could provide support for triple-A auto paper, and so that is one option that is being looked at.

Mr. NEUGEBAUER. Chairman Bernanke, you have allowed nontraditional entities to come to the Fed window currently, is that correct? You said that in your testimony?

Mr. BERNANKE. We have opened the window to primary dealers as well as banks.

Mr. NEUGEBAUER. So, captive finance companies currently, do you have the authority to allow captive finance companies to come to—

Mr. BERNANKE. If we invoked our ability to lend under unusual and exigent circumstances, and if we were fully collateralized, we would have that power. We have not made a decision to do that.

Mr. NEUGEBAUER. But you could do it?

Mr. BERNANKE. Yes.

Mr. NEUGEBAUER. Now, then, to the three of you, I wrote you a letter, I think, on Friday, and one of the concerns that I have is that we keep focusing on $700 billion.

I think in your testimony, just a while ago, or you answered a question, Chairman Bernanke, that your total assets now are about $2 billion—I mean, $2 trillion, BETs. A year ago, you were about a trillion, is that correct?

Mr. BERNANKE. Eight hundred billion, something like that.

Mr. NEUGEBAUER. So you have doubled, more than doubled the size of the Federal Reserve, really, in the last 6 months, is that correct?

Mr. BERNANKE. In order to extend credit to currency swaps to allow dollar liquidity to be provided around the world, to allow access to banks and primary dealers, to provide that security, that liquidity backstop, and to strengthen our financial system, yes, we have done that.

Mr. NEUGEBAUER. If the OCC had a bank outside the Fed growing that fast, I think there would be some concern.

But the question I have, is anybody internally, Secretary Paulson with the TARP programs and some of the other things that you have done; Chairman Bernanke, with the things that you are doing; Chairman Bair, you know, what is our contingent liability, because this isn't a—we are not $700 billion into this.

You know, when I just start doing a little bit of rough accounting, it is over $2 trillion. Maybe it is a bigger number than that when we look at what the potential liabilities in Fannie and Freddie and what you are doing on commercial paper, what are some of the things that Chairman Bair has done to facilitate the taking over the banks—I think the American people, I think this Congress, I think this committee needs, we need a better accounting of where we are in this, and not just be coming in here and saying, well, we need $24 billion more for this and $50 billion for this and $100 billion for this.

I mean, we really have to have—and I am hoping that I can get a fairly quick response to my letter from each one of you as to where you think we are. Because, certainly, hopefully, you are sitting in, as you are making these decisions and looking at, you know, what is a potential downside here?

Obviously, we know, we hope, what the upside is in the economy, and these markets start responding, but I wondered if any of you had an opportunity to put some numbers together before your testimony today.

Mr. NEUGEBAUER. Well, let me make a general comment, which is, I know what the downside was, and the downside was the collapse of the financial system, which would have wreaked huge havoc on this economy for many years.

Now, part of the issue that we have in answering the question precisely is because these programs are very different. For instance, let's just take a $250 billion bank capital plan. That is not an expenditure; it is an investment.

I think it would be extraordinarily unusual if we, the government, did not get that money back and more. And so that gets accounted for as an expenditure against the deficit. That will be coming back in, for instance.

The Fannie and Freddie, that is a, you know, there is, the government is standing up there for the credit of those entities and making good on what I believe our responsibilities were and what investors in this country and around the world understood our responsibilities to be, in that situation.

The liquidity programs by the Fed are not expenditures, but they are impacting the markets, and right now, for instance, this year, we will issue roughly $1.5 trillion of treasuries, roughly 3 times than we ever have before.

Now, right now, there is huge demand for those securities, huge demand all over the world. But that is to fund liquidity programs that are shorter in duration.

Ben, I don't know, what about you?

Mr. BERNANKE. Only that our programs are mostly short-term lending and well collateralized.

The CHAIRMAN. We are over time.

Mr. NEUGEBAUER. Well, I think—my intention is, I want to follow up as you submit this response to me. Any time, and we all know this, any time you are making an investment, whether you call it an expenditure or investment, now, we also have to ascertain, what is the risk, and what is the potential downside loss of that?

So I understand what the economic downside was, but I think we need some numbers of kind of where we are in this process.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman.

I would like to associate myself with your statements, particularly those dealing with the mortgage foreclosure prevention and the use of TARP funds to achieve that goal.

Earlier in our discussion, there was discussion of the intent of the Secretary of the Treasury and the intent of Members of Congress being balanced in interpreting this law. I want to point out that, under the Constitution, Congress writes the law, and legislative intent is the only intent that should govern the construction of a statute.

I have a question for the record that I hope all three of you would respond to, and that is whether you will use your influence over banks to remind them of how important it is to lend to creditworthy projects being done by charitable organizations?

The work of charities is very important during this recession, and all too often, banks refuse to lend or refuse to provide letters of credit to charitable projects because they are concerned about the bad public relations that they would have if they ever had to foreclose. I think it is important that they get some bad public relations for refusing to lend and some pressure from you folks in achieving that objective.

Secretary Paulson, I want to commend you for buying preferred stock rather than toxic assets. First, your approach ensures that we are only bailing out U.S. institutions and not buying toxic assets that were in safes in Beijing on September 20th.

Second, you are buying a much more valuable asset. Any 9th grader would tell you, any 9 year-old would tell you that a toxic asset is less valuable than preferred stock.

But I can't commend you on accepting half the rate of return and one-sixth the number of warrants that Warren Buffet was able to get on similar transactions. Our children will have a larger national debt because we have been so generous in the terms on the preferred stock.

I would also point out that, as Mr. Secretary, this would bother me a lot except I wasn't in favor of buying toxic assets, but you have basically testified here that October 3rd, you had already decided to change your mind and not buy toxic assets and instead buy preferred stock, and you didn't tell Congress immediately before our vote that you would be going in a different direction. Perhaps I have misinterpreted your comments, and, if I have, I am sure the record will reflect that if you hadn't made that decision until after our vote on October 3rd.

I gather from your facial expression that is what you are meaning to say.

Secretary PAULSON. Absolutely.

Mr. SHERMAN. Then thank you, let me move on.

Secretary PAULSON. This was a world changing—

Mr. SHERMAN. Then thank you, let me move on.

Secretary PAULSON. And very seriously different situation—

The CHAIRMAN. Mr. Paulson, the members control the time.

Mr. SHERMAN. That I did misinterpret your comments and if you made the decision after October 3rd, I fully understand.

Now under section 111 of the bill, you are supposed to put forward regulations limiting executive compensation to that which is appropriate. You have been remarkably liberal in that you have only imposed by regulations the minimum standards set forth in the statute and that you therefore allow unlimited regular salaries and unlimited bonuses to be declared by boards of directors.

But while you have been so liberal in that, defining that part of the bill, another part of the bill requires you to define financial institutions eligible for participation under TARP. In fact, the statute explicitly says that insurance companies are eligible, and yet the CPP has issued regulations saying that only depository institutions are eligible; the insurance companies have to go out and buy depository institutions, as noted on the first page of today's Wall Street Journal.

But the issue that I would like you to address orally is bailing out or providing some sustenance to the automobile companies. We know how important that is to the economy. If you got rid of your CPP regulations and looked at the statute, you would see that auto companies do qualify, since they are incorporated under the United States, and they are regulated by the United States and its State governments.

But, instead, your definitions in the CPP regulations limit you to just depository institutions.

So the question I have for you, Mr. Secretary, is, if the bill, as properly interpreted, allows you to buy preferred stock from the three major auto companies, would you at least buy enough preferred stock to tide them over until the new Administration could make a policy decision? Or do you think—

The CHAIRMAN. If the gentleman wants an answer, you are going to have to wrap that up now

Mr. SHERMAN. Or to have the Obama Administration just look at three companies in Chapter 7.

Secretary PAULSON. Again, I have answered this a couple of times. I will answer it again.

I think it is very, very important to stay within the purpose of the TARP, because this is all about protecting the financial system, avoiding collapse and recovery. There is a good deal more that needs to be done before this system is recovered, the market is functioning as normal, credit is flowing, and that will make a big difference.

Now, with regard to the auto companies, what we have said, and I think you have heard me say it, you, the Congress has acted. You have a bill that was passed, a $25 billion bill, the Department of Energy—and, again, I urge you to modify that, to have a path for making an investment in a viable company.

The CHAIRMAN. The gentleman from Georgia is recognized for 5 minutes.

Mr. PRICE. Thank you, Mr. Chairman.

I want to thank the panelists for their attendance here this morning and their, oftentimes, responsiveness.

Now, I want to follow up a bit on the insurance companies purchasing banks issue. We have learned over the past couple of days that is, indeed, occurring.

I would ask you, Mr. Secretary, whether you believe that is appropriate or consistent with the mission of the program?

Secretary PAULSON. The mission of the program is focused on banks and bank holding companies and getting capital into the system. We don't have capability at the Federal level looking at insurance. So what we are going to do is applications. If applications—

Mr. PRICE. I understand what the process is. But my question is, is it appropriate for insurance companies to be forced through the machinations of this program to go out and purchase banks to gain access to this money?

Secretary PAULSON. I am not sure that is going to be a successful strategy. We are going to look only at applications that we think make sense after they are forwarded to us by the regulator.

Now, there are a number of insurance companies that already and have been bank holding companies for some time, have been regulated at the Federal level for some time. And in my judgment, it may make sense to put capital into those institutions who are playing a vital role lending and keeping our economy going.

Mr. PRICE. Let me ask the question and move on to some smaller entities. I have many constituents who are members of credit unions and small community banks, and they have many concerns about them not being eligible for participation in the TARP.

How are you working to address the concerns of these smaller financial institutions which are oftentimes the keys to their local communities?

Secretary PAULSON. I think they are keys, and I think they will do a lot of lending. And I had said in my opening testimony that we have published regulations yesterday which have now extended the term sheet for private banks, C corps, there are thousands of them.

We expect to get applications from a number of community banks and banks that are going to be very vital to this economy, and we are expecting regulators to forward many of those applications to us, and we are expecting to put capital into many of them.

Mr. PRICE. Let me—I think the general concern that many of us have voiced on both sides, and that is the Federal Government picking winners and losers in this process, and there is a general angst up here, as there is across the Nation, about a relative lack of confidence in the Federal Government to be able to get this right.

There are some fundamental principles that many of us believe have resulted in the remarkable success of the United States over hundreds of years. I might have broadened this to the Chairman as well.

What fundamental principles do you believe are consistent with the TARP program?

Secretary PAULSON. Okay. I will answer it briefly and then go to Ben.

The purpose of the TARP program is, as I said, fundamentally about preserving our system here, keeping it from collapsing and then helping it recover.

Now, once you have the government intervene, that is by definition going against many of principles that we believed in for a long time in terms of markets. We are doing this to preserve our markets.

So we have—there are two programs we have outlined to date. One program, if there is a failing institution, and the failure would be big enough to be systemic, we need to come into that.

With regard to the healthy bank program, my concern was the exact opposite of yours, just to be candid. My concern was, I thought, if we were looking back in history, the biggest concern I might have would be government intervenes and puts money into institutions that weren't viable and weren't going to be competitive long term. Now, we at Treasury—

Mr. PRICE. I am running out of time on that—

Secretary PAULSON. I don't have the capability to handle that—

The CHAIRMAN. The gentleman from Georgia is recognized.

Mr. PRICE. Mr. Chairman, if you would comment as to what fundamental principles you believe are consistent with TARP.

Mr. BERNANKE. Certainly, this situation has sometimes been represented as a failure of capitalism. I don't think that is right.

The problem is that our financial system, there have been problems of regulation and problems of execution that have created a crisis in the financial system.

We have seen, in many cases, historically and in other countries, that a collapse in the financial system can bring down an otherwise very strong economy. So our efforts have been very focused on stabilizing the financial system.

And as that situation is rectified, going forward, we need to really think hard about our supervision and regulation and make sure we get it right. But I don't think that this is an indictment of the broad market system.

Mr. PRICE. I would just very briefly echo some of the comments from the other side that said that we need to also specifically identify an exit strategy so that we can return to those fundamental principles.

The CHAIRMAN. The hearing is—briefly, Mr. Secretary.

I am getting you out of here, so if you want to talk.

I thank the three witnesses. There will be—does the gentleman from California have a unanimous consent request?

Mr. BACA. Yes, thank you very much, Mr. Chairman, for holding this hearing. I would like to submit my questions for the record and thank you. I know that I wanted to—

The CHAIRMAN. The questions will be submitted without objection.

Mr. BACA —ask about—

The CHAIRMAN. The gentleman from Texas has a request.

Mr. NEUGEBAUER. Mr. Chairman, I would ask unanimous consent to submit two letters: One from the National Association of Federal Credit Unions; and the other one from the Credit Union National Association.

The CHAIRMAN. Without objection, it is so ordered.

Any other information, material, or questions that members want to submit, without objection, will be submitted.

This panel is excused.

We will now call up the next panel, and let's move quickly here. We will begin on our side, the questioning where we left off. The first question will be with Mr. Meek.

Please don't impede people's ability to leave. People can socialize out in the hall.

Will the panel please be seated.

The gentleman from Pennsylvania will preside as we begin this next panel.

Mr. KANJORSKI. [presiding] If we will reconvene the second panel now. We will start our testimony with the honorable Steve Bartlett, president and chief executive officer, Financial Services Roundtable.

STATEMENT OF THE HONORABLE STEVE BARTLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Thank you, Mr. Chairman, and Mr. Neugebauer from Texas.

Mr. Chairman, I have submitted testimony for the record.

In addition, Mr. Chairman, I submitted two additional letters for the record that I would like to have entered into the record.

Mr. KANJORSKI. Without objection, it is so ordered.

Mr. BARTLETT. Mr. Chairman, to summarize my written testimony, first, we believe that the TARP has had a positive effect so far. It has only been 6 weeks, however, and so there is a long ways to go.

We think that the implementation of the TARP has added to liquidity, particularly in the LIBOR market, which was at critical levels and upon which most of the other financing globally is based.

Secondly, we think it has stabilized and provided a good deal of stability with depository institutions and with deposits, and we think it has strengthened the commercial paper market.

We also believe that the TARP has, by being used for the sale, there is a support the sale of weaker institutions to stronger institutions, we think that has generally helped the economy.

Secondly, we believe, and I have submitted in the testimony, some evidence that commercial lending has increased, actually rather substantially. We did a survey of eight of the major lenders out from their 10Qs, from the third quarter, showing an increase of lending from 12 percent. We have done some verbal interviews for September, October, and November and concluded that lending during those months and going forward will also increase.

I would note, however, that the economy is generally down, so loan demand is down, but the banks have not changed or raised their underwriting standards.

Third, with regard to the difference between asset purchases and capital infusion, we think that the capital infusion method was right. We think it has had some positive effect. However, we do think that the Treasury will and should look at both asset purchases and asset guarantees going forward. We think all of those are authorized by the legislation.

Fourth, Mr. Chairman, I provided some information on mortgage rates. Financial Services Roundtable believes that home mortgage rates are artificially high, and it is urging the Treasury, the Federal Reserve, and others take some action to reduce those home mortgage rates, because until home mortgage rates come down, the economy cannot recover.

Our evidence indicates that mortgage rates are 165—for conforming mortgage-backed securities of GSEs, are 165 basis points above comparable treasuries, even though the GSEs are now in conservatorship and should be traded like treasuries. What that means is that rates should be about 5.5 percent, but in fact, they are 6.2 percent. That prices out of the market large numbers of homeowners. We think, at 5.5 percent, that would allow about 30 percent of current mortgages to refinance.

Fifth, we think that the fair value accounting continues to be an overwhelming problem. I have submitted for the record a letter from the Center for Audit Quality, which historically has been defending fair value accounting, but which makes some very specific recommendations on ways to improve fair value accounting. We think that this committee, this Congress, and all the players of the Executive Branch should take that letter and those suggestions seriously.

Sixth, Mr. Chairman, we are totally committed to foreclosure prevention. Foreclosures are too high. Our organization through HOPE NOW and our specific lenders are producing about 200,000 loan modifications and repayment plans a month. We expect our new streamlined plan, which is not dissimilar to the plan that FDIC Chairwoman Bair has proposed, we think that plan will increase it to another 100,000 a month. There is still a long ways to go. We have a total commitment that we are going to review the FDIC plan to determine ways to make that work.

And last, Mr. Chairman, we believe that the Federal Reserve, and we have communicated this to the Federal Reserve, should take specific and proactive and aggressive steps to expedite the application of bank holding companies. We think that if a company is seeking to be a bank holding company, if it is applicable, that would strengthen the system, not weaken it.

We think the Federal Reserve has taken those steps in three specific cases of very large institutions; that is good. But we think other institutions that are large- and medium-sized would also strength the economy. We think that the Federal Reserve should take specific steps to be the quarterback to cause the bank holding company applications to be expedited.

And with that, Mr. Chairman, I yield back my remaining 52 seconds.

[The prepared statement of Mr. Bartlett can be found on page 126 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Bartlett.

Now we will here from our second witness, Mr. Edward L. Yingling, president and chief executive officer, American Bankers Association.

STATEMENT OF EDWARD L. YINGLING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BANKERS ASSOCIATION

Mr. YINGLING. Thank you, sir.

I appreciate the opportunity to testify on the current status of the Troubled Asset Relief Program.

The TARP program has served to calm financial markets and does have promise to promote renewed economic growth. However, it is also a source of great frustration and uncertainty to banks. Much of the frustration and uncertainty is because of the numerous significant changes to the program and the misperceptions that have resulted on the part of the press and the public. Hopefully, this hearing will help clarify the situation.

ABA greatly appreciates the consistent statements by members of this committee, and particularly its leadership, that regulated banks were not the cause of the problem and have generally performed well. Not only did regulated banks not cause the problem, they are the primary solution to the problem, as both regulation and markets move toward the bank model. Thousands of banks across the country did not make toxic subprime loans, are strongly capitalized, and are lending.

As you know, TARP started out focused on asset purchases. But then after European countries announced they were putting capital in undercapitalized banks, everything changed. Overnight, nine banks were called to Washington and requested to take capital injections.

As this program was extended beyond the first nine to other banks, it was not initially clear that the program was to focus on healthy banks and its purpose was to promote lending. ABA was extremely frustrated with the lack of clarity, and we wrote to Secretary Paulson asking for clarification. The press, the public, Members of Congress, and banks themselves were initially confused.

Many people understandably did not differentiate between this voluntary program for a solid institution and bailouts.

Bankers, for a few days, were not sure of the purpose, although they were sure their regulators were making it clear it was a good idea to take the capital. Put yourself in the place of a community banker. You are strongly capitalized and profitable. Your regulator is calling you to suggest taking TARP capital is a good idea. You, the banker, can see that it might be put to good purposes in terms of increasing lending, but you have many questions about what will be a decision that will dramatically affect the future of your bank, questions like, what will my customers think? What will the markets think? What restrictions might be added ?

Despite the uncertainty, banks are signing up. In my written testimony, I have provided examples of how different banks can use the capital in ways to promote lending.

One aspect of the program that needs to be addressed further is the fact that it is still unavailable to many banks. Last night, the Treasury did offer a term sheet for private corporations, and we greatly appreciated that. However, term sheets for many banks, including S corporations and mutual institutions, have not been issued. This is unfair to these banks, and it undermines the effectiveness of the program.

In my written testimony, I have discussed the fact that while TARP is designed to increase bank capital and lending, other programs are actually in conflict and are actually reducing capital and lending.

In that regard, I once again call to the attention of the committee the dramatic effect of current accounting policies which continue unnecessarily to eat up billions of dollars in capital by not understanding the impact of mark-to-market and dysfunctional markets.

Finally, in our written testimony, ABA also supports efforts to address foreclosures and housing. We have proposed a four-point plan: First, greater efforts to address foreclosures; second, efforts to address the problems caused by securitization of mortgages that you have championed, Mr. Kanjorski; third, the need to lower mortgage interest rates, which are not following normal patterns; and fourth, tax incentives for purchasing homes.

Thank you.

[The prepared statement of Mr. Yingling can be found on page 194 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Yingling.

Now, we will hear from the third panelist, Ms. Cynthia Blankenship, vice chairman and chief operating officer, Bank of the West, on behalf of the Independent Community Bankers of America.

STATEMENT OF CYNTHIA BLANKENSHIP, VICE CHAIRMAN AND CHIEF OPERATING OFFICER, BANK OF THE WEST, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Ms. BLANKENSHIP. Thank you, Acting Chairman Kanjorski, and members of the committee. Thank you for allowing the Independent Community Bankers of America to testify today.

I am Cynthia Blankenship. I am chief operating officer and vice chairman of Bank of the West in Grapevine, Texas, and chairman of the Independent Community Bankers of America.

We want to express our appreciation to Chairman Frank, Representative Kanjorski, Representative Bachus, and many others on the committee for their support of important community bank provisions in the Emergency Economic Stabilization Act.

ICBA commends the extraordinary efforts of Congress, Treasury, the Federal Reserve, and the FDIC to address the current economic crisis. Given the speed and the enormity of the undertaking, it is understandable that significant issues have come up regarding the Troubled Asset Relief Program's Capital Purchase Program.

The terms released by Treasury several weeks ago were unworkable for privately-held banks, Subchapter S banks and mutual institutions because of legal constraints and organizational structures peculiar to each of the types of these institutions.

ICBA and others have provided Treasury concrete suggestions to overcome the obstacles. We have had a constructive dialogue with Treasury on these issues, and last night, Treasury released a term sheet for a privately held C corporation bank.

But a term sheet is still urgently needed for the more than 3,000 Subchapter S and mutual banks. This represents one-third of most of the community banks, privately-held banks, in the United States that still have no access to the TARP.

While Treasury is working in good faith to produce term sheets, ICBA members are growing increasingly concerned about the rate the funds are flowing out of the program. At this point, only $60 billion is left uncommitted from the $250 billion Capital Purchase Program. And, yet, more than 6,000 privately-held Subchapter S and mutual institutions have not had the opportunity to apply.

There are more than 8,000 community banks nationwide, and they are well-positioned to extend lending in their communities should they choose to use the Capital Purchase Program. Including them will stimulate lending in those communities.

ICBA applauds FDIC's actions to unlock the market through the Temporary Liquidity Guarantee Program. The guarantee provides deposit insurance in transaction accounts and will enhance depositor confidence in community banks and free up capital to large deposits.

The guaranteed program for our senior unsecured debt, however, provides few benefits for community banks, as they do not issue much in the way of senior unsecured debt, other than Federal funds purchased. The current processing for the program makes it unattractive for Federal funds to purchase transactions.

Overnight Federal funds pose little risk of default. And at current prices for Federal funds, the 75 basis point fee exceeds the interest rate. We have suggested that the FDIC adopt risk-based pricing for the guarantee so that it will be more attractive for overnight transactions and consider allowing banks to separately opt out of the guarantee for overnight Federal funds.

If the guarantee fee does not cover the cost of the program, only banks and thrifts will be subject to a special assessment fee to make up that deficit; yet holding companies with significant nonbank subsidiaries can participate in the program. Some mechanism is needed to ensure these holding companies pay their fair share.

Community banks played no role in causing the current economic crisis, the foreclosure crisis, and by and large they did not engage in subprime lending practices. And they did not become entangled with toxic investment products. As a result, community banks are not experiencing unusual levels of mortgage defaults. When defaults do arise, community banks understand that foreclosure is the least attractive alternative and do everything they can to avoid it.

Our involvement in servicing loans and finding solutions for consumers extends beyond our own customers, and we offer refinancing to many troubled borrowers and loans from other institutions.

Mr. Chairman and members of the committee, ICBA stands ready to work with you to maximize participation in the programs authorized under the EESA and to promote the free flow of capital so essential to our economy.

I appreciate the opportunity to testify today.

[The prepared statement of Ms. Blankenship can be found on page 145 of the appendix.]

Mr. KANJORSKI. Thank you very much.

Now, a fourth member of our panel, the honorable D. Cameron Findlay, executive vice president and general counsel, Aon Corporation, on behalf of the Council of Insurance Agents and Brokers.

STATEMENT OF THE HONORABLE D. CAMERON FINDLAY, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, AON CORPORATION, ON BEHALF OF THE COUNCIL OF INSURANCE AGENTS AND BROKERS

Mr. FINDLAY. Thank you, Congressman Kanjorski.

I am Cameron Findlay, the executive vice president and general counsel of Aon, and I appreciate the opportunity to testify today on behalf of the Council of Insurance Agents and Brokers.

My written testimony provides the details of an innovative proposal for the Department of the Treasury to exercise the authority you have granted under Section 102 of TARP, so please permit me here just to summarize the high points.

We start with the premise that the insurance industry has a lot to offer in the efforts to stabilize the economy, because insurance is a critical but sometimes overlooked part of the financial services industry.

Put simply, we believe that the Department of the Treasury should use its statutory authority, the authority you have granted it, to establish a program to insure a portion of the expected payment of principal and interest from troubled and illiquid financial instruments.

While Treasury's efforts to inject capital in financial institutions is important—and has succeeded in some respects—this effort doesn't address a primary cause of the liquidity problem, the hundreds of billions of dollars of illiquid assets that are on the books of America's financial institutions.

Our proposed approach is an insurance program that would combine risk pooling, risk retention by the financial institutions themselves, and potential government backstop liquidity. In our view, such an approach would benefit all the stakeholders here, taxpayers, financial institutions, and homeowners.

The plan involves, first, the sharing of risk by participants in an asset stabilization pool. Participants in the pool would pay risk-based premiums, and the pool would insure a portion of the principal and the interest from illiquid assets on their books. Thus, the program would insulate an asset holder from having to immediately recognize the decline in value resulting from the nonpayment or expected nonpayment of principal and interest.

Second, our plan requires financial institutions to retain some risk. Just as holders of insurance policies retain risk through deductibles, asset holders would be required to retain a percentage of the shortfall of principal and interest. Asset holders would be reimbursed from the pool for a shortfall, only when the shortfall exceeds their retained amount in a single year. It is just like a deductible in your home insurance policy.

Third, our plan involves the potential of government loans as a backstop. That is, in the event that in the early years, payments from the pool exceeded premium collections, the government could loan the pool funds needed to make good on the guarantees. The government would then be reimbursed by premium collections in subsequent years.

Let me illustrate the proposal by using a very simple example. Suppose an institution holds $1 million in mortgage-backed assets. Assume that the current lack of confidence in the liquidity of these assets has dropped the market value to, say, $600,000. Now, this $400,000 drop is not necessarily the result of a true decrease in the asset's intrinsic value. It may simply be the result, at best, of a lack of information about the value of the asset or, at worst, in the current environment, to sheer panic.

Let's assume in our example that the actual intrinsic value of the asset is $800,000. Without our proposed insurance program, the institution might have to mark the asset to market, resulting in an immediate loss of $400,000 in value or, even worse, the institution might have to sell the asset into a panicked market.

But an insurance pool that guarantees the repayment of the principal and interest from these assets would, under proper accounting treatment, result in the institution holding assets worth $800,000, not $600,000.

The insurance industry knows how to do this. Actuaries can set initial premiums based on the law of large numbers, and then after experience working with the proposed pool, actuaries could use the accumulated data about the performance of the assets to develop ever-more-accurate premium pricing models, reflecting the actual value of the underlying securities.

In our view, this program will have significant benefits for all stakeholders: Taxpayers; financial institutions; and homeowners. For taxpayers, an insurance program would have significantly less short-term cash requirements and capital infusions. Also, because it would be funded by its direct beneficiaries, it would restore liquidity without requiring massive immediate outlays of government funds.

The insurance solution would also assist financial institutions. As an insurance program, it would provide asset holders the option to hold assets until maturity or until economic conditions permit the recognition of the assets' real value. It wouldn't flood the market with distressed assets, which could have the effect of further depressing asset values. An insurance program would also prevent opportunistic purchases of depressed assets by predatory investors.

Finally, our plan helps homeowners as well, homeowners facing foreclosure, by proposing that participating companies have to agree to a plan to restructure individual mortgages as a condition of participation.

On behalf of Aon and the CIAB, I want to thank you again for the opportunity to testify today. We stand ready to work with you on our proposal, and we would be pleased to take any questions that you may have.

[The prepared statement of Mr. Findlay can be found on page 185 of the appendix.]

Mr. KANJORSKI. Thank you very much.

Now, without objection, I ask unanimous consent that an exchange of letters between Federal Reserve Chairman Ben Bernanke and myself dated October 9th, October 20th, and November 17th, be submitted into the record.

Without objection, it is so ordered.

I now recognize the gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

It is good to see you.

Let me start off by asking this question. There were some questions earlier to the first panel, initially by my colleague, Ms. Waters, where I think we are suffering from the same problem, and that is, when you look at the number of constituents who are being foreclosed upon and trying to help them, it has been very difficult.

It is very difficult working with servicers in getting the final information, etc., so that we can make sure we are preserving them and giving them every opportunity to stay in their home. To that end, in my district, I joined hands with a local community organization, CWE, who, every week, they come in with lawyers and financial consultants. They speak to my constituents, and the numbers have just gone up astronomically. And then they call the banks and work things out, and I have called them, my community banks, etc., to let them now, when they hear from this group, to make sure that—see if something can be worked out.

As a result, I can tell you, when we put this program in place as a pilot program about 3 weeks ago, there were about 8 homes that I know were about to go into auction the next day. We were able to save those people from foreclosure. They stayed in their homes.

So my first question is, as opposed to just relying on the whole program, has there ever been any consideration, especially with community banks, who have been, to a great deal responsive, to partnering with some community-based organizations who are on the ground, because we find oftentimes with the number, when the financial institutions, when they get something from them, it just goes right into the garbage can, and they need someone, they are trying to figure someone to trust; we found there is a trust factor that has been missing. And they trust someone else; they trust coming into my office. So my first question is, has there been any consideration about trying to partner with community-based organizations in communities to help people stay in their homes?

Ms. BLANKENSHIP. I don't know of any formal effort that we have at this time, but I will tell you that most community banks have a personal relationship with the borrower. As I stated in my testimony, we do everything we can to avoid foreclosure.

I think if you look at the statistics, you would find that in the community banks, there is going to be a lower percentage of foreclosures, simply because we do have that relationship if the customer will come in. I think it would be beneficial to have an organization to which you speak that could encourage those borrowers, who are sometimes intimidated, when they go into default, to communicate with the bank, because once we get communication, then it would be rare that we couldn't find the solution.

Mr. YINGLING. I would just, one, commend you for your efforts, and, two, say that you hit on one of several very important factors here. That is trust. We know that many people give up, and they shouldn't give up, and having a group that they trust as an intermediary could be very valuable. I think it is something we should do more with. I think it is an excellent idea.

Mr. BARTLETT. Congressman, in fact, we do partner with many organizations, a lot of organizations. Our principal partner on a national level is NeighborWorks. They have an affiliate in virtually every community of the country. We find that working with those nonprofit groups is the most effective way that we have of providing counseling that leads to the results of loan modification.

Now our goal here is, counseling is nice, but counseling has to have the result of a loan modification. That is what we set out to do. And frankly, we pay the costs to those nonprofit counseling organizations and find it to be the most effective way to negotiate.

I will say that it seems, perhaps, on the outside, to be opaque. It is not. If someone is not able to pay their mortgage, then we have to figure out a way with that person to take their income and convert it into mortgage payments and then see if—it is not a gift; it has to be a mortgage to make sure that a mortgage is comparable to or better than—

Mr. MEEKS. Let me ask this question really quick, because I wanted to ask this of Secretary Paulson, but then let me ask you, maybe it will have an effect with you.

Given that Secretary Paulson has unilaterally decided not to purchase the toxic assets, are you concerned at all with the position that may reverse—you know, not buying this—LIBOR rates? You know, this is an international market right now. By not buying this, it could change. We had some stability. And now, things have changed. Does that give you any concern?

Mr. BARTLETT. As it turns out, LIBOR rates have come down rather significantly and are back to a stable level. We think that the Treasury did the right thing with their capital infusion, but we also think they ought to review the other opportunities.

The CHAIRMAN. The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman.

A question for Mr. Bartlett, Mr. Yingling, or Ms. Blankenship, whichever one of you. Most of the TARP money thus far has been spent, as Mr. Bartlett just pointed out, for capital infusions into banks and financial institutions, or will be by the time they finish the first tranche of money.

In all of your views, is the banking system now adequately capitalized such that it can get further capital privately, or do you think that more capital injections are necessary?

Mr. BARTLETT. More capital is always better than less capital. So I would never say adequate.

Mr. CAMPBELL. I understand that.

Mr. BARTLETT. I think the capital has to come from private sources. So the Treasury's infusions was, in essence, to kind of put a foundation and a floor. I think we will see more capital than we have seen and we will see more capital as a result. But it is an ongoing process.

Mr. CAMPBELL. The Treasury Secretary today talked a little about the fact that they are studying an idea to leverage private capital so that when there is a private capital, new private capital investment, stock issuance that the Treasury would then have some kind of matching program. Comments on that idea from any of you?

Ms. BLANKENSHIP. Well, I would just like to comment that until they get the initial program fixed where all banks have access to capital, because still there is—with the Subchapter S and the mutual banks and they did issue the privately held term sheet last night, which is helpful, but you have 8,000 community banks out there that would like access to this capital so they could expand lending in their communities. Because, frankly, that is the only way capital is going to pay off as an investment in a community bank. It is not cheap capital, but it is access to capital; and, you know, that is very much necessary in today's market.

Mr. YINGLING. I would just add that, I must say, I think the reaction of most of the banking industry in that 24-hour period where nine banks just overnight were called in a room and requested to take capital was one of shock and concern. It is not something we had asked for.

Having said that, as the program has rolled out and become clearer, we can see an advantage to it.

I agree with what Ms. Blankenship just said, that at this point there is an equity question and a competitive issue, and all banks ought to be treated equally. But, beyond that, to the degree we can rely on private equity, we ought to; and to the degree that there are other excellent uses for money, such as foreclosure prevention, they ought to be considered.

Mr. CAMPBELL. Thank you.

Let's talk about what the TARP did not do for the three of you again; and then I have one more final question for you, Mr. Findlay. I won't ignore you there.

What it did not do is buy troubled assets, which was obviously what we originally thought we were going to do. Are you seeing any liquidity in that market whatsoever? Are those trading at all? Has there been any thawing in that as there has been a little thawing in commercial paper, a little thawing in interbank lending, a little thawing in a few of these other things? Is there any liquidity in that market right now?

Mr. BARTLETT. No. We think bringing down mortgage rates will help with that. We think, actually, that the capital infusion of the banks will help with that. LIBOR being reduced has helped with that. But in 6 weeks' time, we haven't seen a thawing at this point of the mortgage-backed security market. That has to happen. Nothing can recover until that does happen, and we think that the steps have been taken to cause it to happen. But it hasn't happened yet.

Mr. CAMPBELL. So those are still not tradable assets basically to the extent they sit on anyone's books?

Mr. BARTLETT. I would hate to say not tradable but pretty close to not tradable.

I also suggested in my testimony that dealing with—curing fair value accounting is a big part to that. So fair value accounting continues to be kind of the heavy hand of government that is causing a large part of the problem at this point.

Mr. CAMPBELL. Let me get to Mr. Findlay, if I may, with one final question. How is the program that you describe, this insurance program, how is that different from what is actually in the bill that we passed in the rescue bill in October, which the Treasury is studying, insurance? In listening to you, I wasn't able to see a distinction between the two proposals.

Mr. FINDLAY. In fact, the proposal we have is one that we believe Treasury has authorized under section 102 of the EESA; and our proposal is one that Secretary Paulson said is being studied right now. When we were talking about how much capital outlay is the right amount, I mean, one of the advantages of our program is it doesn't require immediate infusions of capital.

Mr. CAMPBELL. So you are simply expressing your support, I guess, for the idea that was put in in the bill as an option for Treasury?

Mr. FINDLAY. That is exactly right, Congressman.

Mr. CAMPBELL. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman, and I want to thank you and the ranking member for continuing to hold these hearings, and I want to thank the panelists for helping the committee with our work.

Mr. Yingling, I really appreciate the candor of your testimony this morning; and I want to just—I am just going to quote you a little bit, if you don't mind.

You talked about the great frustration and uncertainty to banks caused by the significant and numerous changes to the top program and misperceptions by the public and the press. I just think you might want to add Congress to that list as well.

As you know, and you have been a frequent flyer to this committee in recent weeks, Mr. Paulson had come here and in great detail described a toxic mortgage repurchase program that he put forward to Congress; and much of our time here and your time and those who are trying to protect taxpayers time were spent in examining that specific proposal which was to clear these toxic mortgages off the bankers' balance sheets. And we probed that question in great detail, and the benefit to both the banks and to these distressed homeowners and to the communities that they are located in was quite apparent.

And then it seemed like just a matter of days after Secretary Paulson got the $700 billion, he went to plan "B." He basically abandoned that original plan that was the basis of his request and went to plan "B," which was, as you have described, getting those bankers in a room and then proceeding to—at least in the words of some of those bankers—give them—force money that they didn't need and didn't want, and the process nationalized a considerable percentage of those banks.

And then, after the fact, he has gone to plan "C," which is now to recapitalize some of these credit card issuers.

And I just want to know—I mean, I think he had an obligation here to come to Congress and say, okay, here is plan "A;" and I am going to try this. Here is plan "B."

The problem with the banks wasn't unforeseen. He could have explained that to us. He never mentioned it. As a matter of fact, the only time it ever came up, he rejected the proposal of direct capitalization in the banks.

But I just want to know, what is the response of your constituents, your banking committee as well as—Ms. Blankenship as well, the community banks. What is happening here? What has this done for confidence within the banking community, all the changes that the Secretary has instituted?

Mr. YINGLING. Well, it has been very confusing and very difficult. I would differentiate the question of what is the right policy, because it may be we have arrived at the right policy in terms of the best use of the money at this time. Although, again, I think foreclosures is another important use of money.

We didn't ask for capital infusions. And I can remember when this was announced sitting in my office, and I have to watch the news all the time to see what has been going on and what the effect may be, the immediate response in the hours after this program was announced was a series of stories about how the banking industry had thousands of banks that were going to fail.

It was completely misinterpreted, and it took several days for this to calm down. It also took several days for banks to figure out what was going on, and that is why you saw some statements from bankers, I think, about the use of the funds. It was just because they didn't understand. I think now people are beginning to understand. But I would think it is confusing for bankers. We have done—are starting to do—some polling on do your customers think you are weaker or stronger if you take the money?

Mr. LYNCH. Right.

Mr. YINGLING. Customers don't know how to react to it. All of these things have ripple effects that are unforeseen. And as several of you have commented about your constituents' point of view, we could understand the anger and the concern and the confusion; and, of course, that affects us. We hear from the customers as well, and it can lead to policy confusion.

Mr. LYNCH. I understand. I am running out of time. I just want to ask, what about the fact that Secretary Paulson basically—and this is reflected widely in the press—that the Secretary basically forced people to take the money, when they didn't want the money, they didn't need the money, and now it looks like there won't be enough assistance to help some other banks that may indeed need a little bit of help?

Ms. BLANKENSHIP. Well, that is the total frustration of the community banks. Because, you know, the perception is that the big banks did take it, the nines. And that has been well over a month ago, and still the deadline came and went. And the community banks, the 8,000 that represent over 90 percent of the banks nationwide, they represent Main Street. They couldn't get access to the capital. And still even today we can't get total access to it.

Mr. LYNCH. I appreciate that. That is very helpful to hear.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman from Illinois.

And let me just say, if people are watching this on television and aren't members of the committee, don't come. We have about 16 minutes. We have three members who will be able to ask questions.

We are going to then break at 1:00. We will come back at 2:30, because our academic witnesses had asked that they be allowed to testify in the afternoon. So we will come back for Professors Feldstein and Blinder.

The gentleman from Illinois is recognized.

Mr. MANZULLO. Thank you, Mr. Chairman.

I represent the 16th District of Illinois, which is right on top of the State; and we have a lot of agriculture, a lot of manufacturing, a lot of small independent community banks. And the community bankers are extraordinary people because they have not caused this problem. Their conservative principles, the fact that when you get a loan you sit across a desk and you can judge a person's integrity by looking into their eyes—they represent institutions in this country which really serve to me as models.

And, Ms. Blankenship, I have a question for you. We are told that there is a need to use part of the $700 billion financial services package by the auto industry in large part because the financial arms of the big three are unable to issue any more car loans except to customers with a FICO score of greater than 720. In many cases, they said that they just don't have any money at all. I have been informed by several community banks in the district I represent, including my own banker, that they have plenty of money to lend for automobiles. They are very frustrated with the fact that people are saying—and I am going to be very up front.

The last panel has done more to instill fear into America and, by some of the outrageous statements, are making it more and more difficult to recover. In fact, they are extending the recovery, starting with my good friend Mr. Paulson from Illinois, the statements that he made in September about how the world would collapse unless he was given $700 billion to buy bad assets.

People are not buying automobiles, and they are not going and doing their regular Christmas shopping because of fear. And, all along, the community banks have all kinds of money. My question to you is, are community banks—and I don't want to use the words "able to fill the gap," but are there enough community banks in this country that can work with dealerships and make sure that people receive appropriate and fair and reasonable financing for their automobiles and trucks?

Ms. BLANKENSHIP. Well, I would—

Mr. MANZULLO. Do you like that question?

Ms. BLANKENSHIP. I will take that question.

Of the 8,000 community banks, the banks that are on Main Street and in the agricultural and rural communities that represent 22,000 communities across the Nation, by and large they are well capitalized and they do have money to lend. Our own bank actually has increased in lending—our net lending since this time last year. The market confidence was a huge factor.

When there were comments that thousands of banks would fail, you know, we had—that is where you saw your customers pulling in. It wasn't the fact that the banks didn't have money to lend. The consumer confidence just went to the tank. And so we had to restore that. And coupled with that was the deposit insurance question and, you know, does your bank save? And the confusion over money market guarantees where the mutual funds got unlimited and our banks had $100,000 still. So it is hard to compete.

And yet those customers know us. They know us by name, as you said. And the confidence—we were able to rebuild that confidence. But it was a campaign. We do have money to lend, and we would be glad to lend it.

Mr. MANZULLO. Thank you.

Mr. Yingling.

Mr. YINGLING. Just a few numbers that I think would surprise most people. Consumer and industrial loans for banks are up 15 percent this year. Home equity loans, admittedly from a low base, are up 21 percent. Asset-backed securities lending—not mortgage but other asset backs—down 79 percent. We have a chart on page 10 of our testimony that shows consumer and industrial business lending, and consumer lending is actually up for banks.

Mr. MANZULLO. And this is all banks?

Mr. YINGLING. Right. The world is coming back somewhat to the bank model, and we are ready to go.

Mr. MANZULLO. The question I asked of you, Ms. Blankenship, I just want to make sure that we have a lot of larger banks in our district with local branches and real-life people there. They are also telling me the same things that many of the community banks are saying.

Thank you.

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman, and I thank the witnesses for appearing today.

I have two quick questions. The first is, having heard the plan that Chairwoman Bair has, is there anyone who is in disagreement with the plan? Anyone? And the Chair has taught me that I am to build a record by indicating that the absence of hands—ah, we do have hands. Okay. All right. Let's hear from you please, Mr. Bartlett.

Mr. BARTLETT. Well, we are in agreement with the direction of the plan and with the goals and the broad parameters. But the plan wasn't—the details weren't laid out today. There are some details in the plan that we would like to work with either the FDIC or Treasury to make sure—

Mr. GREEN. Let me be a little bit more specific. Do you agree with the notion of an incentive for the servicers?

Mr. BARTLETT. We agree with the notion.

Mr. GREEN. A monetary emolument?

Mr. BARTLETT. Yes, although we are not asking for it. We can do it without that incentive. But we agree with the plan.

Mr. GREEN. Now I have to ask you, why haven't you done it without it?

Mr. BARTLETT. Well, legally, we are.

Mr. GREEN. The empirical evidence doesn't seem to indicate that you are. It may very well be, but I just haven't found anything to substantiate what I think is a fair position for you to make.

Let me go on to the next. Mr. Yingling.

Mr. YINGLING. We generally agree with the approach. I spoke with Sheila Bair about it 5 weeks ago. We like the idea of using the institutions that know the customer, that are there to work with them, rather than sending it to Washington and that type of delay.

I just raise two caveats. One is—and it is all a matter of calibration—we do have a concern that if it becomes a government program—say you are in a neighborhood in Texas and there are two or three foreclosures, potential foreclosures in your neighborhood—are others going to see this program and see that Bill or Mary got this and say, okay, I will stop paying so I can qualify? That is all a matter of the details and the communication.

And the other is, I think we need to sit down with real, live lenders, community banks and others, and design a program, make sure it works.

Mr. GREEN. Thank you very much.

I take it that there were only two hands, persons who were in disagreement; and they have spoken. Is there a third?

Ms. BLANKENSHIP. I would just like to qualify that the community banks didn't face the same problems as IndyMac because, typically, they make their mortgages just individually; and they are working through those.

Mr. GREEN. Ms. Blankenship, if I may interrupt, because my time is short. Let me just ask, the plan itself, however, are you in agreement or disagreement with it? The concept that you heard.

Ms. BLANKENSHIP. I think the concept is good to work with the consumer.

Mr. GREEN. And to have an emolument, a payment of money for foreclosure avoidance.

Ms. BLANKENSHIP. I don't think it should be a government-mandated plan for the banks. But I think that a tool for the banks to work with would be—

Mr. GREEN. It is not mandated; it is if you buy into the program. Then you will receive the emolument if you participate in foreclosure avoidance. That is the way it is established, as I understand it.

Ms. BLANKENSHIP. Yes.

Mr. GREEN. Would you support that?

Ms. BLANKENSHIP. Yes.

Mr. GREEN. Let's go on to the last person, and I will be done.

Mr. FINDLAY. Everyone keeps forgetting about me here from the insurance industry. We don't have a position on behalf of the CIAB on it. But I support the concept. We believe that there ought to be relief for individual homeowners, and we built something like that into our proposal.

Mr. GREEN. Well, just in response to your question, there were many people who thought that this would not impact them. I say you are involved in it simply because life is an inescapable network of mutuality tied to a single garment of destiny. Whatever impacts one directly impacts all indirectly. That is Dr. Martin Luther King. So we are all in this together.

Thank you very much, Mr. Chairman.

The CHAIRMAN. If I may in the gentleman's remaining time ask—because I appreciate him asking that question. Let me ask each of you to indicate, if we can work out the specifics—and I agree; those are important—would you think it is appropriate to use TARP money for the costs of this? Beginning with Mr. Bartlett.

Mr. BARTLETT. Mr. Chairman, yes, I do, if we can work out the details.

The CHAIRMAN. Mr. Yingling.

Mr. YINGLING. I think it is important that foreclosures and housing be dealt with. Yes, I would.

The CHAIRMAN. Ms. Blankenship.

Ms. BLANKENSHIP. Yes, I would agree.

The CHAIRMAN. And Mr. Findlay.

Mr. FINDLAY. I can't disagree.

The CHAIRMAN. That is very important. We will note that to the Secretary.

The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Findlay, you have talked about the theory of the current crisis is not a liquidity crisis but instead a transparency crisis as it relates to the pricing of illiquid assets and your belief that the insurance program could help. How will the insurance program affect the financial statements of the participating entities?

Mr. FINDLAY. I think the way we view this, Congresswoman, is that the fundamental problem in the marketplace right now is a lack of reliable information on the value of assets and indeed a sort of panic that sets in when you don't have reliable information. You don't want to be the last person holding a troubled asset. And all these financial institutions have on their books assets that they had valued a certain way in August, and it is a fraction of that value today.

We are fairly confident that the fire sale price at which assets are being held today is not the intrinsic value of the asset, and it wouldn't be a good thing to require institutions to mark assets down to that value. So what we have tried to do is come up with an innovative way to take the panic out of the marketplace, and allow information to get into the marketplace, so we can determine what these assets' values are and essentially give a little breathing space to the market over the next year or two to bring these assets back to their intrinsic values, which we know they are not at today.

Mrs. BIGGERT. Thank you.

Mr. Yingling, do you think that this insurance program would really help the banks and financial institutions and be able to—you know, we have the mark to market, which has lowered that. But is the insurance program something that would be to your benefit, to be able to have what these mortgage-backed securities really are worth?

Mr. YINGLING. Well, I think it is very valuable to explore. I think we do have an issue of just how many programs we can have working at one time. But certainly it is a program in terms of its design that makes sense.

Mrs. BIGGERT. But this really was a program that was one of three that was the Secretary's proposal and the alternative—

Mr. YINGLING. Yes.

Mrs. BIGGERT. —and it seems like—I am not sure that the Secretary really wants it to be implemented. And it seems to me that the only way that we are really going to know what the value of these mortgage-based securities is by this program. I haven't heard of any other basis that they are really going to be able to find that out.

Mr. Bartlett, is that important? Do we really have to know what all of these mortgage-based assets are worth?

Mr. BARTLETT. We support the program as outlined by Mr. Findlay; and I put it, actually, in my written testimony. So we think that now that the capital infusion has been put in place, then the Treasury should be looking at other alternatives of additional ways to provide liquidity back in the market of which the asset guaranteed program, the asset purchase perhaps and perhaps the asset guarantee and the insurance program is a better, more leveraged way of providing the same thing.

It is important to note that all the money that is needed for liquidity in the market cannot come from the government, not even a small fraction of it. So the government money has to be used to cause the private money to come to the table; and I think that is the basis of this insurance program, which is the right approach.

Mrs. BIGGERT. Thank you.

Ms. Blankenship, do you look at this program as being helpful or does it apply to the community banker?

Ms. BLANKENSHIP. I do think I would agree, because anything that would help us alleviate the decline in those mortgage-backed securities values, because it affects the industry on all levels, so it would be helpful. Thank you.

Mrs. BIGGERT. Thank you.

I yield back.

The CHAIRMAN. The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

After reading about the supposed demise of my State's influence in the Nation's Capital in the Hill newspaper today, I am very happy to see two fellow Texans on this panel, representing 50 percent of the panel. Obviously, there has been a big discussion about foreclosure prevention in mitigation efforts.

The gentleman from Texas is no longer in the room, my friend, and spoken that he had seen no—I believe—I hope I had the proper context—had seen no empirical evidence that there was voluntary reworkings, refinancings of these mortgages. I haven't looked at numbers recently, but my thought is, as of a few weeks ago, there had been something around the neighborhood of 2.5 million voluntary refinancings. Mr. Bartlett, do you know what the latest number may be?

Mr. BARTLETT. Congressman, actually, it is 2.5 million since July of 2007. Those are real numbers. There is a combination. A little over half of them are modifications; the other is a repayment plan. They get people back in their houses and the mortgage reinstated so that they can afford it.

We believe that the streamlined mortgage, which we announced last week, which is similar but not identical to what Chairwoman Bair proposed, we think that should increase it by another 100,000 a month. So it is running about 200,000 a month. We think we can increase it to about 300,000 a month. It is a long ways to go, but those are big numbers, and they are real, and those are real people that are being able to reinstate their mortgages and keep their homes.

Mr. HENSARLING. Well, there seems to be a belief by some on the committee that these refinancings are not taking place or that you apparently have no incentive to do it. Is it not true that the average foreclosure cost to financial institutions is somewhere in the neighborhood of $60,000 to $80,000? Does anyone feel qualified to answer that?

Mr. BARTLETT. We did a survey a year ago. It was an average of $57,000. So I suspect it is more like $80,000 by now.

Foreclosures are financially as well as emotionally devastating for all involved. But, having said that, it is a mortgage. It is not a grant, and we all know that. So we set out to reinstate the mortgage and modify the mortgage if we can get it back to a basis of a mortgage with a homeowner able to pay that mortgage and stay in the house. We do that 200,000 a month, and we are doing it faster every month.

Mr. HENSARLING. Mr. Yingling, in an answer to a previous question, I think you kind of brought up the moral hazard dilemma about incenting some people with Federal funds to renegotiate their mortgages. I think it begs the question, how many people can't pay their mortgages and how many people choose not to pay their mortgages? And can you speak to the moral hazard of a program that, if not properly structured, is going to incent people to purposefully default?

Mr. YINGLING. We do believe that we need very strong programs to address foreclosure, and one of the issues I believe that came up in a recent hearing at this committee was the securitization issue and how that has been a roadblock to be able to do foreclosures in many cases. What bankers have expressed is a concern. It is all a matter of communication and calibration of the program.

But it is one thing, for example, in IndyMac, where the FDIC goes out with letters to IndyMac borrowers and says, you are an IndyMac borrower; here is what we can do for you. And a more general situation, okay, is where there is a government program that if you miss three payments you qualify for and you will get your monthly payment cut by a third, and that goes around the neighborhood. What you don't want is for people to say, okay, it is a government program. I should be able to participate. I won't pay my mortgage for the next 3 months. Because then the cost to the taxpayers will just balloon.

Now this can be dealt with, but it is something that we really need to think through.

Mr. HENSARLING. Ms. Blankenship, in your testimony—and let me thank you for coming here and making the committee aware of the lack of access to many of our community financial institutions, their inability to access much of the TARP money. You brought the lack of access to our attention and you also stated that community bankers were not the cause of the financial crisis. And perhaps it is the cynic in me pointing out, maybe that is your problem. There tends to be a habit in the Nation's Capital of rewarding failure and punishing success. You might want to think about that for the next round.

Mr. Findlay, I don't know where your voice was 6 weeks ago. I wish we could have heard it more loudly than we have today.

I know that at least our chairman has been quoted in The Washington Post at the time the original legislation passed—I believe I have this right, Mr. Chairman—that you did not expect the insurance program to materialize. And I hope that is "expect" as opposed to "hope." But I think it holds a lot of promise, and I am glad the chairman had an opportunity to hear your testimony.

I see my time is out, and I yield back. I would be happy to yield to the Chair.

The CHAIRMAN. I did express that view after talking to the Secretary of the Treasury.

I thank the panel. We will reconvene at 2:30.

[Recess]

The CHAIRMAN. The hearing of this morning will reconvene.

I apologize. A Democratic caucus was scheduled at the same time. I regret that more of our colleagues won't hear our witnesses, but it will be on C–SPAN. There is nothing competing with it on the Floor of the House. And, obviously, the testimony will be available. It is a subject of continuing importance, I think, as a result of this morning's hearing and the conversations we had, particularly with the Secretary of the Treasury, that this question of what more to do with regard to mortgage foreclosure is very much an open question. And so this testimony will be especially relevant in helping us shape what I think is going to be the next step.

And, with that, we will begin in alphabetical order with Dr. Alan Blinder, who is a professor of economics and co-director of the Center for Economic Policy Studies at Princeton and a former Vice Chair of the Federal Reserve Board of Governors.

Mr. Blinder?

STATEMENT OF ALAN S. BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS AND CO-DIRECTOR OF THE CENTER FOR ECONOMIC POLICY STUDIES, PRINCETON UNIVERSITY

Mr. BLINDER. Thank you, Mr. Chairman, and members of the committee. Thank you for the opportunity to testify here this afternoon.

I have come here neither to praise the TARP nor to bury it, but rather to urge Congress to exercise its oversight authority to ensure that the Secretary of the Treasury pursues the stated goals of the legislation. Failing that, I think Congress should take the Secretary's checkbook away and wait for a new Secretary of the Treasury.

I note that the Secretary just said he is probably not going to ask for the second $350 billion anyway. So that last point might be moot.

Mr. Chairman, I think you will remember that I was among the earliest voices calling for something akin to, though not exactly the same as, the TARP. Specifically, I recommended the establishment of two new institutions, one of which would purchase and refinance imperiled mortgages and the other of which would buy up some of what we now call troubled assets, that is, mortgage-backed securities and the like.

The TARP was, in fact, established to serve both of those purposes. That is in the legislation. So it is with great dismay that I look at what has been done as of today and conclude that the TARP is not, in fact, performing its legislatively-mandated duties.

I object to the decisions Secretary Paulson has made on at least three different levels: First, the choices he has made regarding how to deploy the money; second, the execution of those choices; and, third, what seems to me, although you ladies and gentlemen can judge this better than I, to be a pretty sharp deviation from congressional intent. Let me take each up in turn, starting with the last.

Because the financial crisis has grown to be so complicated and multifaceted, it is worth remembering that it all began with falling house prices and defaults on mortgages or, to be more precise, fears that defaults on mortgages would become rampant.

Foreclosures are personally painful and economically costly. They undermine property values, and they lead to fire sales of homes, which further depress house prices, thereby contributing to the vicious circle. It is difficult for me to see a way out of this mess without reducing foreclosures sharply.

Understanding that, Congress wrote legislation that at numerous points exhorts, encourages, and even, I think, directs the Secretary of the Treasury to use TARP funds, at least some of them, to acquire mortgages and get them refinanced. But, as you all know, he has not done so. Nor has he purchased any of the so-called troubled assets; and he has recently said he does not intend to do so.

The law that you passed in early October authorizes establishment of the TARP to purchase troubled assets, which are defined in Section 3.9. If you have my testimony, the exact words are reproduced on page 3. But they basically say, "A, residential or commercial mortgages and any securities, obligations or other instruments based on mortgages." And then there is clause B, which basically says, "any other instrument that the Secretary deems to be essential to promoting financial market stability." And it adds to that clause, "but only upon transmittal of such determination in writing to the appropriate committees of Congress." I presume this is the appropriate, or at least one of the appropriate, committees.

So I think of that language as defining three eligible classes of assets for the TARP to purchase: Mortgages; mortgage-related securities; and then the catch-all, anything else that the Secretary deems important to financial stability.

Well, I guess I am an old-fashioned believer in constitutional democracy. I followed from a distance—you ladies and gentlemen were right in the middle of it—a pretty rancorous congressional debate over the TARP. And I am pretty sure that Congress believed it was authorizing $700 billion mainly for the first two of those purposes: buying and refinancing mortgages and purchasing mortgage-related securities.

Instead, as you know, almost all the money committed to date is for capital injections into banks, justified under that catch-all phrase, "any other financial instrument." Were I a Member of Congress, I would be pretty unhappy about this turn of events. And, in fact, as a taxpayer shouldering his share of the $700 billion burden, I am unhappy about this turn of events.

To be sure, I am not suggesting that Secretary Paulson overstepped his legal authority by making capital injections. They are, in fact, justified by Section 3.9(B). Nor do I question the wisdom of allocating some of the TARP money to recapitalizing banks. But I think we need to pay attention to the scoreboard, which so far, at almost half-time, reads, "mortgages: zero; mortgage-related assets: zero; other: 100 percent."

I don't believe that such a lopsided allocation of funds is the optimal use of the public's money. And to see why, I would like to review very briefly the arguments that support each of these three alternative uses of the funds, starting with mortgages.

As I mentioned a moment ago, the financial crisis began with mortgages and fears of foreclosures. So, naturally, the legislation directs the Secretary to use TARP funds to get mortgages refinanced. Unfortunately for the country, he has chosen not to do so, and the mortgage problem has festered and worsened.

Second, mortgage-related securities. Three main arguments were used to support the idea of buying these kinds of assets—an idea, as you will remember, that was very controversial. First, panic had virtually shut down mortgage-backed securities (MBS) markets, which had to be put back in working order to restore our mortgage finance system. Second, one of the reasons for the panic, though not the only one, was that nobody knew what these mortgage-related securities were actually worth. A functioning market would at least establish objective values. Third, and most importantly, many mortgages are tied up in complicated securitizations, so buying some of those securities would enable the government to get control of these mortgages and refinance them. In fact, that third objective was written explicitly into the law in several places, prominently in Section 109.

The third purpose is recapitalizing banks or, more precisely, the catch-all, "any other financial instrument." That was a wise addition to the Act because it gave the Secretary much-needed flexibility to respond to unforeseen circumstances. And I believe Secretary Paulson was right to decide that bolstering weak bank balance sheets was, and this is the phrase in the law, "necessary to promote financial market stability."

But this circumstance was hardly unforeseen. It makes one wonder why it wasn't written into the legislation. I would also question whether capital injections are the most appropriate, let alone the only appropriate, use of the TARP money. And I have serious questions about the details of the program, which I will come to in a moment.

So was this a case of bait and switch? Secretary Paulson has appealed to the well-known Keynesian dictum that reasonable people can change their minds when the facts change. And there is no doubt that lots of facts have changed since October 3rd.

But he has not, to my knowledge, explained what new facts invalidate the three arguments that I just gave and that were given in the congressional debate. Foreclosures are still coming en masse, and they still destroy value. The MBS markets are still in ruins.

Furthermore, there is a natural symbiosis between buying up mortgages and buying up troubled assets. Purchasing the MBS helps the government acquire the mortgages to finance, mortgages that were otherwise buried in securitizations. And refinancing mortgages to avert foreclosures should enhance the values of mortgage-backed securities.

And, by the way, each of those should also bolster the financial positions of the banks, which, of course, is the purpose of capital injections.

So I conclude that the arguments for buying both mortgages and mortgage-related securities still stand, as they did on the day Congress passed the legislation. And I think it is a shame that neither of these are being done.

But even given the decision to devote virtually all of the first $350 billion tranche of TARP money to capital injections, taxpayers might reasonably have expected a better designed program.

I would fault the Treasury's execution on at least six dimensions:

First, the program is enshrouded in too much secrecy.

Second, Secretary Paulson decided to purchase preferred stock with no voting or other control rights. So the government winds up providing money while acquiring virtually no influence over the recipient banks' behavior.

Third, taxpayers will receive only a 5 percent dividend rate on their preferred stock investments. Warren Buffet got 10 percent on a similar investment with Goldman Sachs.

Fourth, participating banks are allowed to continue to pay dividends to their shareholders, which I found amazing. It raises the spectacle of banks borrowing money—cheaply, by the way—from the taxpayers in order to maintain dividends to the common stockholders.

Fifth, contrary to many suggestions, Secretary Paulson did not require participating banks to raise private capital pari passu with the government's capital injections, which I, among many, thought would have been a good idea because it at least would have provided a valuable market test of the viability of the institutions.

Sixth, the capital injections are being made with no—I repeat, no—public purpose quid pro quo at all, such as, for example, some minimal lending requirements or maybe a pledge to refinance more mortgages.

So the question is, why make the terms so favorable to banks and, by inference, so unfavorable to taxpayers? Based on what Secretary Paulson has said, I can only presume that he wanted to ensure the widest possible bank participation by avoiding stigma. Indeed, to this end, as you know, he even forced the money on several unwilling banks at that famous October 13th meeting at the Treasury.

The CHAIRMAN. You have 1 more minute.

Mr. BLINDER. One more minute? Okay.

So, to put it mildly, the anti-stigma strategy didn't work. Within minutes, the big banks that didn't want or need the Treasury's capital made that fact known to the markets, and more banks continue to do so daily. And, of course, that is exactly what we should have expected. It is in the interest of the healthy banks to demonstrate their health by saying, "We don't need this money." But by forcing it on recipients who don't need it, the TARP is wasting what, to me, is a precious resource: taxpayer money.

So where do we go from here?

First, I think there has not been sufficient oversight over the TARP's choices and operations. That is probably nobody's fault; it is hard to get organized that fast. And I am glad to see that the congressional oversight panel is at least in sight, although not yet operating.

Second, as I said, I question whether zero allocations of funds to buying and financing mortgages and to buying MBS is really consistent with either the spirit or the letter of the law. I don't think it is.

Thirdly, despite that, one might ask whether Secretary—

The CHAIRMAN. You have to wrap it up.

Mr. BLINDER. Okay—Paulson—finish the sentence?

One might ask whether Secretary Paulson's decisions to date have actually advanced the objectives of the law better than what the law itself called for. I don't think they have.

Thank you.

[The prepared statement of Dr. Blinder can be found on page 164 of the appendix.]

The CHAIRMAN. And next, Professor Martin Feldstein, former chairman, I believe, of the Council of Economic Advisors and my classmate.

So, Dr. Feldstein?

STATEMENT OF MARTIN S. FELDSTEIN, GEORGE F. BAKER PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, AND PRESIDENT EMERITUS, NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.

Mr. FELDSTEIN. Thank you, Mr. Chairman, fellow classmate.

I am very worried about the U.S. economy. I think this financial crisis and the economic downturn are mutually reinforcing and that, without further action from the Congress, this recession is likely to be longer and more damaging than any that we have seen since the 1930's.

The fundamental cause was the underpricing of risk and the creation of excess leverage. But the primary condition that now threatens the economy is the expectation that house prices will continue to decline, leading to more defaults and foreclosures. And those foreclosures put more houses on the market, driving house prices down further.

This potential downward spiral reflects the fact that in the United States, unlike every other country in the world, home mortgages are no-recourse loans. If someone stops paying his mortgage, the creditor can take the home but cannot take other assets or look to the individual's income to make up any unpaid balance. This no-recourse feature gives individuals whose mortgages exceed the value of their homes an incentive to default and to rent until house prices stop falling.

Because the number of defaults is now rising rapidly and expected to go on increasing, financial institutions cannot value mortgage-backed securities with any confidence. That is what stops interbank lending and lending by financial institutions that cannot judge the value of their own capital.

The actions, I think, of the Federal Reserve and the FDIC have done a lot to prevent a runoff of funds from the banks and from the money market mutual funds and to maintain the commercial paper market.

In contrast, I believe that the TARP, itself, has not done anything to resolve the basic problem of the financial sector. The Treasury's original plan to buy impaired loans as a way of cleaning the bank's balance sheet simply couldn't work. Even $700 billion is not enough to deal with more than $2 trillion of negative-equity mortgages. The plan to buy impaired assets by reverse auction couldn't work because of the enormous diversity of those securities. And even if the Treasury had succeeded in removing all of the toxic assets from the banks' portfolios, that would have done nothing to stop the flow of new impaired mortgages and the fear of more such toxic assets in the future. It was good that the Treasury abandoned this asset purchase plan.

Injecting capital into selected banks is also not a way to resolve the problem and get lending going again. A bank like Citigroup has a balance sheet of $2 trillion. Injecting $25 billion of government capital does not provide a significant amount of loanable funds, nor does it give anyone confidence that Citi would have enough capital to cover any potential losses on its mortgage-backed assets. Although it does raise Citi's Tier 1 capital, that was not a binding constraint. So it was good that the Treasury abandoned the equity-infusion plan, as well.

Last week, Secretary Paulson announced that he will now concentrate on propping up credit for student loans, auto loans, and credit cards. He didn't say how that would be done. But doing so will not stop the lack of confidence caused by the expected continuing meltdown of mortgage-backed securities that is driven by the process of defaults and foreclosures.

In light of this poor record, the Treasury's announcement yesterday that it will not seek any of the remaining $350 billion of the original $700 billion TARP funding seems to me to be quite appropriate.

What needs to be done? Stopping the financial crisis and getting credit flowing again requires ending the spiral of mortgage foreclosures and the expectation of very deep further house price declines. To do that, I think, requires two separate new programs, one for homeowners with positive equity and another for homeowners with negative equity. Here, briefly, is a possible way of dealing with each of these two groups.

Consider first the problem of stopping homeowners who have positive equity from falling into negative equity as house prices decline to the pre-bubble level. Earlier this year, I suggested that the government offer all homeowners the opportunity to substitute a loan with a very attractive low interest rate but with full recourse for 20 percent of the homeowner's existing mortgage. This mortgage-replacement loan from the government would establish a firewall so that house prices would have to fall more than 20 percent before someone who now has positive equity would decline into negative equity.

The key to preventing further defaults in foreclosures among the current negative-equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other assets or a fraction of wages if the homeowner defaults, as banks and other creditors do in Canada, in Britain, and, indeed, in every other country in the world.

But the offer of a low-interest-rate loan is not enough to induce a homeowner with a substantial negative equity to forego the opportunity to default and, thus, escape his existing debt. Substituting a full-recourse loan requires the inducement of a substantial write-down in the outstanding loan balance. Creditors now do have an incentive to accept some write-down in exchange for the much greater security of a full-recourse loan.

The government could bridge the gap between the maximum write-down that the creditor would accept and the minimum write-down that the homeowner requires to give up his current right to walk away from his debt. And I described this plan in some more detail in an op-ed piece in today's Wall Street Journal that is attached to the written testimony.

If these two programs are enacted, the financial sector would be stable, and credit would again begin to flow. But while that is a necessary condition for getting the overall economy expanding again, I am afraid it is not sufficient. To achieve economic recovery, the Nation also needs a program of government spending for at least the next 2 years to offset the very large decline in consumer spending and in business investment. To be successful, it must be big, quick, and targeted at increasing production and employment.

I am, as you know, a fiscal conservative. I generally oppose increased government spending and increased fiscal deficit. But I am afraid that is now the only way to increase overall national spending and to reverse the country's economic downturn.

If these two things are done—that is, stopping the incentive to default on home mortgages and increasing government spending—I will be much more optimistic about the ability of the economy to begin expanding before the end of next year.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Feldstein can be found on page 173 of the appendix.]

The CHAIRMAN. I thank you both.

Let me ask Mr. Feldstein, the 20 percent swap, did you say that everybody now has the right to prepay? Are we clear that there are no restrictions on prepayment in anybody's mind?

Mr. FELDSTEIN. No, what I would suggest is that, if you go that route, the legislation provide that individuals have the right to prepay.

The CHAIRMAN. In abrogation of existing contracts?

Mr. FELDSTEIN. To that extent. But I can't believe that there are going to be many creditors who would find that unattractive.

The CHAIRMAN. Well, that had been a problem, but, just what you say, since individuals now have the right to prepay, and they don't. I mean, that is—

Mr. FELDSTEIN. I don't think—did I say that?

The CHAIRMAN. Did somebody else say that?

Mr. FELDSTEIN. I don't think so.

The CHAIRMAN. Yes, it is in your testimony. Well, it is not important. I am sorry; it was in the March 7th piece.

Mr. FELDSTEIN. Oh, yes. Well, I have learned some things.

The CHAIRMAN. Well, no, but it was true, in fairness, it was true that, under the HOPE NOW program, they did get a waiver of prepayment; it wasn't legally binding.

Mr. FELDSTEIN. I would say that they would have—they should be given the right to prepay.

The CHAIRMAN. What about with recourse? What does this do with second mortgages? Which has turned out to be one of our problems in trying to resolve things, is that—and I say this in the spirit of cooperation. I welcome these cooperative things. What about the second mortgage issue?

Mr. FELDSTEIN. I think that has to be done in proportion. In other words—

The CHAIRMAN. That get their share—

Mr. FELDSTEIN. —that they would share in this same thing. I would want to see—

The CHAIRMAN. And I appreciate that. I think we undercompensated them in HOPE for Homeowners. And that is one of the things that I hope will get resolved.

Mr. FELDSTEIN. Well, it is clear you are not getting the take-up in the HOPE for Homeowners—

The CHAIRMAN. Yes. In fact, one of the things I hope they would do with the TARP would be to—if we were redoing HOPE for Homeowners, we have learned some things we would do differently. Some things could be done administratively; some would require a statutory change. But if they did it out of the TARP, they could, in fact, make those changes.

But let me just get to the problem we have, which was the $156 billion figure. That is for the people underwater. That would have to be regular spending?

Mr. FELDSTEIN. Real money.

The CHAIRMAN. Yes. And one of the things we are trying to deal with, and it is helpful to have two economists who don't obviously share the same ideological position make the point, because we run into a lot of resistance with people saying, none of my tax dollars go to help people elsewhere.

Now, you do, to some extent, respond to that with offering the 20 percent repurchase to everybody, so all homeowners with this package could get some advantage. But the $156 billion at this point appears to be a large chunk.

And let me ask—and I welcome, obviously, your testimony about the need for a stimulus, and I think you talked about $300 billion. Is that in addition to the $156 billion, or would that be part of the $300 billion?

Mr. FELDSTEIN. The $300 billion, I think, is a number that, in fact, is a kind of minimal number, and it would be required not just for the coming 12 months but probably for the 12 months after that.

The CHAIRMAN. So that doesn't include the $156 billion?

Mr. FELDSTEIN. It doesn't include the $156 billion. The $156 billion is not going to have a significant stimulus impact.

The CHAIRMAN. It is prevents it from getting worse, is the issue.

Mr. FELDSTEIN. Right. And to that extent, it helps every homeowner, because it stops other home prices from being—

The CHAIRMAN. Yes, we have made that argument. It is a hard sell.

One of the things I said to Chairman Bernanke yesterday, and I will say it with all respect as a, you know, former colleague, counterfactuals buy you more in more academic discussions than they do politically. Harm avoided is rarely something on which you can run for reelection. And that affects, I am afraid, some of my colleagues.

Dr. Blinder, since you have been following this very closely, too, I know, the FDIC plan, would you modify it some?

Let me put it this way. The Secretary of the Treasury has said, in partial criticism of it, that he thinks the way it is, with us guaranteeing half of the loss if there is a redefault, that you could wind up with a fairly small benefit for some homeowner and after 6 months a disproportionately large one for the lender. A, do you think that is reasonable? And B, is it reparable, if it is?

Mr. BLINDER. It is reasonable; it is definitely reparable.

One sentence, and then let me address the question you asked more specifically. I think, at this stage, we have gone so far down the "let the foreclosures rip" road that I, for one, would be ready to board any train that is ready to leave the station. So I would certainly board the Sheila Bair train.

I think her plan could be improved. One thing I don't like about it—though this is in the context of being very favorable toward it compared to what is going on with the TARP—is that eligibility requires delinquency. Any plan that has that feature sort of incents people to stop paying their mortgages. So I would like the eligibility to depend on—

The CHAIRMAN. No, I agree with that. And let me say this. Fortunately, you know, sometimes we get into the legal habit of we have to accept it or not accept it. The TARP is so written as to give, as we are now aware, a great deal of flexibility to the Secretary. The argument that there are this or that aspect of Sheila Bair's very creative planning—she has been a very positive force here—needs modification is simply an argument to modify it. Under the TARP, they could do that. So I take that as encouragement.

And, in fact, it would be good to have two models. The HOPE for Homeowners is a principal-reduction model; the other is an interest-reduction model. And they could both be made available depending on what is appropriate, with elements of Professor Feldstein. I mean, the nice thing about the TARP, its weakness could be its strength, in that it does allow for several approaches.

The gentleman from California.

Mr. ROYCE. Thank you.

Let me ask a question of our two economists here. Because one of the occurrences that we listen to over and over again in this committee is the Federal Reserve coming up here and also Treasury Secretaries saying that there was a systemic risk to the economy because of the leveraging that was occurring in the system. And, specifically, they were identifying the leveraging, which I guess got up to about 100 to 1 at a point, with the GSEs, with Fannie Mae and Freddie Mac doing what somebody described as arbitraging, but borrowing at one rate and then—I guess they borrowed about $1 billion and then went out into the market and had $1.5 billion in these mortgage-backed securities in the portfolios.

And, as they described it, one of the consequences of this was that the financial system worldwide was relying heavily on the mortgage-backed securities and, I guess, also, the debt a lot of the banks were holding as part of their collateral, these instruments from Fannie and Freddie.

So maybe one of the things we weren't thinking about at the time was that there was also all of this leveraging going on not just in the institutions themselves—maybe that got up to 100 to 1—but also, because it was collateral for loans, there was this additional leveraging that was leveraged into the system.

And then, along the way, there was a little bit of nudging from Congress to Fannie and Freddie, in terms of the type of loans that they should be purchasing, the goals that they should have. And so, as a consequence, Alt-A loans, you know, and subprime loans, I mean, this was a place then that those who were writing those loans could get Fannie and Freddie to purchase them, as they got near the end of the year especially and needed to make that target.

And so, as they ended up buying those back into their portfolio, and that being 10 percent of the portfolio, the argument that I have seen is that 50 percent of their losses at one point were these Alt-A loans and subprime loans that they had repurchased.

And so one of the questions was: We have tried creating a charter, we have tried giving direction to a quasi-governmental entity or a private entity, however we want to define Fannie and Freddie, but might it be wiser, going forward, for us to just let market principles play out, rather than take a scheme like securitization through Fannie and Freddie and then disallow or prevent the regulator—in this case, OFHEO, because OFHEO testified here maybe a month ago or so, the Director of OFHEO. He said, if they had gotten the legislation that they wanted, which would have allowed them to regulate for systemic risk, they could have deleveraged the situation, forced more capital. And they felt that even as, you know, 16 months from today, if they could have gotten that authority, they could have deleveraged this problem and made it a lot less of a crisis for at least the GSEs. And that might have staved off—they said it would have staved off the GSE problem.

Be that as it may—that is their opinion—I had carried legislation in 2005 that the Federal Reserve had asked for to try to give them the ability to regulate for systemic risk in this way.

But that is the question I wanted to ask you gentlemen. Do you think, going forward, that perhaps we should back off of the portfolio arrangement there that we have, or the leveraging arrangement, and look at simply market principles maybe, in terms of the way that Fannie and Freddie would conduct itself in the future?

Because I can see, going out 4 years, 5 years from now as we get this thing resolved, that same dynamic occurring again as long as we have that—

Mr. FELDSTEIN. I think there is a built-in flaw in a system that provides a government guarantee, even if it is with a wink, a government guarantee for a for-profit corporation. And I think we have seen the adverse consequence of doing that.

So I would hope that gradually over time that gets wound down. The economic studies of the effects of Fannie and Freddie, in terms of helping the home mortgage market, is that it lowers the cost of mortgages by a very small amount. And so, for most individuals, the gain that comes from that is very small relative to what we now see was a major risk for the system as a whole.

So my own view is the challenge going forward is to find a way to gradually reduce the role of Fannie and Freddie.

Mr. ROYCE. Thank you, Dr. Feldstein.

Mr. BLINDER. I don't entirely agree with what Dr. Feldstein just said. So if I could just suggest something: Fannie and Freddie had their origins in the perceived need—and I don't think the perception was wrong—to create some securitizations, mortgage-backed securities and so on. In our wisdom, we the United States gave them this rather odd duck character once they got privatized. They were sort of private companies but not quite private companies.

They are now operating as nationalized industries, basically. I think that at the end of the day, once we can get out from doing that, this is a case where we need to go to one extreme or the other. One extreme is to make them public enterprises analogous to Ginnie Mae, so nobody questions that this is the government. And, by the way, that is where public purpose, low-income housing, affordable housing would naturally go. Or you go to the other extreme, which is what I think you were suggesting, sir, which is to make them just private companies.

Mr. ROYCE. They do the securitization, but they aren't leveraged 100 to 1.

Mr. BLINDER. They have no line to the Treasury, and, therefore, they could never operate with the kind of leverage that Fannie and Freddie did. They would have leverage, but not as much.

Indeed, I can well imagine that, at the end of the day, we do both. Those are two very large institutions, so that out of the ruins of those institutions comes a new government enterprise—with no ambiguity. It doesn't have shareholders to cater to. It is just a government enterprise. On the other hand, maybe more than one purely private company can also arise. A company or companies that are in the securitization business, with no line to the Treasury, no special privileges at all.

The CHAIRMAN. I think time has expired.

The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Dr. Feldstein, just one point that I wanted to get from you. You have talked about no recourse in home mortgages. But in Pennsylvania we have a dual system; you sign a mortgage, and you also sign a judgment note. And the judgment note stands for any money not covered by the mortgage. So we have a very low default rate or foreclosure rate in Pennsylvania.

Is that not common in a lot of States, that there is a judgment?

Mr. FELDSTEIN. In general, it is not. In most States it is pure no-recourse. In some States, like California, the creditor has the choice between taking the property or going after other ways of collecting, but then the property is taken out of the potential sources of funds.

So I think it is something like 75 percent of mortgages are strictly no-recourse. But the de facto practice in many other places is not to pursue the individuals.

Mr. KANJORSKI. Right. And in Pennsylvania, very seldom do I see any pursuit on the judgment—

Mr. FELDSTEIN. Well, that is also true in Europe, in Canada, and elsewhere. The fact that they can pursue it is enough to discipline individuals to not default, and that avoids the foreclosure.

Mr. KANJORSKI. Right.

Now, I am rather enamored with your proposals, to tell you the truth. What I do not understand is, this is something that will take weeks or several months to finally put in language, statutory language, and to persuade the American people and the Congress to pass something like this.

Why is it not advantageous—or is it advantageous—for us to remain in session, have these types of proposals, reduce them into legislation, so that at least with the new Presidency we are prepared from day one to be able to act, as opposed to waiting around for a blind piece of legislation to appear and then we are all forced to make an either/or selection, knowing full well there are many things we could add to the bill that would make it much more applicable to the situation?

Mr. FELDSTEIN. I think that would be a good thing. I am very worried because of the state of the economy of saying, well, let's just wait until the new President is sworn in, until he builds his team, until everybody discovers where their office is and starts working. That gets you to March, and a lot of damage gets done between now and March.

Mr. KANJORSKI. So if you had your druthers—

Mr. FELDSTEIN. I would keep you all working.

Mr. KANJORSKI. —you would recommend to the leadership that we stay in, or at least establish a committee, whether it is a special committee or whether it is this committee, to start drafting the legislation that would be in total by the time the new President takes his oath of office?

Mr. FELDSTEIN. Of course the President would want to have his input—the President-elect would want to have his input into that. But, again, I assume he is going to name his economic team within a matter of days, and so there is no reason why they couldn't start working with the Congress on this well in advance of late January.

Mr. KANJORSKI. In a way, I am sympathetic, particularly to you because I think I know your philosophical bent, and for you coming with a proposal like this and taking an argumentative position to hold that proposal, I have great admiration for that. But it does set you up with a conflict with my friend from California, who believes that the market itself should be allowed to go forward.

Why, being as free a marketeer as you are, why have you cancelled out the market really being able to resolve this problem?

Mr. FELDSTEIN. Because of the no-recourse nature of loans, the market is not working as well as it should. Because of the mistakes that were made in extending excess credit during this past decade, allowing for very high loan-to-value ratios, I think we need to have some intervention to correct these problems.

Mr. KANJORSKI. Would this require a nationalization of real estate law, basically?

Mr. FELDSTEIN. Certain features of it Congress would have to override the existing contracts and existing State rules. Again, I am not a lawyer, I don't know how broad that would have to be. Somehow I don't think these are major changes in real estate law.

But, for example, if an individual now pays down a piece of his mortgage, the typical practice is that reduces the principal but not the monthly payment, so they end up paying off their mortgage sooner. Well, my 20 percent mortgage replacement loan is intended to reduce their mortgage payments by 20 percent. So the legislation would have to provide for that.

Mr. KANJORSKI. All right. Thank you.

The CHAIRMAN. I would just say, legally, if it was a voluntary decision by a homeowner to accept the 20 percent in return for recourse, there is no problem. I do think you would have a problem, though, abrogating existing contracts unless you had mutual consent. I mean, that would be the legal thing. But substituting a recourse for nonrecourse in return for the 20 percent swap could easily be done.

Mr. FELDSTEIN. And similarly for the negative-equity group, substituting full recourse on the entire thing, again, for the reduction. That is okay for them. The question is—

The CHAIRMAN. I think you would have a hard time legally forcing it on others.

The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Blinder, you talked about, in your statement, that there had been zero purchases of the two asset classes, and it has just been capital injections into the banks. And you say, "Were I a Member of Congress, I would be pretty unhappy about this turn of events. In fact, as a taxpayer shouldering his share of the $700 billion burden, I am unhappy."

But there is still—and I don't know if you were here for the prior panels—well, one of them was a plan for the insurance, which was actually in the bill. What do you think of the insurance plan? Is this something that we should look at? Which would then—you know, the actual financial institutions would carry the burden for paying for the premiums.

Mr. BLINDER. I don't rule it out. But I thought at the time and I still think that, being a different direction and given the complexities of starting from scratch, I would rather jump on the train that is leaving the station.

However, I don't rule it out. The problem with the insurance plan that was being debated back in September—and, by the way, some insurance aspects come into a lot of these plans—was that it was too much like insuring the house after it had burned down. It is very hard to design an insurance plan for catastrophes that have already happened. But insurance is quite relevant to the ones that haven't happened yet, and probably has merit in that regard.

Indeed, a lot of these plans, such as the essence of HOPE for Homeowners, which passed this committee first and then passed the Congress back in July, was to bring in FHA insurance to close the deal. So it was, at its essence, an insurance plan. The government was becoming an insurer. So it really was a first cousin to that idea. Insurance is already in the law.

If I was able to wave a magic wand here, which, of course, I cannot, I would make some amendments to HOPE for Homeowners to broaden it and enhance the eligibility. You need money for that. And I would take that away from the TARP.

And further to your question, insurance is the essence of that.

Mrs. BIGGERT. But we did pass the FHA reform, and we did put a lot of money into the housing bill, the $300 billion. Wasn't that to help with FHA being able to raise the loan limits so that they would be able to participate in the market?

Mr. BLINDER. Yes, but Congress didn't actually put much money in it. That $300 billion was someone's estimate, it might have been the staff of this committee, of the value of the mortgages that were hoped to be refinanced. The bill was carefully crafted, as I understand—I see the chairman has left the room, but other members of the committee are here—to get the CBO scoring down to basically zero. So the official budgetary expenditure was nil.

Mrs. BIGGERT. Well, with the insurance that was talked about today and was in the bill, was really to let us know what the value of these mortgage-backed securities, what the intrinsic value is, what the true value of them is. Is this important or not?

I mean, we have not really addressed that issue. And that was really—the purchase was supposed to be the start of that, that we would know what these mortgage-backed securities were about.

Mr. FELDSTEIN. It is very important and impossible to do as long as there remains this risk of continued defaults driving foreclosures, driving house prices down further. So if you looked at an individual mortgage-backed security or even an individual mortgage, it is hard to know what that is worth if there is a risk that, at some point in the future, that is going to default. And that is what makes it so important.

Mrs. BIGGERT. But it seems like we can't solve the problem until we know what they are worth.

Mr. FELDSTEIN. No, you have to stop the bleeding first, and then the market will put prices on it.

Mr. BLINDER. But if I may interrupt, I do agree that it is important to find out what these things are worth. I may be one of three people left in America who thought the purchase of troubled assets made sense. And one of the reasons is exactly the point you are making: Get some semblance of a market going, and we might actually be able to put prices on these assets.

Mr. FELDSTEIN. I don't think so. I think—of course, the Treasury can put a price on it. It can say, I am prepared to pay "X" for mortgages, adjustable-rate mortgages in California issued in 2007, and that will be a price. But is it a price that private individuals would be prepared to trade at if they couldn't then hand it on to the government? I doubt it, I think, because they don't know whether the foreclosure rate is going double again in the next year and make those assets worth a lot less.

So I think that is the underlying problem here. We don't know what the future foreclosures are going to be.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Dr. Blinder was clear that he would, as an interim proposition, endorse the FDIC proposal. I am not sure we got on the record what Dr. Feldstein's attitude would—I am assuming it would take a while to get the political will or whatever to move to your proposal. Would the FDIC proposal be at least a reasonable step to pursue in the interim?

Mr. FELDSTEIN. Well, I tell you what I worry about with respect to the current version of the FDIC proposal. It would be very tempting for creditors to accept the terms, write down for people who are thinking about defaulting, write down the monthly mortgage payments so that they qualified, but knowing that at the end of 6 months, the individual would default and the government would pick up the—

Mr. WATT. I understand you have reservations about the way it is drafted. I am asking, as an interim proposition between what we have now, which is nothing in this area, and the proposal that you have made, would some variation of that, addressing some of the concerns that everybody has addressed, be a step in the right direction?

Mr. FELDSTEIN. Well, I guess the question is, would it be, as you said, something to do now as we move on to do other things? I think there is room for multiple things. Or would it block the political process?

Mr. WATT. And, Dr. Blinder, I am not sure you are on the record yet as whether you support the approach that Dr. Feldstein has laid out. Is that something that you would endorse?

Mr. BLINDER. I could in principle. But I come back to what I said before about trains that are leaving the station. I think it would take a long time to get from here to there.

Mr. WATT. I understand that. But you think it would be a good place to get to if we could get there?

Mr. BLINDER. Yes, certainly. If you compare it to the status quo, it is a good place to go.

Mr. WATT. Now, could either one of you distinguished gentlemen explain to me what in the world Secretary Paulson is saying when he says that dealing with this mortgage situation is not important to stabilizing the financial system?

Do you all have a clue what he is—I mean, he says this is not the purpose of what we passed. Can somebody—he couldn't explain it to me this morning. I am trying to find somebody who can explain to me what in the world he is saying.

Mr. BLINDER. I am baffled by that, frankly.

Mr. WATT. Okay. So you can't explain it.

What about you?

Mr. BLINDER. If I may, just one more sentence?

Mr. WATT. All right.

Mr. BLINDER. In preparing to come to this testimony, I scanned through the Act. And there must be 15 places or something like that in the Act—

Mr. WATT. The chairman was good at pointing those out to him, which makes it even more baffling.

Explain it to me, Dr. Feldstein.

Mr. FELDSTEIN. I am afraid I cannot.

Mr. WATT. Okay.

I don't have any further questions, and I yield back.

The CHAIRMAN. Having stumped the experts, the gentleman from North Carolina retires in triumph, and the gentleman from Alabama is recognized for 5 minutes.

Let me just say to my colleagues, they are about to start the votes. I think we will be able to get all three questions in, and then we can go over and vote in the caucus. I appreciate it.

The gentleman from Alabama.

Mr. BACHUS. Dr. Feldstein, you are opposed to taxpayer money being used to bailout or to loan to GM and Chrysler, is that correct?

Mr. FELDSTEIN. My first choice would be that they go through Chapter 11. My second choice would be that any money that is given to them be given under the kind of conditions that would make them long-term viable, which, to me, means a rewriting of the labor contracts, the fringe benefits, the retiree benefits.

Mr. BACHUS. All right. And I think if some concessions by the union, management, and maybe the pension funds, would those be the three parties that would have to—

Mr. FELDSTEIN. Exactly. And I think those—if the alternative to getting money and making those concessions was not getting money and going to a bankruptcy court, they might well be willing to make the kind of concessions that would make those companies viable.

Mr. BACHUS. And without any assurance that they would become competitively viable, any loan would actually be very risky. So I agree with you totally.

Mortgage foreclosures—let me ask you three or four things. The basic thing that I am struggling with is, mixed up with this issue of mortgage foreclosure mitigation is this idea of, "stabilizing housing prices." And I am very skeptical that the government, number one, can stabilize housing prices and, even if they could, that it would be beneficial.

Now, I understand that preventing a foreclosure—you know, a house in a neighborhood diminishes housing values. But, you know, the reason we are coming down and housing prices are coming down is, for decades, you loaned money to people about 3 times their income. And then 10 or 15 years ago, we lost our way and we started loaning 4 and 5 and 6 times as much. And then the closing costs went from 2 percent to 5 percent to sometimes 15 percent. And these were loans that they simply—I mean, they couldn't afford these properties on their income.

So is supporting housing prices even—is it realistic that—

Mr. FELDSTEIN. Housing prices have to fall further. So I don't think that government should be trying to stabilize house prices at the current level. They overshot on the way up. They have come partly down. They have to come down further.

The danger is that they can way overshoot on the way down. And that would be a bad thing. That would destroy financial institutions that are holding mortgage-backed securities. It would destroy household wealth, which, in turn, would make people cut back on their spending. That, in turn, would drag the economy down.

So the ideal thing would be to see house prices come down to a sustainable level but not overshoot on the way down. And that is why I talk about this firewall as a way of stopping house prices from falling beyond the amount that is necessary to get back to pre-bubble levels.

Mr. BACHUS. Dr. Blinder?

Mr. BLINDER. I agree with that. But one of the main arguments, to my mind almost the main argument, for pushing foreclosure mitigation is that you can avoid, or minimize anyway, fire sales of houses, which do, almost by definition, overshoot on the way down.

Mr. BACHUS. And I would agree with that. You know, I think many of us conservatives, our dilemma is that we don't believe that government ought to intervene into some of these natural processes. But at the same time, we do care about the communities, we care about the families, and we care about the fire sale and the implications for all involved. And it is a dilemma.

One thing I would like to say—and I am very glad that, Dr. Feldstein, you said, and, Dr. Blinder, I think you agreed—and I have said for the last 2 or 3 months putting a delinquency requirement in these different mortgage mitigation plans is the absolute wrong thing to do. I mean, people get delinquent. And I want to fully endorse and I applaud you for taking that stand.

Let me ask you this: What about the homeowner who is underwater? You know, the house is worth $400,000, and he has a $600,000 mortgage. Now, you know, in that case, it is best for him to walk away, is it not? I mean, isn't that why a lot of these people are walking away?

Mr. FELDSTEIN. It is certainly in his interest now to walk away. But the proposal I described in today's Wall Street Journal op-ed piece tries to address what we could do for that person.

And, basically, the idea would be to take that shortfall between what the house is worth and what he currently owes and divide that, some of it being accepted by the creditor as a write-down and some of it paid by the government to bridge the gap, but then requiring the individual to carry on with that mortgage as a full-recourse mortgage, so that they wouldn't be able to walk away from it.

The CHAIRMAN. The gentleman from Massachusetts.

Mr. BACHUS. Could he respond?

The CHAIRMAN. Quickly.

Mr. BLINDER. I was only going to say that you took an example of something that was really deeply underwater. And in cases like that, the best solution for everybody may just to be to walk away.

Most of the houses in America, thank goodness, are not that deeply underwater.

The CHAIRMAN. Thank you.

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman and the ranking member. I want to thank both of the witnesses here for your thoughtful testimony.

Dr. Blinder, I do want to say that I think it is a double-edged sword, the fact that Secretary Paulson has said he is not going to ask for the other tranche of $350 billion. Instead, he has really, to use a football term, he has punted basically, or fumbled is another football term. He is basically telling us he is not going to ask for any more money.

However, given our recent experience, I don't think we should take him at his word. Not because he doesn't mean it, but because we are having a crisis a week, and it may very well need to happen that he reaches out for more assistance.

One aspect of the problem that we are dealing with here is the fact that we have somewhere in the area of $1.5-, $2 trillion in securitization pools. These mortgages are securitized, they are bundled.

We have some very complex CDOs. There is an opacity, a lack of transparency that is really causing problems with even ascertaining what the value of some of these instruments are. To make matters worse, no one—the banks don't want to lend to each other, because nobody knows what the value of these CDOs are on each other's bank books.

Because the—actually, the CDOs, because they are not liquidating more, no one wants to buy them. It is causing the assets within them and themselves within these banks to being written down, and it is causing a capitalization problem for the banks that are holding these.

The problem for us is that we have seen some efforts so far to pluck, say, the lowest traunch, the equity traunch mortgages out of some of these CDOs. Because the way they are structured and the agreements that govern them, we have had senior traunches, or people with interest in the senior traunches, basically, stop that practice.

How do we deal with this $1- to $2 trillion of securitized mortgages? How do we get at those in order to deal with homeowners who happen to be in that unhappy position?

Mr. BLINDER. Yes, well, first let me say it is a very difficult problem, and we are not going to solve it fully.

Having said that, one of the ideas of the original conception of the TARP, as I mentioned in my testimony was to buy some of these assets, MBS, CBOs, whatever, to get control of them inside the TARP. The government then would be the controlling investor, and the government could then go in and pluck out mortgages and refinance them.

I thought that was a good idea, actually. It is not being done.

Mr. LYNCH. I don't know if you saw it this week, Gretchen Morgenson had a column about two gentleman, Thomas Patrick and Max Taylor, who have a pretty good plan to go in there. Do you have familiarity with that plan?

Mr. BLINDER. I read the article. I am not a good enough lawyer to know exactly what is the right point of attack. But the basic principle is clear, that if the government becomes the beneficial investor, it then can restructure the mortgages and wipe out the others. Now, you won't be able to do this for every single one of them, but you can do it for some.

Mr. LYNCH. Okay. Thank you both, gentlemen.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. This is for both of you. We have to go. I wanted to talk about situational conservatism, but we don't have time, Dr. Feldstein. I mean, it is always amusing that people are opposed to government involvement until they want government involvement, but that is just not what I am going to talk about now, because I don't have time.

But the question I want to ask is, do either of you find that there is something wrong with the fact that the banks are able to borrow cheap money from the government? The loan rate, the lending rate between banks is still unstable; and, at the same time, the consumers' borrowing costs seem to be rising. I mean, is there something—does that bother you, trouble you at all, particularly when you consider the fact that we are putting money into these lending institutions?

Mr. BLINDER. It does. I think that is part of the essence of the problem. The risk-free or virtually risk-free short-term interest rates are extremely low. The target Federal funds rate, as you know, is 1 percent and, in fact, the actual rate is trading at a quarter of a percent. The LIBOR has come way down, although it is not very low by historic standards.

The essence of getting out of this broader financial problem is to get the risk spreads, that intervene between the risk-free rates and the rates that real borrowers have to pay, down. That is, in some sense, the overall uber goal of the whole thing, the whole effort.

The specific issue that does bother me—you started to allude to it in your question, Congressman—is the low rate that the taxpayers are receiving on the preferred stock that it is injecting into banks. It is a bargain rate.

Mr. CLEAVER. Dr. Feldstein.

Mr. FELDSTEIN. I think what Alan said is essentially correct. The fact that mortgage rates have not come down at all, even though the Federal funds rate has come down to 1 percent, tells you how dysfunctional the credit markets are and how wide these risk spreads are. Until we get the financial institutions to a point where they are willing to buy long-term assets and take those kinds of risks, we are going to see the situation in which interest rates facing consumers are very high, despite the action by the Federal Reserve in bringing down the short-term rates.

Mr. CLEAVER. Thank you. I wish we had more time. Thank you very much. I appreciate it.

The CHAIRMAN. Witnesses, I very much appreciate this. This has been very useful. As I said, this is ongoing; and we will be doing more.

We are now, the Democrats, going to have to go vote in caucus.

In closing the hearing, the ranking member had a statement he wanted to make, and he will close out the hearing.

Mr. BACHUS. [presiding] Thank you, Mr. Chairman.

In fact, going forward—and you two gentlemen may be aware of this—as we address the foreclosure delinquencies and our foreclosures and mortgage delinquencies, that next year we will face somewhere between 250,000 and 300,000 resets of mortgage interest rates, that is, people that can pay the mortgages now but can't next year. And sometimes people hadn't factored that in, as if that was not a problem.

In the year 2010, we face approximately 700,000 of these, as I call them exploding mortgages. Of all the planning we need to do, that is something that we need to factor into our plans going forward.

I don't know if you have a comment on that as we close.

Mr. BLINDER. I think you are 100 percent right. From the get-go, when I first started writing about this problem in January, that was one of the problems on my mind and on many other people's minds. It is a prime argument for getting more of these mortgages refinanced so that the ticking time bomb doesn't actually blow up when the time comes. Yes, absolutely.

Mr. BACHUS. Dr. Feldstein?

Mr. FELDSTEIN. Yes, I agree with that.

Mr. BACHUS. It is one of the most disturbing challenges we face in going forward.

Thank you very much for your attendance. The committee is recessed—or adjourned, actually.

[Whereupon, at 3:58 p.m., the hearing was adjourned.]

A P P E N D I X

November 18, 2008

Statement by Rep. Michele Bachmann
House Financial Services Committee Hearing
"Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities; Impact on Economy and Credit Availability"

November 18, 2008

Thank you, Mr. Chairman, for convening this important hearing regarding the implementation of the Troubled Asset Relief Program (TARP). I appreciate Secretary Paulson, Chairman Bernanke, and Chairman Bair coming before our Committee today to discuss the progress of TARP, the significant changes recently announced to the underlying program and what plans are in store to begin to stabilize our financial markets.

As someone who voted against the $700 billion bailout in October, I continue to have serious reservations about the TARP and continue to believe that it is not the appropriate solution to stabilizing America's financial markets and easing the nation's credit crunch.

We were told that the primary function of the TARP would be to buy up toxic assets in the marketplace under the premise that companies would gain relief on their balance sheets, investors' confidence would be restored and our markets would be rejuvenated. We were rushed to pass far-reaching legislation that gave the Secretary of the Treasury tremendous power over our financial services sector. And, we were told that making capital infusions in financial institutions was not the best course of action. Yet today, our markets remain volatile and what was once an asset purchase program is almost entirely a capital injection program.

I am pleased that the government will no longer pursue a haphazard quest to purchase troublesome mortgage-backed securities on the taxpayers' tab -- a task I never thought our government could handle sufficiently and one that would surely be unsuccessful over the long run. From conflict of interest concerns to the long history of proof that government is inherently unable to execute such complex matters, I was unconvinced that this approach would work. It appears that the Treasury Department now agrees.

However, this rapid change of course only raises more questions. Though I understand that policymakers must be flexible at times to maximize end results, the more questions government sends into the marketplace, the longer it will take to reach recovery. Our financial system is desperate for signs of certainty, but the Treasury Department's implementation of TARP has been far from clear and consistent. I am hopeful that this hearing will serve to answer many of the questions we all still hold about the direction of the TARP.

I am also interested in hearing about the panelists' plans to implement the insurance program that was established in the Emergency Economic Stabilization Act. Intended to give value to troublesome assets by insuring them, rather than purchasing them on the backs of taxpayers, this part of the plan was something many of us could agree on but it has yet to be implemented. I look forward to hearing your comments about this issue.

Thank you, Mr. Chairman, and I yield back the balance of my time.

U.S. Congresswoman
Ginny Brown-Waite
Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Committee on Financial Services
"Oversight of Implementation of the EESA"
November 18, 2008
Statement for the Record

Thank you Mr. Chairman for holding this hearing today.

It is almost two months to the day since Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke last came before this committee to seek $700 billion to buy the toxic assets off the balance sheets of banks. Although I disagreed with the financial rescue package then and still do now, a majority of my colleagues voted in favor of the package. We are here today to review the implementation of the $700 billion authority Congress granted Treasury.

However, over the past six weeks, the financial rescue package has transformed from the original Congressional intent of the Troubled Assets Relief Program to a Capital Purchase Program. I do not doubt that the bill gave Treasury the authority to do this, but I am concerned over the duplicitous statements made in front of this committee.

For this committee and for Congress to make sound decisions, we need to be well-informed. In September, Secretary Paulson frequently denounced a capital purchase program as being unworkable and economically foolhardy. In October, with the legislation passed, Secretary Paulson announced that a capital purchase program was necessary to ensure economic prosperity.

On the face of it, Secretary Paulson's turn-around is prudent; banks can leverage a direct equity stake of $1 into $10 in assets. However, that is not happening. Instead, companies like Citibank and Bank of America are discussing using the money from Treasury for mergers and acquisitions. Such a move may be good for the company's bottom line, but it does nothing for Main Street, and that is a problem when the company is using taxpayer dollars to fund mergers not mortgages.

Even in hindsight, it is not possible to say whether Congressional hearings on a capital purchase program rather than a troubled assets relief program would have revealed such flaws, but I am certain Congress would have placed safeguards on the program to ensure proper implementation. Instead, we are here today to discuss for the first time a program that has no independent oversight and has already made over $100 billion in loans.

Mister Chairman, thank you again for holding this hearing and I look forward to hearing from the witnesses before the committee today.

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON IMPLEMENTING THE EMERGENCY ECONOMIC STABILIZATION ACT AND OTHER MARKET INTERVENTIONS

NOVEMBER 18, 2008

Mr. Chairman, the Congress took swift action last month to provide the Administration with unprecedented powers and extraordinary means to protect against a meltdown of the global financial system. Today, we will learn more about how the Administration is using these new authorities, as well as its previously existing tools, to address the problems in our markets.

Each of us has the responsibility to ask tough questions of the individuals overseeing these programs and the entities participating therein. For my part, I intend to focus on aid to American International Group. During the last two months, the government's assistance to AIG has skyrocketed from an excessive $85 billion to an astronomical $173 billion.

Because AIG is by far the biggest benefactor of the government's help, it requires special scrutiny. In this regard, I have already exchanged several letters on AIG with Chairman Bernanke. In submitting this correspondence into the record, I should note that I am displeased with the responses provided so far. Maybe today's proceedings will yield better results.

In announcing the initial loan to AIG, the Federal Reserve stated, "The interests of taxpayers are protected by key terms of the loan." I disagree. The Federal Reserve has failed to do enough. We need strong oversight of AIG's daily operations. Despite the Federal Reserve's position that "as a lender it is not in a position to review or approve all of the specific expenditures related to AIG's ongoing business" as it stated in response to my letters, the American taxpayer wants more. I want more.

This is not all about AIG and its unnecessary junkets to exotic places. It is about the bigger picture. With extraordinary power comes extraordinary responsibility. I therefore must ask our distinguished witnesses about what actions they are taking to ensure that taxpayer money is being used for the intended purposes.

After all, the overseers of our markets are now in a precarious position. They are serving as both direct regulators and indirect market participants. We must ensure that the insertion of government money at AIG neither undermines market discipline nor prevents fair competition.

The decision to provide AIG with a capital infusion from the Treasury and access to other special programs at the Federal Reserve has also sparked a split in the insurance industry about requesting government help. Several life, multi-line, and bond insurers now want capital infusions, while most property-casualty insurers oppose accessing federal funds at this time.

No matter where one sits on this issue, AIG's near collapse and the desire of other insurers to access federal aid raise legitimate concerns about regulation of the insurance industry. I believe these circumstances have demonstrated the need for more federal oversight and information in this field going forward, especially with regard to systemic risk. We will advance this regulatory debate today.

In closing, I look forward to a somber discussion of where we are and a lively debate about where we should go. These important matters demand our careful attention.

Statement by Congressman Steven C. LaTourette (R-OH)
House Committee on Financial Services
November 18, 2008

Mr. Chairman, I thank you for holding this important hearing today on Oversight of Implementation of the Emergency Economic Stabilization Act of 2008. This is an especially important hearing for the employees and shareholders of National City Bank in Cleveland, OH, who I believe have been horribly damaged by this Act.

Mr. Chairman, there is only one bank among the nation's 25 largest that was denied bailout money – National City Bank. This Civil War-era bank was one of the few that survived the Great Depression in Cleveland, yet it couldn't weather a few weeks of Treasury Secretary Paulson and his great bailout scheme. National City Bank – a Fortune 500 company and the nation's seventh largest bank for deposits – was forced into a merger at a fire-sale price by Comptroller of the Currency John Dugan, a rogue regulator with a $700 billion checkbook and no accountability.

National City was not only denied bailout funding, but its share was directed to its buyer – PNC of Pittsburgh. Mr. Chairman, this Act gives authority to the Secretary of the Treasury, not the Comptroller of the Currency or the various regulators. They should not be calling the shots and picking winners and losers, that is the sole authority of Secretary Paulson. The law specifically states under Necessary Actions: "The *Secretary* is authorized to take such actions as the *Secretary* deems necessary to carry out the authorities in this Act."

The bill never states or even implies that it is the job of Comptroller of the Currency, John Dugan. In fact, I find it interesting that the Comptroller of the Currency is mentioned just once – one time – in a more than 300-page law! The only reference is that "the Secretary shall consult with the Board, the Corporation, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the National Credit Union Administration Board, and the Secretary of Housing and Urban Development."

Mr. Chairman, I had a conversation with Neel Kashkari shortly after the acquisition of National City by PNC was announced. He was hand-picked by Secretary Paulson to administer the TARP or troubled assets program. He's from my district and grew up in the great city of Stow, OH. He's bright and a Browns fan, so I'm inclined to like him. Mr. Kashkari walked me through the process. I appreciated his candor, but I also found what he told me alarming. He made it abundantly clear that he is basing TARP decisions and awards solely on the recommendations of regulators like John Dugan. I don't know if that was the truth, buck-passing or he was hiding behind the Comptroller's skirt, but it's wrong. This isn't the "Secretary" consulting with the Comptroller of Currency; it's the Secretary carrying out the Comptroller's wishes -- lock, stock and barrel.

Congress didn't pass a $700 billion bailout bill that gave Comptroller of the Currency John Dugan any real authority, much less the authority to play God and pick winners and losers. The Comptroller has no authority to steer a "losing" bank's TARP share to a winning bank. This bill was sold as one to purchase troubled assets, not banks.

As recently as last week, Secretary Paulson stressed that TARP money is to be used for lending. How can National City expand lending when more than $3 billion in TARP money it's eligible for is given to another institution, PNC? Does anyone think more lending will be the outcome in the Cleveland area when a bank that's been around since 1845 is gobbled up with government money and ceases to exist?

This bailout bill, which I opposed, has already morphed from a troubled assets or TARP program to a Capital Purchase Program. Secretary Paulson said last week that on the day the bill was signed into law, he knew that buying up troubled assets wasn't going to work and he'd have to go to Plan B, whenever he happened to arrive at a Plan B.

This bill was supposed to calm the markets, ease the credit crisis and restore confidence. It has failed miserably on all counts. Let's end the pretense that this is a rescue bill or there's even a TARP program. In the eight weeks since Secretary Paulson first mentioned a bailout, on September 19, the DOW has dropped about 25 percent. Ask any American how their 401k is doing. Are you or the economy better off now than eight weeks ago? The answer is NO.

I am asked often by constituents if Treasury is just winging this and making it up as they go along, and how can anyone dispel that? There is not a single provision in this law that outlines the creation of a Capital Purchase Program. Today, it is not merely a part of TARP, but seems to have replaced it.

Mr. Chairman, imagine if Congress passed legislation that gave the Secretary of Health and Human Services the authority to immediately spend $700 billion to provide health care to families and the Secretary, without consulting Congress, decided he wouldn't provide health care to anyone and instead would give billions of dollars to private insurers with few strings attached. This isn't just a bait and switch; it's a wholesale disregard for law.

In addition, the bailout law REQUIRES the Secretary of Treasury to publish program guidelines within 45 days of enactment of the bill or within 45 days of the first purchase of troubled assets. Guess what? Today is the 46th calendar day since the bill was enacted. Not a single troubled asset has been bought, and it appears that not a single program guideline has been published. Now, we find out that no troubled assets will be purchased. Does that mean we move forward with essentially no rules or guidelines?

We were also promised transparency, and that perhaps is an even greater bait and switch than the promise that the money would buy up troubled assets. Treasury is not even identifying most of the institutions getting TARP money, and is leaving the announcing duties up to the recipients. I had counsel on this committee help draft a sweeping and inclusive public records request to Treasury and OCC on Oct. 30. They were given until Nov. 3 to indicate if they intended to comply and until November 10 to provide ALL records pertaining to the use of TARP money as it related to the acquisition of National City by PNC. Yesterday, Treasury sent me a letter saying it does not intend to provide a single record, and cannot compel Currency to do so. Even worse, Treasury wrote that after nearly three weeks of searching they were "unable to locate records reflecting an application by National City Bank for funding under Treasury's Capital Purchase Program." That explanation is about as plausible as "the dog ate my homework."

I would like to remind the Chairman that when I raised the possibility that Comptroller Dugan may have steered $7.7 billion in bailout money to his former client, PNC, it took less than 24 hours for him to issue a very curt, 'How dare you impugn my integrity?' response. He also was able to immediately submit a letter to the editor of the *Cleveland Plain Dealer*. Yet, when Treasury/OCC were given weeks to provide records that might shed light on how the National City-PNC unfolded, officials had little to say and no records to share. The *Wall Street Journal* reported that on Sunday, Oct. 19, Comptroller Dugan sent "a carefully worded email to National City's angry directors, saying he couldn't assure them that the company would have access to any of the government programs."

What's in that email and others that the Comptroller and Treasury refuse to release? When Mr. Dugan replied to my letter (a response he immediately released to the national media), he claimed he was "astonished" that I would make accusations about his role in the National City-PNC deal. Well, I'm astonished if Mr. Dugan and the Secretary think they can do this deal in secret when $7.7 billion of taxpayer money is in play. The American public and National City's shareholders deserve to know how winners and losers are picked, and why.

The New York Times reported November 4: "Industry sources said that banks, after filing a two-page application, are assigned a ranking from 1 to 5 — with 1 or 2 essentially guaranteeing that they are eligible, and 5 insuring they are not — by their regulator. The five officials then make what can be a life-or-death decision, with a thumbs-down generally interpreted to mean that a bank was not healthy enough to survive on its own."

My guess is that Mr. Dugan will assert that National City never received TARP money because it never technically applied for it, but it is abundantly clear that National City wanted help and was shot down every step of the way by the Comptroller's office. I am reluctant to use a Titanic reference, but Mr. Dugan has apparently decided it's his role to stand on the deck and decide who gets a life raft. Goldman Sachs, Secretary Paulson's former employer, was a bank holding company a matter of weeks; it received $10 billion from Treasury. Most of the regional banks eventually got help, too. But National City, which almost every analyst agreed had turned the corner and had weathered the sub-prime mess, was completely shut out of the process.

Mr. Chairman, I have pored through thousands of pages of SEC reports, media reports and analyst accounts of this deal. I remain deeply troubled that National City was bullied and taunted by this regulator into a quick sale. National City had a gun to its head to be sure – and that gun was the omnipresent threat from John Dugan and his office that National City should not expect any funding or help, and the clock was ticking. There was a deadline National City didn't dare cross, and that deadline was going to be an announcement on Friday, October 24, that another round of 22 banks would get bailout money and National City would not be on that list. The message was clear to National City and its board members: If you don't play along, your stock will crash and your bank will be taken over by the Feds and will cease to exist.

I wish I could tell you how National City or PNC were ranked on the bailout meter. But I cannot because Treasury has decided this must be done in a cloud of secrecy, which is a far cry from what Anthony Ryan, Acting Under Secretary for Domestic Finance, said at an October 28th conference in New York. "We are… moving with great transparency, communicating with Congress and the oversight authorities at every step." I'm not sure how he said that with a straight face, but another comment from him at the same event rings eerily true: "A program this large and complex would normally take months or years to establish. We don't have months or years and so we are moving quickly, and methodically, to facilitate the necessary results."

Was the wholesale demise of National City Bank a necessary result? Why does Citigroup, which has lost 70 percent of its stock in the past year, get $25 billion in bailout funding? Was it so they could turn around weeks later and cut 53,000 jobs? Remember, just weeks ago Citigroup was allegedly so financially robust that it planned to acquire Wachovia. Why does US Bank, whose stock has tumbled 60 percent in the year, get $15 billion? Why does PNC, whose Tier 1 Capital Ratio was 8.2 percent, get $7.7 billion? Why does National City, with Tier 1 capital at 11 percent and among the highest of the nation's largest banks, get shunned, treated like a financial leper and forced into a sale by a handful of regulators?

Mr. Chairman, I do not fault PNC in this endeavor. It seems they played by rules, but let's be clear that the rules were very advantageous to them. They will benefit tremendously from a stealth tax break that Treasury/IRS implemented on September 30 that could almost equal the purchase price of National City. They are, in effect, getting a bank with $100 billion dollars in deposits and $150 billion assets for free.

PNC will benefit tremendously from TARP money, and submitted an application for their fair share. It is not PNC's fault that regulators urged them to modify their application to also ask for National City's share. I have to imagine the folks at PNC were downright giddy when Treasury told them not to settle for $3.5 billion in TARP money when they could get $7.7 billion, including National City's share.

PNC was able to buy National City at $2.23 a share on Friday, Oct. 24th, a 19 percent discount from its $2.75 close just one day earlier. Most analysts feel National City's stock was actually worth between $4 and $5 a share.

On October 24, PNC Chair Jim Rohr held a conference call and was asked by Deutsche Bank analyst Mike Mayo if the sale of National City was "forced by the government." Rohr responded: "I don't know if it was forced by the government. You would have to ask them. It was a competitive bid last night."

Just two days before the sale, bank analyst Mike Mayo released a report on National Bank (NCC) and suggested that NCC might use the TARP program "which we will feel will benefit NCC as much as any bank." He also wrote that "National City maintained a peer leading Tier 1 ratio (11%) and a ...tangible equity ratio of 8.93%. Avg. deposits were down 3% annl. and period end balances were down slightly more, but the number of new accounts in the retail bank increases across most products and it seems deposits have increased during October."

The head of PNC has indicated he intends to keep a number of jobs in Cleveland, and I have no doubt that PNC will be a good corporate citizen. Still, the way this deal came together raises questions. PNC has indicated it had been in discussions to buy National City for nine months, yet they never did – not when National City's stock was valued at $15, $8 or even $2 a share. SEC records indicate that PNC signed a confidentiality agreement with National City on Oct. 3, the very day the bailout became law, and began formal negotiations on Oct. 5, when National City was trading at $3.51 a share.

The *Wall Street Journal* reports that PNC passed on buying National City on Oct. 12, even though National City's stock had closed the previous Friday at $2 a share. In the Friday, Oct. 17th edition of the *Pittsburgh Tribune-Review*, PNC Chair Jim Rohr is quoted as saying that PNC was "evaluating" whether to take TARP funding. In that same article, Mr. Rohr declined to discuss National City merger rumors, and said PNC would be "wary of any acquisition today." He further states that "In this environment, you have to be very careful because the economy is headed south, and you don't want to catch a falling knife." National City's stock closed at $3 on Oct. 17.

As we all know, just one week later, a merger agreement was finalized and PNC had agreed to buy National City at $2.23 a share, with the federal government gifting PNC $7.7 billion in TARP funding and up to $5.5 billion in a tax break. I guess National City was no longer considered a falling knife. It was a gift. The deal, as they say, was too good to pass up.

Mr. Chairman, I do not know whether we can un-ring this bell, or if the consequences of un-ringing it are far worse for the employees and shareholders of National City Bank, and the Northeast Ohio. What I do know is that this bailout is not working as intended, and that our government, and particularly the Comptroller of the Currency, has irreparably injured National City Bank, its employees and its shareholders, apparently just because it can.

Mr. Chairman, if you read the bill you will see that the purposes of the Act are:
(1) to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States; and

(2) to ensure that such authority and such facilities are used in a manner that--

(A) protects home values, college funds, retirement accounts, and life savings;

(B) preserves homeownership and promotes jobs and economic growth;

(C) maximizes overall returns to the taxpayers of the United States; and

(D) provides public accountability for the exercise of such authority.

What do you say to the guy in Lexington, KY, who invested in National City and lost \$109,000 from this deal – a good chunk of his retirement? Is that protecting life savings? What do you say to the National City employee who spent his career there and his 401(k) is now worth \$21,000? Is that protecting retirement accounts?

The Act is intended to promote jobs and economic growth, yet Treasury wants to vaporize one of Cleveland's largest employers; 29,000 jobs in nine states are at risk, including 8,000 jobs in Ohio. Also, are we truly maximizing returns to taxpayers by giving one bank \$7.7 billion in taxpayer money to force another one off a cliff? And as for public accountability, that is simply a sham.

Congress can insist that no future bailout money be used for mergers and acquisitions, but that does nothing to help the one merger on the table – National City and PNC. The clock is ticking. There are other banks out there – perhaps in your district – that might be strong-armed and intimidated by the Comptroller of the Currency. Mr. Chairman, any bank that is passed over for TARP money or simply fears being passed over will watch closely to what happened to National City Bank. They will also watch to see what action – if any – we take to ensure this doesn't happen again. The Treasury must give National City its share of bailout money and squash this punitive merger. We have to decide if a handful of bureaucrats led by John Dugan and other regulators -- who have no real authority under this law -- are going to be allowed to run the show and use taxpayer money to drive banks like National City out of business.

It is not what Congress intended, nor what Congress should stand for.

REMARKS OF THE HONORABLE DONALD A. MANZULLO BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

"Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on Economy and Credit Availability"

November 18, 2008 9:30AM in Room 2128 Rayburn House Office Building

Mr. Chairman, thank you for holding this important oversight hearing today. With the allocation of over 40 percent of the $700 billion financial marketplace intervention package, it is critical that the American people understand how those funds are being used. Even for Members of Congress who opposed the package, we want to make sure that the funds serve the public good.

I am concerned that the purpose of the financial package shifted from buying troubled assets – particularly mortgage-related debt – to injecting equity into financial institutions that offer consumer credit. That is one of the reasons why I twice voted against the $700 billion financial package because it gave one man – the Treasury Secretary – the authority to pick and choose "winners" and "losers" in our economic system.

The tragedy is that Congress was never given an opportunity to vote on private sector alternatives, many of which are still viable options today. In particular, I strongly urge the House leadership to accelerate the domestic manufacturing tax deduction to give our companies a cash infusion they could use to sustain and create new jobs in America.

The *American Jobs Creation and Economic Stimulus Act of 2008* (H.R. 5101), which I authored along with Representative Dan Lipinski (D-IL) earlier this year, would speed up the domestic manufacturing tax deduction to give manufacturers a larger tax break on the goods they produce in the United States. The tax deduction – which I originally helped create in 2004 – currently provides a 6 percent tax rate reduction for manufacturers on the goods and services they produce in the United States. The tax rate reduction is scheduled to increase to 9 percent by 2010. H.R. 5101 would accelerate the phase-in to 9 percent retroactively to Jan. 1, 2008.

This legislation gives our manufacturers an extra 3 percent cut in their tax rate immediately that they can use to sustain and create jobs in America. It also provides a greater incentive for our manufacturers to keep jobs in the United States and actually bring some jobs back from overseas because they would pay a 9 percent tax premium on any work they send offshore.

I also support several other free-market strategies to strengthen our economy, including:

- Allowing companies to repatriate their overseas profits back to the United States tax free for one year if the money is used to pay off distressed debt or support business expansion or job creation.
- Suspending the capital gains and recapture taxes for two years to encourage Americans to invest in America and encourage corporations to sell unwanted assets and acquire the capital they need to sustain and create jobs.
- Allowing companies to carry-back losses an additional two years, generating a tax refund and immediate capital.
- Directing the Securities and Exchange Commission (SEC) to suspend the mark-to-market regulatory rules until the agency can issue new guidelines that will allow firms to mark these assets to their true economic value.
- Reducing the corporate tax rate from 35 to 15 percent.

These policies are forward-thinking proposals that will improve the landscape for all American businesses. We can take action on these policies this week and provide immediate relief to numerous troubled industries without any more disbursements of taxpayer dollars to "rescue" certain industries and adding to our already massive federal budget deficit. Again, thank you, Mr. Chairman, for holding this hearing today.

Opening Statement Submitted for the Record
Rep. Ed Perlmutter (CO-07)

Thank you, Mr. Chairman.

The recapitalization of major financial institutions appears to have loosened credit among the major financial institutions. However, businesses both big and small have yet to see any of their credit loosened. Moreover, community and neighborhood banks have not received much in the way of credit from either the big banks or the Treasury Department.

Proposed dividends, bonuses and acquisitions by the big banks undercut the purpose of the rescue plan which is to restore the credit market and foster responsible lending among ALL financial institutions as well as to businesses and individuals throughout America, not just on Wall Street.

The funds in the Troubled Asset Relief Program (TARP) must be made available and responsibly and quickly disbursed to small banks, businesses and individuals to shore up the economy.

If credit is not made available to Mainstreet, the economy will continue to falter and all of the effort put into stabilizing the credit markets will be for naught and financial hardship on Mainstreet will grow.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

OVERSIGHT OF IMPLEMENTATION OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 AND OF GOVERNMENT LENDING AND INSURANCE FACILITIES

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

November 18, 2008
Room 2128, Rayburn House Office Building

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding recent efforts to stabilize the nation's financial markets and reduce foreclosures.

The events of the past several months are unprecedented. Conditions in the financial markets have shaken the confidence of people around the world in their financial systems. Losses in the stock markets have reduced the valuations of publicly-traded companies and have imposed losses on individual investors. Credit markets have not been functioning normally, contributing to a rising level of distress in the economy. In addition, high levels of foreclosures are contributing to downward pressure on home prices.

The impact on confidence resulting from the cumulative impact of these events has required the government to take extraordinary steps to bolster public confidence in our financial institutions and the American economy.

Achieving this goal requires a sustained and coordinated effort by government authorities. Congress passed the Emergency Economic Stabilization Act of 2008 (EESA), which provides authority for the purchase of troubled assets and direct investments in financial institutions, a mechanism for reducing home foreclosures, and a temporary increase in deposit insurance coverage. Working with our colleagues at the

Treasury Department and our fellow bank regulators, the FDIC is prepared to undertake all necessary measures to preserve confidence in insured financial institutions.

Despite what we hear about the credit crisis and the problems facing banks, the bulk of the U.S. banking industry is healthy and remains well-capitalized. What we do have, however, is a liquidity problem. This problem originally arose from uncertainty about the value of mortgage-related assets, but credit concerns have broadened over time, making banks reluctant to lend to each other or lend to consumers and businesses.

In my testimony, I will detail recent actions by the FDIC to restore confidence in insured financial institutions. I also will discuss the FDIC's continuing efforts to address the root cause of the current economic crisis – the failure to deal effectively with unaffordable loans and unnecessary foreclosures.

Recent Actions to Restore Confidence

The FDIC has taken several actions in coordination with Congress, the Treasury Department, the Federal Reserve Board, and other federal regulators, designed to restore confidence in insured financial institutions. These have included temporarily increasing deposit insurance coverage and providing guarantees to new, senior unsecured debt issued by banks, thrifts or holding companies. These measures will help banks fund their operations.

Increased Deposit Insurance

With the enactment of the EESA, deposit insurance coverage for all deposit accounts was temporarily increased to $250,000, the same amount of coverage previously provided for self-directed retirement accounts. Temporarily raising the deposit insurance limits has bolstered public confidence and successfully provided additional liquidity to FDIC-insured institutions.

The FDIC implemented the coverage increase immediately upon enactment of EESA. The FDIC website and deposit insurance calculators were updated promptly to reflect the increase in coverage and ensure that depositors understand the change. It is important to note that the increase in coverage to $250,000 is temporary and only extends through December 31, 2009. The FDIC will work closely with Congress in the coming year to ensure that consumers are fully informed of changes to the deposit insurance coverage level, as well as the temporary nature of the increase, and understand the impact on their accounts.

Temporary Liquidity Guarantee Program

On October 14, the FDIC Board of Directors approved a new Temporary Liquidity Guarantee Program (TLGP) to unlock inter-bank credit markets and restore rationality to credit spreads. This voluntary program is designed to free up funding for banks to make loans to creditworthy businesses and consumers. The Board issued an interim rule[1] and requested comments on a number of issues. Comments were due by November 13 and the Board will be reviewing those comments and considering any changes before publishing a final rule. The Board expects to adopt a final rule at its meeting scheduled for Friday this week.

The program as outlined in the interim rule has two key features. The first feature is a guarantee for new, senior unsecured debt issued by banks, thrifts, bank holding companies, and most thrift holding companies, which will help institutions fund their operations. Eligible entities include: 1) FDIC-insured depository institutions; 2) U.S. bank holding companies; 3) U.S. financial holding companies; and 4) U.S. savings and loan holding companies that either engage only in activities that are permissible for financial holding companies under section 4(k) of the Bank Holding Company Act (BHCA) or have an insured depository institution subsidiary that is the subject of an application under section 4(c)(8) of the BHCA regarding activities closely related to banking.

The guarantee applies to all senior unsecured debt issued by participating entities on or after October 14, 2008, through and including June 30, 2009. In general, issuers will be limited in the amount of guaranteed debt they raise, which may not exceed 125 percent of senior unsecured debt that was outstanding as of September 30, 2008, and scheduled to mature before June 30, 2009. For eligible debt issued on or before June 30,

[1] 73 F.R. 64179 (October 29, 2008) and 73 F.R. 66160 (November 7, 2008).

2009, coverage is only provided until the earlier of the date of maturity of the debt or June 30, 2012.

We originally announced that eligible entities would automatically participate in the FDIC's TLGP unless they opted out by November 12. The Board subsequently extended this date to December 5 in order to give banks additional time to determine how to proceed once the FDIC adopts a final rule. Participating institutions will be subject to supervisory oversight to prevent rapid growth or excessive risk-taking. The FDIC, in consultation with the entity's primary Federal regulator, will determine continued eligibility and parameters for use.

Unsecured bank funding was under extreme pressure in recent weeks, with the interest rate for short-term funding ballooning to several hundred basis points over the rate for comparable U.S. Treasury bills. Since the introduction of this program, we have seen bank funding rates moderate significantly. The new temporary FDIC guarantee has allowed banks and their holding companies to roll maturing senior debt into new issues fully backed by the FDIC.

The second feature of the new program provides insurance coverage for all deposits in non-interest-bearing transaction accounts at insured depository institutions unless they choose to opt out. These accounts are mainly payment processing accounts such as payroll accounts used by businesses. Frequently, such accounts exceed the current maximum insurance limit of $250,000. Many smaller, healthy banks had expressed concerns about deposit outflows based on market conditions.

The temporary guarantee will expire December 31, 2009, consistent with the temporary statutory increase in deposit insurance. This aspect of the program allows bank customers to conduct normal business knowing that their cash accounts are safe and sound. The guarantee has helped stabilize these accounts, and helped the FDIC avoid having to close otherwise viable banks because of large deposit withdrawals.

It is important to note that the TLGP does not rely on taxpayer funding or the Deposit Insurance Fund. Instead, both aspects of the program will be paid for by direct user fees. Coverage for both parts of the program is initially automatic. By December 5, eligible entities must inform the FDIC whether they will opt out of the guarantee program. If an entity does not opt out of the program within a timely manner, it must participate in the program. For an entity that opts out of the program by the opt-out deadline, coverage extends at no cost until the entity opts out. For an entity that remains in the program, premiums or user fees for the coverage will begin accruing as of November 13.

Under the interim rule, premiums are proposed as follows. All newly issued senior unsecured debt will be assessed an annualized fee equal to 75 basis points multiplied by the amount of debt issued under the program. This assessment will generally be at the time of issuance or shortly thereafter. For noninterest-bearing transaction deposit accounts, a 10 basis point surcharge will be applied to deposits in noninterest-bearing transaction deposit accounts not otherwise covered by the existing deposit insurance limit of $250,000. This surcharge will be added to the participating bank's existing risk-based deposit insurance premium paid on those deposits.

As noted above, the comment period on the interim rule closed on November 13 and we expect a final rule to be considered by the FDIC Board at the end of this week. We received numerous comments on several aspects of the interim rule, including the type of debt guaranteed, the types of transaction accounts guaranteed, the disclosures to be required, and the user fees. We are evaluating carefully all the comments received and may make some changes to the program when we adopt a final rule. For example, we are considering suggestions with regard to whether the debt guarantee program should cover very short term funding or whether we should have a tiered fee structure based upon the maturity of the debt guaranteed.

The TLGP is similar to actions by the international community. If the FDIC had not acted, guarantees for bank debt and increases in deposit insurance by foreign governments would have created a competitive disadvantage for U.S. banks. Along with Treasury's actions to inject more capital into the banking system, the combined coordinated measures to free up credit markets have had a stabilizing effect on bank funding.

Since these measures were implemented on October14, we have seen steady progress in reducing risk premiums in money and credit markets. Yields on short-term Treasury instruments, which had approached zero in mid-September, have now risen back in line with longer-maturity instruments. Quotes for Libor, the London Interbank Offer Rate, also have declined in relation to Treasury yields -- indicating a slow thaw in the interbank lending market. Interest rates on short-term commercial paper have fallen back to their lowest levels since mid-September, indicating that liquidity is also starting to return to that market. While it is clearly too early to declare the end of the crisis in our financial markets, as a result of the coordinated response of the Fed, the Treasury, the FDIC and our counterparts overseas, we are making steady progress in returning money and credit markets to a more normal state.

The FDIC's action in establishing the TLGP is unprecedented and necessitated by the crisis in our credit markets, which has been fed by rising risk aversion and serious concerns about the effects this will have on the real economy. The FDIC's action is authorized under the systemic risk exception of the FDIC Improvement Act of 1991. In accordance with the statute, the Secretary of the Treasury invoked the systemic risk exception after consultation with the President and upon the recommendation of the Boards of the FDIC and the Federal Reserve. The systemic risk exception gives the FDIC flexibility to provide such guarantees which are designed to avoid serious adverse effects on economic conditions or financial stability.

TARP Capital Purchase Program

As a part of EESA, the Treasury also has developed a Capital Purchase Program (CPP) which allows certain financial companies to make application for capital augmentation of up to three percent of risk weighted assets. As mentioned earlier, the federal government intervened to inject capital in banks and to guarantee a larger portion of their liabilities so they can better meet the credit needs of the economy. The ongoing financial crisis has already disrupted a number of the channels through which market-based financing is normally provided to U.S. businesses and households. Private asset-backed securitization remains virtually shut down, and the commercial paper market is now heavily dependent on credit facilities created by the Federal Reserve. In this environment, banks will need to provide a greater share of credit intermediation than in the past to support normal levels of economic activity. By contrast, a significant reduction in bank lending would be expected to have strong, negative procyclical effects on the U.S. economy that would worsen the problems of the financial sector.

Before the recent capital infusions, banks appeared to be on course to significantly reduce their supply of new credit as a response to an unusually severe combination of credit distress and financial market turmoil. Standard banking practice during previous periods of severe credit distress has been to conserve capital by curtailing lending. In the present episode, lending standards were likely to be tightened further due to higher funding costs resulting from overall financial market uncertainty. There was ample evidence in the Federal Reserve's *Senior Loan Officer Survey* in October that bank lending standards were being tightened to a degree that is unprecedented in recent history.[2]

Government intervention was essential to interrupt this self-reinforcing cycle of credit losses and reduced lending. We fully support the CPP as a means of countering the procyclical economic effects of financial sector de-leveraging. We see the TLGP as a necessary complement to this effort, and are looking at additional ways that we might structure our liquidity guarantees to enhance the incentive and capacity to lend on the part of FDIC-insured institutions.

The combined federal policy response will make capital and debt finance more readily available to banks on favorable terms. The expectation is that banks will actively seek ways to use this assistance by making sound loans to household and business borrowers. Doing so will require a balanced perspective that takes into account the long-term viability of these borrowers and the fact that they may have unusual short-term liquidity needs.

We recognize that banks will need to make adjustments to their operations, even cutting back in certain areas, to cope with recent adverse credit trends. However, the goal of providing government support is to ensure that such adjustments are made mostly in areas such as dividend policy and the management compensation, rather than in the volume of bank lending. These considerations are consistent with the precept that the highest and best use of bank capital in the present crisis is to support lending activity.

[2] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, October 2008, http://www.federalreserve.gov/boarddocs/snloansurvey/200811/

Ongoing supervisory assessments of bank earnings and capital will take into account how available capital is deployed to generate income through expanded lending.

In addition, we maintain that compensation programs must discourage excessive risk-taking and the pursuit of near-term rewards with long-term risks. Only compensation structures that create appropriate incentives for bank managers and reward long-term performance are consistent with the basic principles of safe-and-sound banking. The federal banking regulators expect that all banks will compensate their managers in ways that will encourage the type of sustainable lending that leads to long-term profitability. Bank supervisors will consider the incentives built into compensation policies when assessing the quality of bank management.

Thus far, a number of the largest banking companies in the U.S. have taken advantage of the CPP, significantly bolstering their capital base during a period of economic and financial stress. In addition, over 1,000 community financial institutions have applied to this program. We understand that Treasury will soon finalize terms of the CPP program for the great majority of banks which are not actively traded public companies, including those organized as Subchapter S corporations and mutuals.

It is critically important that community banks (commonly defined as those under $1 billion in total assets) participate in this program. Although, as a group, community banks have performed somewhat better than their larger competitors, they have not fully escaped recent economic problems.

Community banks control eleven percent of industry total assets; however, their importance is especially evident in small towns and rural communities. Of the 9,800 banking offices located in communities with populations of under 10,000, 67 percent are community banks. In these markets, the local bank is often the essential provider of banking services and credit. Their contribution to small business and agriculture lending is especially important and disproportionate to their size. As of June 30, bank lending by community banks accounted for 29 percent of small commercial and industrial loans, 40 percent of small commercial real estate loans, 77 percent of small agricultural production loans, and 75 percent of small farm land loans.[3]

Although the viability of community banks as a sector continues to be strong, the CPP offers an opportunity for individual institutions to strengthen their balance sheets and continue providing banking services and credit to their communities.

Also, last week the FDIC issued an *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* to all FDIC supervised institutions. The statement encourages financial institutions to support the lending needs of creditworthy borrowers, strengthen capital, engage in loss-mitigation strategies and foreclosure-prevention strategies with mortgage borrowers, and assess the incentive implications of compensation policies.

[3] Small commercial and industrial loans and small commercial real estate loans are in amounts under $1 million. Small agricultural production loans and small farm land loans are in amounts under $500,000.

Efforts to Reduce Unnecessary Foreclosures

Minimizing foreclosures is essential to the broader effort to stabilize global financial markets and the U.S. economy. There were an estimated 1.5 million U.S. foreclosures last year, and another 1.2 million in the first half alone of 2008. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes. While some level of home price decline is necessary to restore U.S. housing markets to equilibrium, unnecessary foreclosures perpetuate the cycle of financial distress and risk aversion, thus raising the very real possibility that home prices could overcorrect on the downside.

The continuing trend of unnecessary foreclosures imposes costs not only on borrowers and lenders, but also on entire communities and the economy as a whole. Foreclosures may result in vacant homes that may invite crime and create an appearance of market distress, diminishing the market value of other nearby properties. Foreclosures add inventory and create distressed sale prices which place downward pressure on surrounding home values. In addition, the direct costs of foreclosure include legal fees, brokers' fees, property management fees, and other holding costs that are avoided in workout scenarios. These costs can total between 20 and 40 percent of the market value of the property.[4] The FDIC has strongly encouraged loan holders and servicers to adopt systematic approaches to loan modifications that result in affordable loans that are sustainable over the long term.

[4] Capone, Jr., C. A., *Providing Alternatives to Mortgage Foreclosure: A Report to Congress*, Washington, D.C.: United States Department of Housing and Urban Development, 1996.

Over the past year and a half, the FDIC has worked with mortgage lenders, the securitization industry, servicers, consumer groups, other regulators and Congress to identify and correct barriers to solving current market problems while establishing controls to guard against their reappearance in the future.

As we all know from events over recent months, no single solution or "silver bullet" can address the adverse effects of the deficiencies that have contributed to the current market turmoil. However, as foreclosures escalate, we are clearly falling behind the curve. Much more aggressive intervention is needed if we are to curb the damage to our neighborhoods and broader economic health.

HOPE for Homeowners Act

The FDIC has been playing a role in the implementation of the HOPE for Homeowners Act. As a member of the Board of Directors of the HOPE for Homeowners Program (Oversight Board), which oversees implementation of the Act, the FDIC has joined the Departments of Housing and Urban Development (HUD) and Treasury and the Federal Reserve in establishing requirements and standards for the Program that are not otherwise specified in the legislation, and prescribing necessary regulations and guidance to implement those requirements and standards.

By working cooperatively to address the many issues necessary to achieve implementation, the Oversight Board was able to meet the October 1, 2008 statutory deadline for implementation. The final rules, as well as other guidance documents and disclosures, were posted on the Program's website on October 1, and the final rules were published in the Federal Register on October 6. Interagency staff is working on revisions to the rules to reflect amendments to the HOPE for Homeowners Act made by EESA and plans to take them to the Oversight Board in the near future. Outreach efforts to servicers, investors, housing counselors and borrowers are underway.

The statutory approach for the Program makes use of existing governmental and market structures. By modeling the proposal on existing FHA programs, the time and expense of implementing the Act were significantly reduced. The Program design incorporates certain principles that the FDIC considers necessary to be effective. In particular, it converts troubled mortgages into loans that should be sustainable over the long-term and subsequently convertible into securities. It also requires that lenders and investors accept significant discounts, protects the Federal Housing Administration (FHA) against redefault risk, and prevents borrowers from being unjustly enriched if home prices appreciate. The Program is still in the early stages of implementation. As a member of the Oversight Board, the FDIC will work to make the Program as effective as possible within the parameters of the statute. The Program has the potential to provide relief to several hundred thousand homeowners. However, given the inherent limitations in a loan-by-loan refinancing process, we believe additional measures must be undertaken to provide stronger incentives for wide-scale loan restructuring.

Emergency Economic Stabilization Act

The EESA, recently passed by Congress, provides broad authority to the Secretary of the Treasury to take action to ameliorate the growing distress in our credit and financial markets, as well as the broader economy. The EESA specifically provides the Secretary with the authority to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures. We believe that it is essential to utilize this authority to accelerate the pace of loan modifications in order to halt and reverse the rising tide of foreclosures that is imperiling the economy.

The FDIC has proposed to Treasury the creation of a guarantee program based on the FDIC's practical experience in modifying mortgages at IndyMac Federal Bank in California. We believe this program could prevent as many as 1.5 million avoidable foreclosures by the end of 2009. As outlined in more detail below, we have proposed that the government establish standards for loan modifications and provide for a defined sharing of losses on any default by modified mortgages meeting those standards. By doing so, unaffordable loans could be converted into loans that are sustainable over the long term. This proposal is authorized by the EESA and may be implemented under the authority provided to the Secretary under that statute. We have strongly advocated this type of approach to Treasury and continue to believe that it offers the best mechanism for providing appropriate protection for homeowners.

In recent months, the FDIC has demonstrated through our actions with the troubled loans owned or serviced by IndyMac Federal Bank that it is possible to implement a streamlined process to modify troubled mortgages into loans that are affordable and sustainable over the long-term. Not only can the approach used successfully at IndyMac serve as a model for the servicing and banking industry, but we believe it can provide the foundation for a loss sharing guarantee program under the EESA.

IndyMac Federal Bank Loan Modifications

As the Committee knows, the former IndyMac Bank, F.S.B., Pasadena, California, was closed July 11. The FDIC is conservator for a new institution, IndyMac Federal Bank, F.S.B. (IndyMac Federal), which continues the depository, mortgage servicing, and certain other operations of the former IndyMac Bank, F.S.B. As a result, the FDIC has inherited responsibility for servicing a pool of approximately 653,000 first lien mortgage loans, including more than 60,000 mortgage loans that are more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying. As conservator, the FDIC has the responsibility to maximize the value of the loans owned or serviced by IndyMac Federal. Like any other servicer, IndyMac Federal must comply with its contractual duties in servicing loans owned by investors. Consistent with these duties, we have implemented a loan modification program to convert as many of these distressed loans as possible into performing loans that are affordable and sustainable over the long term. In addition, we are seeking to refinance distressed mortgages through FHA programs, including FHA Secure and HOPE for Homeowners, and have sent letters proposing refinancing through FHA to more than 2,000 borrowers.

On August 20, the FDIC announced a loan modification program to systematically modify troubled residential loans for borrowers with mortgages owned or serviced by IndyMac Federal. This program modifies eligible, delinquent mortgages to achieve affordable and sustainable payments using interest rate reductions, extended amortization and, where necessary, deferring a portion of the principal. By modifying the loans to an affordable debt-to-income ratio and using this menu of options to lower borrowers' payments for the life of their loan, the program improves the value of these troubled mortgages while achieving economies of scale for servicers and stability for borrowers. Of the more than 60,000 mortgages serviced by IndyMac Federal that are more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying, approximately 40,000 are potentially eligible for our loan modification program.[5] Initially, the program was applied only to mortgages either owned by IndyMac Federal or serviced under IndyMac Federal's pre-existing securitization agreements. Subsequently, we have obtained agreements to apply the program to many delinquent loans owned by Freddie Mac, Fannie Mae, and other investors.

It is important to recognize that securitization agreements typically provide servicers with sufficient flexibility to apply the IndyMac Federal loan modification

[5] Loans not eligible for a modification proposal under the IndyMac Federal modification program include non-owner-occupied loans, loans subject to bankruptcy proceedings, completed foreclosures, and loans secured by properties held after a prior foreclosure.

approach. While some have argued that servicing agreements preclude or routinely require investor approval for loan modifications, this is not true for the vast majority of servicing agreements. In fact, the American Securitization Forum has repeatedly confirmed that most servicing agreements do allow for loan modifications for troubled mortgages that are delinquent or where default is "reasonably foreseeable" if the modification is in the best interest of securityholders as a whole.[6] If, as under the model applied at IndyMac Federal, the modification provides an improved net present value for securityholders as a whole in the securitization compared to foreclosure, the modification is permitted under the agreements as well as applicable tax and accounting standards. In fact, the agreements at IndyMac Federal were more restrictive than those that apply to many other securitizations as they limited modifications to mortgages that were "seriously delinquent" rather than permitting modification when default was "reasonably foreseeable." As a result, the model applied at IndyMac Federal can be applied broadly for securitized as well as for portfolio loans.

Using the model at IndyMac Federal to achieve mortgage payments for borrowers that are both affordable and sustainable, the distressed mortgages will be rehabilitated into performing loans and avoid unnecessary and costly foreclosures. By taking this approach, future defaults will be reduced, the value of the mortgages will improve, and servicing costs will be cut. The streamlined modification program will achieve improved recoveries on loans in default or in danger of default, and improve the return to uninsured depositors, the deposit insurance fund, and other creditors of the failed institution. At the

[6] ASF Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans, Dec. 6, 2007; ASF Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans, June 2007.

same time, many troubled borrowers can remain in their homes. Under the program, modifications are only being offered where doing so will result in an improved value for IndyMac Federal or for investors in securitized or whole loans, and where consistent with relevant servicing agreements.

Applying workout procedures for troubled loans in a failed bank scenario is something the FDIC has been doing since the 1980s. Our experience has been that performing loans yield greater returns than non-performing loans. In recent years, we have seen troubled loan portfolios yield about 32 percent of book value compared to our sales of performing loans, which have yielded over 87 percent.

Through this week, IndyMac Federal has mailed more than 23,000 loan modification proposals to borrowers, and will mail over 7,000 more in the next several days. We have contacted many thousands more in continuing efforts to help avoid unnecessary foreclosures. Already, over 5,000 borrowers have accepted the offers, verified their incomes, and are now making payments on their modified mortgages. Thousands more are making lower payments as we complete verification of incomes. I am pleased to report that these efforts have prevented many foreclosures that would have been costly to the FDIC and to investors. This has been done while providing long-term sustainable mortgage payments to borrowers who were seriously delinquent. On average, the modifications have cut each borrower's monthly payment by more than $380 or 23 percent of their monthly payment on principal and interest. Our hope is that the program we announced at IndyMac Federal will serve as a catalyst to promote more loan modifications for troubled borrowers across the country.

Loss Sharing Proposal to Promote Affordable Loan Modifications

Although foreclosures are costly to lenders, borrowers and communities, efforts to avoid unnecessary foreclosures are not keeping pace with delinquencies. By the end of 2009, more than 4.4 million non-GSE mortgages are estimated to become delinquent. While the HOPE for Homeowners refinancing program is part of the solution, the limitations inherent in refinancing mortgages out of securitization transactions indicate that other, more streamlined approaches are necessary.

A major acceleration in loan modifications is essential if we are to stem the growing flood of foreclosures. Yet today, only around 4 percent of seriously delinquent loans are being modified each month. While the FDIC's experience at IndyMac demonstrates that modifications provide a better return than foreclosure in the vast majority of mortgages today, many servicers continue to rely on slower custom modifications that are not focused on long-term affordability. Many servicers continue to argue that they are concerned about proving to investors that modifications provide a better return than foreclosure. As a result, far too many of the responses to troubled mortgages have focused on repayment plans, temporary forbearance, or short-term modifications often based on verbal financial information.

Today, the stakes are too high to rely exclusively on industry commitments to apply more streamlined loan modification protocols. The damage to borrowers, our communities, our public finances, and our financial institutions is already too severe. An effective remedy requires targeted, prudent incentives to servicers that will achieve sustainable modifications by controlling the key risk from the prior, less sustainable modifications – the losses on redefault. The FDIC's loss sharing proposal addresses this risk directly by providing that the government will share up to 50 percent of the losses with lenders or investors if a mortgage -- modified under the sustainable guidelines used at IndyMac Federal -- later redefaults. With the government sharing the risk of future redefaults, we propose to reduce this risk even further by modifying the mortgages to an even more affordable 31 percent ratio of first mortgage debt to gross income. By controlling this risk, the greater net present value of many more modifications compared to foreclosure will be clear.

Over the next two years, an estimated 4 to 5 million mortgage loans will enter foreclosure if nothing is done. We believe that this program has the potential to reduce the number of foreclosures by up to 1.5 million, thereby helping to reduce the overhang of excess vacant homes that is driving down U.S. home prices. In addition, this approach keeps modified mortgages within existing securitization transactions, does not require approval by second lienholders, ensures that lenders and investors retain some risk of loss, and protects servicers from the putative risks of litigation by providing a clear benefit from the modifications.

The program, limited to loans secured by owner-occupied homes, would have a government loss-sharing component available only after the borrower has made six payments on the modified mortgage. Some of the other features of the proposal include:

- Standard Net Present Value (NPV) Test – In order to promote consistency and simplicity in implementation and audit, a standard test comparing the expected NPV of modifying past due loans compared to foreclosure will be applied. Under this NPV test, standard assumptions will be used to ensure that a consistent standard of affordability is provided based on a 31 percent borrower mortgage debt-to-income ratio.
- Systematic Loan Review by Participating Servicers – Participating servicers would be required to undertake a systematic review of all of the loans under their management, to subject each loan to a standard NPV test to determine whether it is a suitable candidate for modification, and to modify all loans that pass this test.
- Reduced Loss Share Percentage for "Underwater Loans" – For loan-to-value ratios (LTVs) above 100 percent, the government loss share will be progressively reduced from 50 percent to 20 percent as the current LTV rises. If the LTV for the first lien exceeds 150 percent, no loss sharing would be provided.
- Simplified Loss Share Calculation – In general terms, the calculation would be based on the difference between the net present value of the modified loan and the amount of recoveries obtained in a disposition by

refinancing, short sale or REO sale, net of disposal costs as estimated according to industry standards. Interim modifications would be allowed.

- *De minimis* Test – To lower administrative costs, a *de minimis* test excludes from loss sharing any modification that did not lower the monthly payment at least 10 percent.
- Eight-year Limit on Loss Sharing Payments – The loss sharing guarantee ends eight years after the modification.

Assuming a re-default rate of 33 percent, our plan could reduce the number of foreclosures initiated between now and year-end 2009 by some 1.5 million at a projected program cost of $24.4 billion.

This proposal efficiently uses federal money to achieve an objective that is critical to our economic recovery – stability in our mortgage and housing markets. Mortgage loan modifications have been an area of intense interest and discussion for more than a year now. Meanwhile, despite the many programs introduced to address the problem, the problem continues to get worse. During the second quarter of this year, we saw new mortgage loans becoming 60 days or more past due at a rate of more that 700,000 per quarter – net of past due loans that returned to current status. No one can dispute that this remains the fundamental source of uncertainty for our financial markets and the key sector of weakness for our economy. We must decisively address the mortgage problem as part of our wider strategy to restore confidence and stability to our economy.

While the proposed FDIC program would require a cash outlay in the event of default, we must consider the returns this guarantee would deliver in terms of our housing markets and, by extension, the economic well-being of our communities. While we support the various initiatives taken to date, if we are to achieve stability in our credit and financial markets we cannot simply provide funds to market participants. We must address the root cause of the financial crisis – too many unaffordable mortgages creating too many delinquencies and foreclosures. The time is overdue for us to invest in our homes and communities by adopting a program that will prudently achieve large-scale loan modifications to minimize the impact of foreclosures on households, lenders and local housing markets.

Conclusion

The FDIC has engaged in unprecedented actions to maintain confidence and stability in the banking system. Although some of these steps have been quite broad, we believe that they were necessary to avoid consequences that could have resulted in sustained and significant harm to the economy. The FDIC remains committed to achieving what has been our core mission for the past 75 years – protecting depositors and maintaining public confidence in the financial system.

I will be pleased to answer any questions the Committee might have.

STATEMENT
of
THE HONORABLE STEVE BARTLETT
PRESIDENT AND CEO
THE FINANCIAL SERVICES ROUNDTABLE

Before the
HOUSE FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

OVERSIGHT OF IMPLEMENTATION OF THE
EMERGENCY ECONOMIC STABILIZATION ACT OF 2008
AND GOVERNMENT LENDING AND INSURANCE FACILITIES;
IMPACT ON THE ECONOMY AND CREDIT AVAILABILITY

NOVEMBER 18, 2008

Mr. Chairman, Ranking Member Bachus, and members of the Committee, I am Steve Bartlett, the President and Chief Executive Officer of the Financial Services Roundtable ("Roundtable").

The Roundtable is a trade association for the nation's largest financial services firms. Our members provide banking, insurance, securities and other financial products and services to millions of individual consumers and businesses throughout the United States.

On behalf of the member companies of the Roundtable, I appreciate the opportunity to address the implementation of the Emergency Economic Stabilization Act of 2008 ("EESA"), and the impact of that Act and other government lending and insurance programs on the economy and credit availability.

Congress and the Administration Have Taken Extraordinary Actions

The EESA was an unprecedented intervention by the Congress and the Administration to restore liquidity and stability to the U.S. financial system, and thereby promote economic growth. EESA gave the Treasury Department ("Treasury") extraordinary authority not only to purchase or guarantee mortgage related assets held by financial institutions, but also to purchase other financial instruments from financial institutions. EESA also increased, temporarily, the level of deposit insurance from $100,000 to $250,000 per depositor.

In the six weeks since the enactment of the EESA, Treasury has moved rapidly to implement the Act. It sought public comment on key features of the Act, such as the asset guarantee program, and it retained legal, accounting and other experts to help manage the programs authorized by the Act. Most significantly, it used its authority to purchase financial instruments from financial institutions to inject capital into the financial system. Treasury also modified section 382 of the Internal Revenue Code, a tax provision that was a long-standing impediment to healthy companies' abilities to acquire failing ones. We encouraged lawmakers to consider options that both protect that taxpayer and ensure continued depositor and consumer confidence in the financial system. Changing Section 382 achieves both of these goals.

At the same time, Treasury and the federal banking agencies have made use of pre-existing authorities to take a number of other actions to stabilize financial markets. The Federal Reserve Board established a liquidity facility for commercial paper, using its long-standing, but rarely used, power to support any company in "unusual and exigent" circumstances. The Federal Deposit Insurance Corporation ("FDIC") used, for the first time, its "systemic risk" authority to guarantee senior, unsecured debt issued by depository institutions and their holding companies. The new Federal Housing Finance Agency used powers granted in the Housing and Economic Recovery Act of 2008, ("HERA") to place Fannie Mae and Freddie Mac into conservatorship, and Treasury provided equity and liquidity support to these Government-Sponsored Enterprises ("GSEs") to help stabilize mortgage markets.

Collectively, these actions have started to thaw frozen credit markets, and limited the scope of the financial crisis. We have seen a decline in key interest rates, such as the London Interbank Offered Rate ("LIBOR"), which is linked to many consumer and business loans.

Mortgage interest rates have stabilized, although they remain at a very high level. The run on money market funds and individual banks has stopped. In sum, we are making progress.

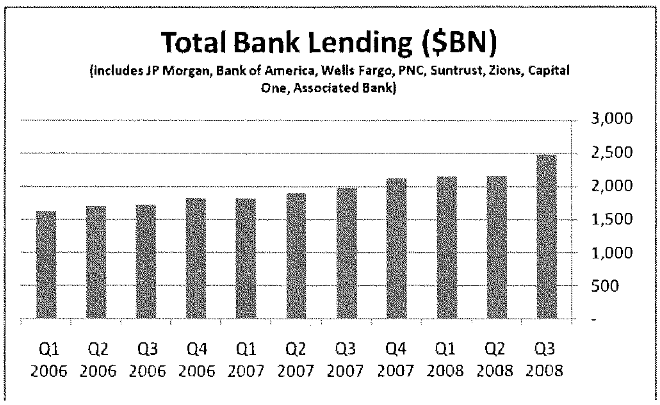
The Capital Purchase Program

During the consideration of EESA, it was widely anticipated that Treasury initially would use the EESA to purchase distressed mortgage-related assets held by financial institutions. Asset purchases were intended to permit financial institutions to focus on new lending, not problem assets. As we now know, Treasury decided to pursue a different course.

Treasury initiated a Capital Purchase Program ("CPP") to inject capital into financial institutions. The stated goal of the CPP is to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. The injection of $250 billion in capital into our financial system should have this effect. Capital infusions will enable institutions to fund credit to good credit risks. Capital infusions also will enhance lending indirectly by permitting stronger institutions to acquire weaker institutions. Dollar for dollar, capital injections will have a greater overall impact on lending activity than the purchase of distressed assets because financial institutions will be able to leverage capital with other sources of funds.

It is too early to fully assess the impact of CPP. While some institutions have received capital injections, the deadline for publicly-traded financial institutions to participate in the program was just last Friday. Additionally, Treasury has yet to announce the procedures and filing deadlines for non-public financial institutions.

Nonetheless, as credit markets continue to unfreeze, our members will continue to lend to qualified buyers. Our analysis of lending data indicates that banks are extending credit, and actually are increasing credit to qualified buyers – those with good credit risks. The following table, which is based upon 10Q filings, illustrates the historical levels of lending by several money center and regional banks. The chart shows that lending by these institutions has increased, including the third quarter of this year.



Additionally, we have conducted verbal interviews with loan officers regarding lending activities within the last 3 months, several conclusions can be drawn from these interviews: First, well-capitalized banks continue to make commercial loans to qualified customers based on demand. Second, lenders have not changed underwriting standards for business loans. Therefore, customers with good credit that meet these underwriting standards will continue to have no difficulty in getting loans. Third, strong banks are picking up loans from lenders that are not as well-capitalized. Access to CPP funds, as well as other programs instituted by the

Administration, will help lower the cost of credit and essentially, will increase access to capital for qualified borrowers.

Finally, we should not lose sight of the fact that loan demand is being affected by the general state of the economy. As the economy slows, many companies are reducing, not increasing, their demand for new credit. Regardless of the increase in commercial lending to qualified borrowers, deteriorating economic conditions continue to add stress to the market.

Mortgage Markets Remain Under Stress

While the actions taken by Congress and the Administration have done much to stabilize financial markets, the nation's mortgage markets remain under considerable stress. Mortgage interest rates have stabilized, but remain at unacceptably high levels. Until we see an appreciable reduction in these rates, housing will continue to be a significant drag on the economy.

In the past few weeks, the mortgage markets entered a new and potentially more dangerous stage. Traditional purchasers of mortgage securities and GSEs debt have curtailed their normal purchases of such assets. This decline in the demand for mortgage securities and GSE debt is forestalling a decline in mortgage interest rates.

Throughout the first half of this year, all institutional investors (foreign-institutions, GSEs, domestic banks, asset managers and hedge funds) purchased an average of $54 billion in mortgage backed securities ("MBS") per month. Since August, however, we have seen a reversal in the demand for MBS. These investors sold approximately $40 billion in MBS in August.

Moreover, the spread on GSE debt in relation to Treasury obligations remains at record highs, and most asset managers are not purchasing GSE debt with maturities greater than one year.

This turnaround in the demand for MBS and GSE debt is due, in part, to the global de-leveraging that is underway. However, it also is an unintended consequence of policy actions taken by Congress and the Administration. Markets are confused by the extent of federal support for the GSEs beyond December 31, 2009. That is the end date for the purchase of unlimited GSE debt and equity by Treasury under the terms of HERA. Additionally, the FDIC's recent guarantee program for senior, unsecured bank and holding company debt caused investors to view those obligations as more secure than GSE debt. Last week, I asked a senior trader for a large bank why GSE debt is trading so high in comparison to Treasury bills, he said that "despite the government assurances thus far, many investors remain concerned about the credit of the GSEs and the ambiguity about whether the long-term debt of the GSEs is actually guaranteed."

The solution to this problem is two-fold. First, Treasury should eliminate market confusion over the scope of its support for the GSEs by explicitly guaranteeing GSE debt in a manner identical to the FDIC support for bank debt. Treasury could do so by expanding its contractual commitment to provide capital support beyond the $100 billion it already has pledged to support the GSEs. Also, Treasury reportedly has interpreted HERA to permit it to support the GSEs beyond the December 31, 2009 date. If so, Treasury should release a legal opinion to that effect. These actions would help to convince investors that GSE debt is supported by the federal government, and that would allow spreads to return closer to historical levels.

Second, Treasury should reverse the falling demand for MBS and GSE debt by using its existing authority under HERA to purchase MBS issued or guaranteed by the GSEs. Reportedly, Treasury has made some purchases, but we recommend that it do so on a more systematic and public basis. Treasury, in conjunction with the FHFA, should direct the GSEs to issue new debt, and should then purchase the amount of loss previously discussed (at least $15 to $20 billion) in MBS per month until mortgage markets return to normal. These purchases should be steady and transparent. This will help to reduce volatility in the markets as well.

Combined, we believe these actions, which are within the control of Treasury, would reduce the rate on 30-year fixed rate mortgages to at least 5.50%. At that level, a substantial portion of homeowners could refinance into lower monthly payments freeing up cash to spend on goods and services, thereby providing needed stimulus to the economy. We should see an upturn in the demand for new home purchases as mortgage financing becomes more affordable and this, in turn, should reduce downward pressures on home prices.

Mortgage Foreclosures

The rate of mortgage foreclosures is a continuing concern. The Roundtable and its member companies are devoting significant resources to helping homeowners avoid foreclosure. Individual companies have aggressive programs to assist their mortgage customers and several major lenders have recently announced new efforts. In addition, Roundtable member companies were instrumental in the creation of the HOPE NOW Alliance, through which lenders are modifying approximately 100,000 mortgages a month. HOPE NOW also was involved in the development of the streamlined loan modification program announced last week by the Federal

Housing Finance Agency, the GSEs and Treasury. That streamlined modification framework is designed to accelerate the structuring of modified mortgages that the highest risk homeowners can afford and could help hundreds of thousands of at-risk homeowners avoid foreclosure.

There are also proposals to utilize TARP funds to guarantee additional mortgage modifications. Additional assistance to advance broad-based streamlined loan modifications should be considered. However, we would urge that these proposals be carefully considered to assist those homeowners most in need, to minimize incentives for others to default and to ensure new programs work in conjunction with the efforts now underway. In addition to discussion of a new government guaranteed loan modification program, we urge that the FHA Secure program be continued in 2009 and that adjustments be made to the Hope for Homeowners program to maximize its effectiveness.

Additional Policy Actions

The Roundtable believes that Congress and the Administration should take some additional actions to accelerate our return to economic growth and job creation.

Expand the Capital Purchase Program

To further stimulate lending and investment, Treasury should permit other financial institutions to participate in the CPP. To date, the Treasury has permitted only insured banks and thrifts and their holding companies and insurance companies within the thrift and bank holding company regulatory structure to participate in this program. Other financial institutions perform equally important roles in supporting and stabilizing the economy, including life insurance firms and consumer finance companies, and the EESA authorizes assistance to all financial institutions. Some financial institutions, such as property and casualty insurers have decided not to participate in the CPP. That is an appropriate decision for those companies.

Private mortgage insurance companies, for example, are essential to restoring mortgage lending to the hundreds of thousands of creditworthy borrowers who cannot afford a 20 percent cash down payment, but who are otherwise well qualified to purchase and finance a home. A variety of steps are needed to return stability and the availability of credit to the housing market. Life insurance companies are a major provider of mortgage funds, and consumer lending companies are a critical component for our consumer industries.

Moreover, CPP should be available to foreign-owned financial institutions that have a significant operation in the United States. The U.S. customers of those institutions should be able to benefit from the program. While we understand the public policy arguments of not including foreign-owned institutions, there are many foreign-owned institutions that are "controlled" by their U.S. subsidiaries. Additionally, foreign-owned institutions play a significant role in the U.S. market. For example, foreign-owned life insurance companies comprise approximately 25% of the life insurance market in the U.S.

Treasury has the statutory authority to extend the program to all types of financial institutions, including foreign-owned financial institutions with significant operations in the U.S., and it should do so, in the context of addressing financial services stability and U.S.

competitiveness in global markets. A letter we submitted to the Treasury Department on this matter can be found at:

http://www.fsround.org/policy/pstatements/pdfs/RoundtableLetter_treasurycapitalprogram_final.pdf.

Implement the Asset Guarantee Program

The Treasury Department should move forward expeditiously with the EESA authorized asset guarantee program. This program is an ideal complement to the on-going CPP and would go a long ways toward helping stimulate additional lending. It would permit financial institutions to obtain, for a premium, a federal guarantee for both loans and securities. Such guarantees would help maintain these assets until markets stabilize. Moreover, if it is priced properly, this program should operate at no cost to the taxpayers. The Roundtable's letter to the Treasury on how best to implement this program can be found at:

http://www.fsround.org/policy/regulatory/pdfs/RoundtableLetter_guaranteeprogram_final.pdf.

Expedite Holding Company Applications

The Federal Reserve Board and the Office of Thrift Supervision, in cooperation with the other federal banking agencies, should establish uniform procedures for expediting holding company applications for institutions that seek such status. The Board has shown that it is able to do so for some of the nation's largest financial firms. All financial firms, regardless of size, should be afforded similar treatment.

Fix Fair Value Accounting

Fair value accounting is broken and needs to be fixed. The most recent announcement by the Securities & Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") has relieved the pressure on some institutions, but even that announcement is being interpreted differently by different auditing firms. The Roundtable recommends: (1) the creation of a new sub-category under the fair value hierarchy that will aid in the valuing of long-term, non-trading assets in an inactive market, and (2) clearer guidance from the SEC, FASB, and the Public Company Accounting Oversight Board on the use of judgment when determining a value under FAS 157.

Additionally, FASB should consider other than temporary impairment rules that are consistent with those of the International Financial Reporting Standards. Our submission to the SEC, in response to the fair value assessment mandated by EESA can be found at: http://www.fsround.org/policy/regulatory/pdfs/Roundtablecomments_SEC_FVAstudy_final.pdf.

Create a Market Stability Regulator

We need a market stability regulator. No single agency or entity is officially empowered to monitor all markets and all financial services firms, and raise a red flag when practices or policies need to be adjusted or modified to minimize systemic risk. The Treasury and the Federal Reserve Board have done an outstanding job in the current crisis, given current authorities. However, going forward, Congress should empower some agency or authority to keep abreast of market developments, and help foresee, and forestall, a repeat of this crisis.

Optional Federal Charter for Insurance

There is a need for federal insurance supervision that will strengthen the oversight of insurance markets and potential insurance risks by authorizing optional federal chartering and supervision of firms engaged in the business of insurance. Numerous state regulators focused on different areas of insurance – without any common principles – or any coordination create further instability in the market. We support a federal charter for insurance companies that do interstate business. The state by state regulation of national insurance products is the last vestige of the 19th Century regulation --- it is now time to move to the 21st Century.

Summary

In summary, the actions taken by the Congress and the Administration to date have helped to thaw the credit markets. Those borrowers with good credit continue to have access to loans at reasonable terms, but it will take some time for actions taken by the Congress and the Administration to filter throughout the economy. The cost of mortgage credit is a continuing, and serious concern. If mortgage interest rates do not come down, housing will continue to be a drag on our economy. Congress has given Treasury the tools to address this issue in HERA, which was passed earlier this year. We urge Treasury to use these tools. Finally, the Roundtable believes that Congress and the Administration should take some additional actions to accelerate economic growth and job creation, such as expand the CPP, implement the asset guarantee program, expedite bank holding company applications, fix fair value accounting, create a market stability regulator, and create an optional federal charter for insurance companies that do interstate business.

For release on delivery
9:30 a.m. EST
November 18, 2008

Statement by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

November 18, 2008

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate having this opportunity to review some of the activities to date of the Treasury's Troubled Asset Relief Program, or TARP, and to discuss recent steps taken by the Federal Reserve and other agencies to support the normalization of credit markets.

The legislation that created the TARP put in place a Financial Stability Oversight Board to review the actions of the Treasury in administering the program. That Oversight Board includes the Secretary of the Treasury, the Secretary of Housing and Urban Development, the Chairman of the Securities and Exchange Commission, the Director of the Federal Housing Finance Agency, and the Chairman of the Federal Reserve Board. We have met four times, reviewing the operational plans and policy initiatives of the TARP and discussing possible additional steps that might be taken. Officers for the Oversight Board have been appointed, and the Federal Reserve and the other agencies are providing staff support for the board. Minutes of each meeting are being posted to a special website established by the Treasury.[1] In addition, staff members of the agencies whose heads are participating in the Oversight Board have met with staff from the Government Accountability Office to explore strategies for coordinating the oversight that the two bodies are required to perform under the enabling legislation.

The value of the TARP in promoting financial stability has already been demonstrated. The financial crisis intensified greatly in the latter part of September and spread to many countries that had not yet been touched by it, which led to grave concerns about the stability of the global financial system. Failure to prevent an international financial collapse would almost certainly have had dire implications for both the U.S. and world economies. Fortunately, the existence of the TARP allowed the Treasury to react quickly by announcing a plan to inject

[1] See U.S. Department of the Treasury, Emergency Economic Stabilization Act website, www.ustreas.gov/initiatives/eesa.

$250 billion in capital into U.S. financial institutions. Nine large institutions received the first $125 billion, and the remainder is being made available to other banking organizations through an application process. In addition, the Federal Deposit Insurance Corporation announced that it would guarantee non-interest-bearing transaction accounts at depository institutions and certain other liabilities of depository institutions and their holding companies, and the Federal Reserve expanded its provision of backstop liquidity to the financial system. These actions, together with similar measures in many other countries, appeared to stabilize the situation and to improve investor confidence in financial firms. Notably, spreads on credit default swaps for large U.S. banking organizations, which had widened substantially over the previous few weeks, declined sharply on the day of the joint announcement. Going forward, the ability of the Treasury to use the TARP to inject capital into financial institutions and to take other steps to stabilize the financial system--including any actions that might be needed to prevent the disorderly failure of a systemically important financial institution--will be critical for restoring confidence and promoting the return of credit markets to more normal functioning.

As I noted earlier, the Federal Reserve has taken a range of policy actions to provide liquidity to the financial system and thus promote the extension of credit to households and businesses. Our recent actions have focused on the market for commercial paper, which is an important source of short-term financing for many financial and nonfinancial firms.

Normally, money market mutual funds are major lenders in the commercial paper markets. However, in mid-September, a large fund suffered losses and heavy redemptions, causing it to suspend further redemptions and then close. In the next few weeks, investors withdrew almost $500 billion from prime money market funds. The funds, concerned about their ability to meet further redemptions, began to reduce their purchases of commercial paper and limit the maturity of such paper to only overnight or other very short maturities. As a result, interest rate spreads paid by issuers on longer-maturity commercial paper widened significantly, and issuers were exposed to the costs and risks of having to roll over increasingly large amounts of paper each day.

The Federal Reserve has developed three programs to address these problems. The first allows money market mutual funds to sell asset-backed commercial paper to banking organizations, which are then permitted to borrow against the paper on a non-recourse basis from the Federal Reserve Bank of Boston. Usage of that facility peaked at around $150 billion. The facility contributed importantly to the ability of money funds to meet redemption pressures when they were most intense and remains available as a backstop should such pressures reemerge.

The second program involves the funding of a special-purpose vehicle that purchases highly rated commercial paper issued by financial and nonfinancial businesses at a term of three months. This facility has purchased about $250 billion of commercial paper, allowing many firms to extend significant amounts of funding into next year.

A third facility, expected to be operational next week, will provide a liquidity backstop directly to money market mutual funds. This facility is intended to give funds confidence to extend significantly the maturities of their investments and reduce over time the reliance of issuers on sales to the Federal Reserve's special-purpose vehicle. All of these programs, which were created under section 13(3) of the Federal Reserve Act, must be terminated when conditions in financial markets are determined by the Federal Reserve to no longer be unusual and exigent.

The primary objective of these and other actions we have taken is to stabilize credit markets and to improve the access to credit of businesses and households. There are some signs that credit markets, while still quite strained, are improving. Interbank short-term funding rates have fallen notably since mid-October, and we are seeing greater stability in money market mutual funds and in the commercial paper market. Interest rates on higher-rated bonds issued by corporations and municipalities have fallen somewhat, and bond issuance for these entities rose a bit in recent weeks. The ongoing capital injections under the TARP are continuing to bring stability to the banking system and have reduced some of the pressure on banks to deleverage, two critical first steps toward restarting flows of new credit. However, overall, credit conditions are still far from normal, with risk spreads remaining very elevated and banks reporting that they continued to tighten lending standards through October. There has been little or no bond issuance by lower-rated corporations or securitization of consumer loans in recent weeks.

To help address the tightness of credit, on November 12 the federal banking agencies issued a joint statement on meeting the needs of creditworthy borrowers. The statement took note of the recent strong policy actions designed to promote financial stability and improve banks' access to capital and funding. In light of those actions, which have increased the capacity of banks to lend, it is imperative that all banking organizations and their regulators work together to ensure that the needs of creditworthy borrowers are met in a manner consistent with safety and soundness. As capital adequacy is critical in determining a banking organization's ability and willingness to lend, the joint statement emphasizes the need for careful capital planning, including setting appropriate dividend policies. The statement also notes the agencies' expectation that banking organizations should work with existing borrowers to avoid preventable foreclosures, which can be costly to all involved--the borrower, the lender, and the communities in which they are located. Steps that should be taken in this area include ensuring adequate funding and staffing of mortgage servicing operations and adopting systematic, proactive, and streamlined mortgage loan modification protocols aimed at providing long-term sustainability for borrowers. Finally, the agencies expect banking organizations to conduct regular reviews of their management compensation policies to ensure that they encourage prudent lending and discourage excessive risk-taking.

Thank you. I would be pleased to take your questions.

INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

Cynthia Blankenship
Vice Chairman/COO, Bank of the West

On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Financial Services

Hearing on

"Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on Economy and Credit Availability"

November 18, 2008
Washington, DC

Chairman Frank, Ranking Member Bachus, Members of the Committee. My name is Cynthia Blankenship, and I am the Chief Operating Officer and Vice Chairman of Bank of the West in Irving, TX, and the Chairman of the Independent Community Bankers of America (ICBA). Bank of the West is a state-chartered bank with $250 million in assets and is part of a two-bank holding company. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on "Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Issues: Impact on Economy and Credit Availability."

Summary

Troubled Asset Relief Program

ICBA commends the efforts of the Congress, Treasury, the Federal Reserve and the FDIC to address the current economic crisis. This is a formidable task.

However, ICBA has significant concerns with the pace of implementation of the Troubled Asset Relief Program's Capital Purchase Program (CPP). The term sheet released by the Treasury several weeks ago for large publicly traded banks will just not work for the many privately held banks, thinly traded banks, Subchapter S banks and mutual institutions because of statutory constraints and organizational structures peculiar to each of these types of institutions. ICBA and others have provided Treasury concrete suggestions to overcome the obstacles for these smaller banks. We believe we have had a constructive dialogue with Treasury about these issues, and that Treasury is working in good faith to produce term sheets that will work for each of these types of institutions.

ICBA members are growing increasingly concerned, however, that only $60 billion is left uncommitted from the $250 billion Capital Purchase Program and still more than 6,000 financial institutions cannot qualify for the CPP under the initial public term sheet. There are more than 8,000 community banks nationwide, and they are well-positioned to extend lending to their communities using capital from the Capital Purchase Program. Including these banks in the Capital Purchase Program will stimulate additional lending in local communities throughout the country.

Banks nationwide interested in expanding lending through the Capital Purchase Program are rightly concerned about a provision in the CPP agreement that will allow the government to retroactively change any of the contract terms of the established Securities Purchase Agreement should there be a change to a federal statute. ICBA suggests this provision be modified to say that only future changes to federal law that apply to all financial institutions, not those changes directed solely at institutions participating in the CPP program, could be incorporated retroactively into the agreement. This would ameliorate the concern of community banks that significant terms of the agreement could be retroactively changed.

FDIC Temporary Liquidity Guarantee Program

ICBA applauds the FDIC's actions to unlock the credit markets through its Temporary Liquidity Guarantee Program (TLGP). The Transaction Account Guarantee part of the TLGP, which provides unlimited deposit insurance in non-interest bearing transaction accounts, will enhance depositor confidence in community banks. It will also free up bank capital that is now used to purchase securities in connection with secured repurchase agreements for the benefit of large depositors. ICBA supports expanding the Program to fully insure all transaction accounts (interest and non-interest bearing) through December 31, 2009. Expanding coverage to include all transaction accounts would level the playing field for community banks and other institutions NOT too big to fail by eliminating the incentive for customers to move funds to too-big-to-fail institutions or mutual fund money market accounts. Many community banks have few demand deposit accounts over $250,000, but transaction accounts with high balances are typically NOW accounts for small businesses, non-profits, and governmental entities.

The Debt Guarantee Program for senior unsecured debt, however, as currently constituted, provides few benefits for community banks. In contrast to larger institutions community banks, by and large, do not issue much in the way of senior unsecured debt, other than some federal funds purchased. The current pricing for the Debt Guarantee Program (an across the board 75 basis point fee) makes it unattractive for federal funds purchased transactions. Overnight federal funds transactions pose little risk of default and, at current prices for federal funds, the 75 basis point guarantee fee exceeds the interest rate on the instruments. We have suggested the FDIC adopt risk-based pricing for the guarantee, so the guarantee will be more attractive for overnight transactions, and consider allowing banks to separately opt-out of the guarantee for overnight federal funds.

Under the law under which the TLGP was established, holding companies cannot be assessed any special fee that may be required to make up any final deficit in the TLGP, but all banks and thrifts will be subject to such a special assessment. The inability to levy a special assessment against bank holding companies, particularly those with substantial non-bank subsidiaries, creates an inequity in the TLGP. If bank holding companies with substantial non-bank subsidiaries remain in the program, some mechanism should be devised to insure that these holding companies pay their fair share of any net costs of the TLGP.

Foreclosure Mitigation

Community banks played no role in causing the current problems because they did not engage in the subprime lending practices at the heart of the crisis. As a result, community banks are not experiencing unusual levels of mortgage defaults. When community banks do encounter a default, they recognize that foreclosure is the least attractive alternative. It is bad for the borrower, the institution and other homeowners in the borrower's community. Community banks work with homeowners to restructure mortgages, when that is a viable option, including through loan modifications under the Hope 4 Homeowners Program and other avenues.

Community banks are truly invested in long-term relationships with their customers and their communities. When community banks service mortgages, they have a strong interest in maintaining those relationships, and not just guarding the interests of investors. Community banks' involvement in finding solutions for consumers extends beyond their own customers. They have frequently offered refinancing to troubled borrowers with loans from other institutions.

Community Bankers Strongly Supported the EESA

The ICBA and its 5,000 community banks were strong supporters and advocates of the Emergency Economic Stabilization Act of 2008, which created the Troubled Asset Relief Program (TARP). Although the community banking industry avoided the subprime mortgages and lending practices that are at the center of the current economic and credit crisis, the effects of the crisis have had an impact on community banks and their Main Street customers. We were very pleased Congress included provisions in the legislation addressing key concerns of community banks, and we appreciate the support of Chairman Frank, Subcommittee Chairman Kanjorski, and others on the Committee for including these Main Street bank provisions.

The EESA addresses several key community bank priorities. The legislation provides a temporary increase in deposit insurance limits from $100,000 to $250,000 through December 31, 2009. The increase in FDIC insurance provides the dual benefits of providing additional liquidity to banks for lending as well as providing additional reassurance to depositors with account balances above the $100,000 limit.

The EESA allows community banks to take capital losses against ordinary income for Fannie Mae and Freddie Mac preferred share losses. In many cases, regulatory examiners and outside accounting firms encouraged community banks to purchase GSE preferred stock as a good, safe asset for diversification. While the government's conservatorship of the government sponsored enterprises (GSEs) may have been necessary to restore calm to financial markets, it did, in effect, wipe out the interests of not only the holders of the GSE common stock, but also the holders of preferred stock, including many community banks. Allowing community banks to take these losses as deductions against ordinary income softened the impact of the GSE conservatorship and provided some compensation for the government's actions. The EESA also permits the Treasury to use TARP funds to provide financial assistance to community banks that suffered the most serious impact to capital (Section 103 (6)) This provision is separate from the Treasury's Capital Purchase Program. ICBA urges Treasury to use this option to mitigate the damage to the most seriously affected banks owning Fannie and Freddie preferred stock.

The EESA requires that the SEC to conduct a study of mark-to market accounting standards and their impact on financial institutions and the quality of financial information available to investors. ICBA has told the SEC that full mark-to-market, or fair value, accounting is inappropriate for community bank financial statements. We have also said that current standards have exacerbated the current financial crisis as financial instruments are priced not at "fair value," but at forced liquidation values, despite current guidance. Accounting measures should more closely reflect the way financial instruments generate earnings and cash flows.

Community banks are particularly pleased the EESA prohibits the Treasury from establishing future guarantee programs for money market mutual funds. Community banks have paid billions of dollars for federal deposit insurance. The four basis point fee paid by the mutual fund industry is not comparable to banks' current assessment fees (five to seven basis points for the least risky banks) nor to proposed FDIC assessment rates for 2009 (12 to 14 basis points in the first quarter, 10 to 14 basis points thereafter). It would be inequitable to establish another guarantee fund for the money market mutual funds through regulatory actions. We are also pleased the EESA allowed the Federal Reserve to pay interest on so-called bank "sterile reserves" beginning Oct. 1, 2008, three years earlier than previously permitted.

ICBA is particularly appreciative that the EESA ensures community banks will have equal access to the TARP (Section 103 (5)). This language is significant as the focus of Treasury's efforts have centered on the TARP Capital Purchase Program.

EESA's TARP Intended for All Banks

The ICBA greatly appreciates the Committee's attention to ensure the Emergency Economic Stabilization Act and, specifically, the TARP's Capital Purchase Program (CPP) are widely available to all interested banks. ICBA has discussed with Treasury many community banking concerns and proposed specific recommendations to facilitate private bank access to the TARP and CPP as intended by Congress.

However, ICBA members are growing increasingly concerned that only $60 billion is left uncommitted from the $250 billion Capital Purchase Program and still more than 6,000 financial institutions cannot qualify for the CPP under the initial public term sheet. Half of the CPP's $250 billion was quickly given to just nine of nation's largest banks.

Notably, an additional $40 billion has been granted to insurer American International Group from the general TARP funds.

Large companies such as credit card company American Express have rapidly converted to a bank holding company so they too may access the TARP funds. This follows the rapid conversion of the gigantic investment firms such as Goldman Sachs and Morgan Stanley into bank holding companies after being battered in the markets. All the while, thousands of traditional community banks stand ready, willing and interested in TARP CPP access to help boost lending, but to date without a term sheet for private banks, they have been largely shut out.

Community banks did not cause the current financial crisis. Nevertheless, many community banks are now suffering the consequences of frozen credit markets and finding it difficult to raise capital in the current marketplace. Community banks, interested in the CPP, therefore deserve prompt access to the TARP capital.

More than 6,000 financial institutions still cannot qualify to participate in the CPP because they are thinly-traded banks, Subchapter S banks, private banks, and mutual institutions that cannot meet the terms of the Treasury's initial public term sheet. If Treasury makes these thousands of community banks eligible, they would be able to boost lending in their local communities.

Community Banks Positioned to Lend on Main Street

Some 48 percent of small businesses get their financing from banks with $1`billion and under in assets. By only granting a few dozen of the nation's largest banks the CPP funds, more than half of small businesses may not see any change in their available credit. ICBA believes to get more dollars flowing to Main Street and to boost economic activity as Congress intended, a greater number of interested community banks must be part of the CPP.

We appreciate the Treasury allowing us the opportunity to directly spell out the unique structure of our nation's 6,000-plus private banks and to suggest a means to include private banks, lightly-traded banks, 2,505 Subchapter S banks, and more than 600 mutuals in a term sheet that will work for their structure.

We hope Treasury will release new terms for the CPP program soon so smaller banks can participate. Also we urge that an appropriate application deadline be given to these banks to allow sufficient time for understanding and qualifying for CPP funds and to secure the needed shareholder and board approvals.

Strong Community Bank Interest in CPP

Notably, there is very strong interest in the CPP capital from community banks. ICBA surveyed its membership which showed some 20 percent of community banks want to access CPP capital and another 30 percent are interested and want to review the detailed terms for their access. The vast majority of community banks entered this economic slowdown in solid shape and did not stumble on exotic lending and toxic investments. So interested community banks may be better positioned to use the CPP funds to bolster lending rather than solely replace capital due to massive losses seen by the giant investment banks.

Capital access is not solely a problem for the nation's giant banks. According to the ICBA survey, of the community banks interested in accessing CPP funds, some 57% noted they do not have easy access to new capital. Some 31% said capital is not available at any cost. About one-third of banks said they would consider shrinking their balance sheet to increase their capital position -- meaning less lending in their communities unless CPP funds would be available to supplement needed capital.

Key Concerns on Private Bank CPP Access

ICBA believes it is entirely feasible to craft workable terms for thinly-traded banks, private banks, Subchapter S banks, and mutuals so they can access CPP funds under similar economic terms as the large publicly traded banks. ICBA has made detailed recommendations to Treasury to incorporate private banks into the CPP.

The major needed modifications for these banks center on obstacles presented in a few areas. They include the inability to issue preferred stock (Subchapter S banks and mutuals) or easily discover a market price for common stock warrants (private banks, non-SEC registered banks, thinly-traded banks and S corporation banks). This can be overcome by offering a private term sheet to banks that are not traded on one of the three major stock exchanges and by substituting a perpetual junior subordinated debt instrument in place of the preferred stock. The junior subordinated debt would pay Treasury the same rate of return as it will receive on the larger banks' preferred shares. Instead of common stock warrants, these smaller institutions would issue Treasury book value-priced "phantom stock" and pay a redemption fee based on income growth. This mechanism could substitute for the upside "equity kicker" Treasury is seeking from the common stock warrants.

Dividend Policy Deserves Appropriate Attention

Tax liability on Subchapter S banks' earnings pass directly to the shareholders who must pay taxes on this income, whether or not it is actually distributed to the shareholders. Therefore S corporation banks must pay out substantial dividends in order for individual shareholders to pay the banks' taxes. The potential over-restriction on dividend payments for Subchapter S banks participating in the CPP can be addressed by allowing dividends to grow in sync with bank income and tax rates to cover the increase in flow-through income and tax liability. ICBA urges Treasury to address this issue and other issues affecting the more than 2,500 Subchapter S banks and thrifts through a term sheet for Subchapter S institutions.

ICBA also believes preference should be given in the CPP program for banks that suffered substantial Fannie Mae and Freddie Mac preferred stock losses and hits to their capital due to the GSEs into conservatorship.

These ICBA-recommended terms would allow community banks to participate in the TARP CPP and help boost lending to families and small businesses. Every dollar in new capital a community banks can raise it will facilitate an additional seven to ten dollars of community lending . The cost of this CPP capital is not inexpensive for community banks, at some 7.5% tax effective rate in the first five years, plus further warrant-related costs. So the community banks that use this capital will put it to good use by doing what they do best – lend on Main Street.

Concern on Changing the CPP Terms Retroactively

ICBA is also concerned with a provision in recently released documents to be signed by Treasury and CPP program participants. Specifically, Section 5.3 of the Securities Purchase Agreement states that the Treasury Department can:

"unilaterally amend any provision of this Agreement to the extent required to comply with any changes after the Signing Date in applicable federal statutes."

Banks are rightly concerned this new provision will allow the government to retroactively change any of the contract terms of the established Securities Purchase Agreement should there be a change to a federal statute.

Notably, the Supreme Court's decision in the 1996 case of *United States v. Winstar* established the principle that the government cannot retroactively change the original terms of an agreement it has entered without being subject to damages for breach of contract. In *Winstar*, the federal regulators encouraged a group of investors to take over an ailing thrift under a supervisory merger agreement that allowed the resulting institution to count goodwill as part of its regulatory capital. Thereafter, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was passed which prohibited thrifts from counting supervisory goodwill and capital credits in computing the required reserves. In essence, the government retroactively changed the terms of the agreement.

Although the court in the *Winstar* case held against the government, it left open the issue of whether future agreements could include provisions that allow the government to unilaterally and retroactively change the terms of an agreement. To participate in the CPP, banks must be able to rely on the agreement and have certainty the contracts and terms they agree to will not change retroactively. Without this certainty, changes made unilaterally and retroactively by Treasury could substantially change the economics of the arrangement, making it difficult for bankers to responsibly decide whether to participate in the CPP program.

ICBA therefore requests the Treasury modify Section 5.3 to clarify that only future changes to federal law that apply to all financial institutions and that are not directed solely at institutions that participate in the CPP program could be subject to retroactive changes to the Securities Purchase Agreement. This would ameliorate the concern of community banks that the agreement could be changed retroactively.

FDIC's Temporary Liquidity Guarantee Program

On October 14, 2008, the FDIC announced the establishment of a Temporary Liquidity Guarantee Program (TLGP) as part of coordinated government efforts to unlock credit markets, particularly inter-bank credit markets, which had ceased to function properly. The disruptions in credit markets have significantly impaired the ability of creditworthy companies to issue commercial paper and longer term debt.

The TLGP consist of two parts. The Debt Guarantee Program would provide an FDIC guarantee of all senior unsecured debt issued on or after October 14, 2008 through June 30, 2009 by an eligible entity. An "eligible entity" includes a domestic bank, thrift, bank holding company and most thrift holding companies. The guarantee expires on the earlier of the maturity date of the underlying debt or three years. The FDIC will assess a fee equal to 75 basis points of the guaranteed amount, on an annualized basis. The amount of senior unsecured debt that can be guaranteed under the program is an amount equal to 125% of the amount of senior unsecured debt the institution had outstanding on September 30, 2008. The FDIC will allow banks with little or no senior unsecured debt as of September 30th to request an increase in the amount of debt that is eligible for the FDIC guarantee.

The second part of the TLGP is the Transaction Account Guarantee Program, which provides 100% guarantee for all amounts in non-interest bearing transaction accounts. The FDIC will assess a ten basis point fee (on an annualized basis) only on amounts in transaction accounts above $250,000. The expanded guarantee lasts through December 31, 2009.

Eligible entities have until December 5, 2008, to opt out of either program or both programs. Once an institution opts out of a program, the guarantee terminates.
The FDIC issued interim regulations and provided the public an opportunity to file comments by November 14, 2008.

ICBA applauds the FDIC's actions to unlock the credit markets. The Transaction Account Guarantee Program will enhance depositor confidence in community banks and free up bank capital used to purchase securities in connection with secured repurchase agreements for the benefit of large depositors. The Debt Guarantee Program, however, as currently constituted, provides few benefits for community banks. These institutions generally, in contrast to larger institutions, do not issue much in the way of senior unsecured debt, other than some federal funds purchased. The current pricing for the Debt Guarantee Program makes it unattractive for federal funds purchased transactions. The ICBA has provided the FDIC detailed suggestions on how to improve the proposal through our comment letter, including a requirement that all-too-big-too-fail banks participate in the program to help prevent a deficit in the program; a 10-50 basis point range for a risk-based assessment for the Debt Guarantee Program fee, instead of an across the board 75 basis point fee; a guarantee cap formula that includes secured liabilities as well as unsecured senior debt; modification to the Transaction Account Guarantee Program to include all NOW accounts as NOW accounts above $250,000 typically belong to small businesses, governmental entities and charities.

We would like to bring to the Committee's attention one issue that may take congressional action to address. The FDIC used its systemic risk authority to establish the program. The net costs of any activity undertaken pursuant to the systemic risk authority must eventually be borne by all FDIC-insured banks and thrifts through an assessment based on the institutions' assets minus equity. The statute does not expressly authorize the FDIC to assess bank and thrift affiliates, including holding company parents. The Debt Guarantee Program has been extended to holding companies because much of the bank debt that is issued is done at the holding company level. However, should a special assessment be needed to make up for any deficit in the TLGP, the FDIC cannot levy an assessment against the non-bank assets of a holding company.

We have suggested the FDIC exclude from the program holding companies with significant non-bank subsidiaries if it cannot develop a method for assessing holding companies to pay their fair share of program losses, as it would be grossly unfair for community banks and other insured depository institutions to be left with the tab, through a special assessment on FDIC-insured institutions only. It would also be appropriate for Congress to amend the systemic risk statute to authorize the FDIC to assess the consolidated assets of all affiliated companies of a bank or thrift.

Foreclosure Mitigation

As noted, community banks played no role in causing the current crisis because, by and large, they did not engage in unwise subprime lending practices. As a result, community banks are not experiencing unusual levels of mortgage defaults. And, ICBA members are still making mortgage loans. Community bank mortgage originations have remained steady over the first nine months of this year. Based on mortgage origination data we collect through ICBA Mortgage Corporation, we estimate community banks have originated approximately 300,000 mortgage loans for an aggregate principal amount of approximately $47 billion for the first nine months of this year.

But we agree that minimizing foreclosures is an important part of the effort to stabilize the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes.

In preparation for this hearing, we have asked Taylor, Bean and Whitaker (TB&W), a national wholesale mortgage lender and servicer that services mortgages on behalf of many of our members, about their foreclosure mitigation efforts. TB&W works with a representative cross section of our membership. As a result, the servicing practices of TB&W fairly reflect the mortgage practices of community banks. We also have information from some ICBA members who retain servicing.

TB&W and community banks that service their own mortgages monitor payment activity for changes that might signal a borrower could have difficulty paying the mortgage. If that occurs, it is the practice of these servicers to contact the borrower quickly to avoid potential problems. It is not their practice to rush to foreclosure, which has significant negative consequences for both borrowers and lenders.

A number of ICBA members prepared to use the Hope 4 Homeowners Program by sending staff to training and applying to become approved FHA lenders. TB&W is a leading FHA approved lender. ICBA has partnered with TB&W to provide ICBA members easier access to all FHA programs, including the HOPE 4 Homeowners Program. Community banks and TB&W will continue to work with individual borrowers to find the best solution to keep borrowers in their homes, including loan modifications under the Hope for Homeowners Program or under any new government programs that would support mortgage modifications.

Community banks are truly invested in long-term relationships with their customers and their communities. When community banks service mortgages, they have a strong interest in maintaining those relationships, and not just guarding the interests of investors. Community banks' involvement in finding solutions for consumers extends beyond their own customers as community banks have offered refinancing to troubled borrowers with loans from other institutions as well.

Thank you for this opportunity to testify, I would be happy to answer any questions.

Whatever Happened to the *Troubled Assets* Relief Program?

Testimony of

Alan S. Blinder
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs
Princeton University

to the
House Committee on Financial Services

November 17, 2008

Mr. Chairman, members of the Committee, I'd like to thank you for the opportunity to testify here today. I come neither to praise the TARP ("Troubled Assets Relief Program"), nor to bury it, but rather to urge Congress to exercise its oversight authority to ensure that the Secretary of the Treasury pursues the stated goals of the legislation. Failing that, Congress should invoke Section 115 of the legislation to take the Secretary's checkbook away. We'll have a new Secretary of the Treasury in about two months.

Mr. Chairman, I think you remember that I was among the earliest voices calling upon Congress to establish something akin to the TARP. Specifically, I recommended two new institutions: one to purchase and refinance imperiled mortgages, the other to buy up some of what are now called "troubled assets," that is, mortgage-backed securities ("MBS") and related assets. The Emergency Economic Stabilization Act, signed by the President on October 3rd, established the TARP to serve both purposes. So it is with great dismay that I survey what has been done and conclude that the TARP is not performing its legislatively-mandated duties.

I object to the decisions Secretary Paulson has made on at least three levels: the choices he has made regarding how to deploy the money; the execution of those choices;

and what seems to me a sharp deviation from congressional intent. I'll take them up in turn, after a few words of background.

1. Overview: The Purposes of the TARP

Months ago, before the legislation was passed, people like me, who were recommending such an institution, thought of it as one component—albeit an important and expensive one—of a plan to get the nation's financial markets out of the EMS stage and into the surgical ward, where it will subsequently need major repairs. The hope was that, if we acted quickly, the wounded financial system might not drag the real economy into a deep recession.

But we did not act quickly, and all such hopes vanished the day Lehman Brothers was allowed to fail. So we remain in the EMS stage, with the financial markets in many respects sicker than they were before Lehman. And the hope that we might avoid a serious recession is now gone. I now view the TARP, the many initiatives of the Federal Reserve, what I hope will be a large new stimulus bill, and much else as pieces of a broad package designed to hold the recession line at, say, 8% unemployment. We have a chance of achieving that modest goal, but the odds are shifting against us daily.

Since the financial crisis has grown to be so complex and multi-faceted, it is worth recalling that it all began with falling house prices and defaults on mortgages—or, rather, fears that defaults would become rampant. (Those fears depressed the values of securities based on mortgages, and made them "troubled.") Foreclosures are personally painful and economically costly; they undermine property values; and they lead to fire sales of homes, which depress house prices further, thereby continuing the vicious cycle. It is difficult to see a way out of this mess without reducing the coming tsunami of defaults and foreclosures.

Understanding that, Congress wrote legislation that, at numerous points, exhorts, encourages, and even directs the Secretary of the Treasury to use TARP funds to acquire mortgages and get them refinanced. But he has not done so. Nor has he purchased any mortgage-related assets. So let me start with congressional intent.

2. What the Law Says

The law authorizes establishment of the TARP to purchase "troubled assets," which it defines in Section 3.9 as:

(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, ...the purchase of which the Secretary determines promotes financial market stability; and
(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

I think of this language as defining three classes of assets as eligible for purchase: mortgages, mortgage-related securities, and the catch-all "any other financial instrument." And please notice that Congress required specific justification, in writing, for utilizing the catch-all category.

I guess I'm old-fashioned, but I still believe in constitutional democracy. I followed the rancorous congressional debate over the TARP closely, and I'm pretty sure that Congress thought it was authorizing $700 billion mainly for the purchase of mortgages and mortgage-related securities. What we have gotten, instead, is zero purchases of either of these two asset classes. Instead, almost all the monies committed to date are for capital injections into banks, justified by the catch-all "any other financial instrument" clause.

Were I a Member of Congress, I'd be pretty unhappy about this turn of events. In fact, as a taxpayer shouldering his share of the $700 billion burden, I am unhappy.

3. The Allocation of TARP Funds

To be sure, I am not suggesting that Secretary Paulson overstepped his legal authority by making capital injections. Section 3.9(B), quoted above, clearly justifies doing so, if he deems that "necessary to promote financial market stability"--as I presume he has done, in writing, to this and other committees. Nor do I question the wisdom of allocating *some* of the TARP funds to recapitalizing banks, although I was always less enthusiastic about this use of the money than many of my colleagues.

But we should pay attention to the scoreboard, which so far reads:

Mortgages: 0%
Troubled assets: 0%
Other: 100% (including a large allocation to an insurance company)

I do not believe that such a lopsided allocation is the optimal use of the public's money. To see why, let's review the arguments supporting these three alternative uses of the $700 billion.

(1) Mortgages: As noted earlier, the financial crisis began with mortgages and fear of foreclosures. FDIC Chairwoman Sheila Bair, among many others, has repeatedly called attention to this as the root cause of the problem; and I agree. Congress apparently agreed, too, because the legislation directs the Secretary to use TARP funds to get mortgages refinanced. Unfortunately for the country, he has not done so. And the mortgage problem festers and worsens.

(2) Mortgage-related securities: Three main arguments were used to sell the idea of buying troubled mortgage-backed securities (MBS) and the like to a very reluctant

Congress. First, panic had virtually shut down the MBS markets, which had to be put back in working order to restore our system of mortgage finance. Second, one of the reasons for panic was that nobody knew what these mortgage-related securities were worth. A functioning market would at least establish objective valuations; creating some buying pressure might even raise their prices. Third, many mortgages are tied up by complicated securitizations and derivatives. Buying up some of these securities would enable the government to acquire and refinance the captive mortgages and refinance them. In fact, this third objective was written explicitly into the law in several places; *cf.* Section 109.

(3) Recapitalizing banks: The catch-all "any other financial instrument" category was a wise addition to the Act. It gives the Secretary much-needed flexibility to respond to unforeseen circumstances. While Section 3.9(B) may get stretched even further, it has thus far mainly been used to inject capital into banks. Given the parlous financial condition of some of our banks, I believe Secretary Paulson was right to decide that bolstering their balance sheets was "necessary to promote financial market stability." But this circumstance was hardly unforeseen. Why wasn't it written into the legislation? I also question whether capital injections are the *most* appropriate, let alone the *only* appropriate, use of the TARP money. And I have serious questions about the details of the Capital Purchase Program, which I'll come to shortly.

Was this a case of bait and switch? Secretary Paulson has appealed to the well-known Keynesian dictum that reasonable people might change their minds when the facts change. I have no doubt that many facts have changed since October 3rd. But he has not explained what new facts invalidate the three arguments that were used only weeks ago to justify the TARP's original design. Foreclosures are still coming *en masse*, and they still destroy value. The MBS markets are still in ruins. Furthermore, a natural symbiosis exists between buying mortgages and buying troubled assets: Purchasing MBS helps the government acquire mortgages to refinance, and refinancing mortgages to avert foreclosures enhances the values of MBS. By the way, each of these policies also can bolster the financial positions of banks—which is the purpose of capital injections.

I conclude that the arguments for TARP buying both mortgages and mortgage-related securities still stand. It is a shame that neither of these is being done today.

4. Some Problems with the Treasury's Capital Purchase Program

Even given the decision to devote virtually all of the first $350 billion of TARP money to capital injections, taxpayers might reasonably have expected a better-designed program. I fault the Treasury on at least six dimensions:

First, while I understand the need to keep proprietary information confidential, the program is enshrouded in too much secrecy. It is, after all, the taxpayers' money being put at risk.

Second, Secretary Paulson decided to purchase preferred stock with no voting, or other control, rights. So the government provides money, but acquires virtually no influence over the recipient banks' behavior.

Third, taxpayers will receive only a 5% dividend on their investment (for the first five years). Curiously, just days before the legislation was passed, Warren Buffet concluded a deal with Goldman Sachs (a major recipient of TARP money) that included both preferred stock with a *10%* dividend yield and more attractive warrants. Surely, Goldman Sachs is one of the best credits participating in the Capital Purchase Plan. If so, how can a 5% dividend yield be consistent with the Act's requirements that "prices paid for assets are reasonable and reflect the underlying value of the asset" (Section 113(c)), that purchases are made "at the lowest price that the Secretary determines to be consistent with the purposes of this Act" (Section 113 (b)1), and that he spend the money in ways that "maximize the efficiency of the use of taxpayer resources" (Section 113(b)2)?

Fourth, participating banks are allowed to continue to pay dividends to their shareholders. This raises the spectacle of banks borrowing money (cheaply) from taxpayers in order to maintain their common stock dividends.

Fifth, contrary to many suggestions, Secretary Paulson did not require participating banks to raise private capital *parri passu* with the government's capital injections, which would at least have provided a valuable market test of viability.

Sixth, the capital injections are being made with no public-purpose *quid pro quos* at all—e.g., a minimal lending requirement, or a pledge to refinance more mortgages.

Frankly, I find it all breathtaking.

What can be the rationale behind terms that are so favorable to banks and so unfavorable to taxpayers? Based on what Secretary Paulson has said, I can only presume that his objective was to ensure the widest possible bank participation by avoiding stigma. Indeed, to this end, he even forced money on several unwilling banks at that famous October 13th meeting at Treasury.

To put it mildly, the anti-stigma strategy did not work. Within minutes, the big banks that neither needed nor wanted the Treasury's capital injections made that fact known to the markets. More banks are doing so daily. Nor should the strategy ever have been expected to work. It is in the commercial interests of the healthiest banks to distinguish themselves from the pack by demonstrating their health in every possible way—including turning down government funds. By forcing money on recipients who don't need it, the TARP wastes a precious resource--taxpayer money--that the law requires the Secretary to husband carefully.

5. Where Do We Go from Here?

Congress should now be pondering such questions as these:

First, is there now sufficient oversight over the TARP's choices and operations? My answer is clearly no. The Congressional Oversight Panel called for in Section 125 has yet to be established, though I noted with relief that three of the members were named just a few days ago. But that still leaves two slots open, and the Panel may be a long way from opening for business. When it does, it sure has its work cut out for it.

Second, are zero allocations of funds both to buying and refinancing mortgages and to buying mortgage-related assets really consistent with either the spirit or the letter of the law? My answer is again no.

Third, despite that, have Secretary Paulson's decisions to date advanced the objectives of the law better than the original design? I am far from convinced. According to Section 2 of the Act, these objectives include: to "protect home values" and "preserve homeownership," and to "maximize overall returns to the tax payers." The Secretary's assets allocations do not serve these purposes at all well.

Fourth, and perhaps most basic, can and will the manifold defects in the TARP's design and execution to date be remedied by the current Secretary of the Treasury? That is for you ladies and gentlemen to judge. But I have my doubts.

This thought leads me to my final question for Congress. Section 115 of the Act wisely provided for the $700 billion to be distributed in three tranches. The first two tranches, amounting to $350 billion, have already been authorized. But Congress retains the right to block the final $350 billion via the following mechanism. To gain access to the final $350 billion, "the President transmits to the Congress a written report detailing the plan of the Secretary" to use the remaining funds (Section 115(a)3). Congress then has 15 days in which to pass a "Joint Resolution of Disapproval" (Section 115(c)), which would block the disbursement of the remaining $350 billion. If not, the Secretary gets it.

Based on Secretary Paulson's performance to date, I believe Congress should pass that resolution unless he mends his ways. I say this with great reluctance because the financial system remains in urgent need of repair. But I have concluded that taxpayers will be better served by waiting for the new administration to take office.

Testimony of

Martin Feldstein

Professor of Economics, Harvard University

Before the

House Committee on Financial Services

November 18, 2008

Thank you, Mr. Chairman. I am pleased to testify today about the Treasury's Troubled Asset Relief Program and about other steps that I think are needed to deal with the current economic situation.

The Problem

I am very worried about the U.S. economy. The financial crisis and the economic downturn are mutually reinforcing. Without further action by the Congress, the current recession is likely to be longer and more damaging than any that we have seen since the 1930s.

The fundamental cause of our current problems was the underpricing or risk and the resulting excessive leverage of both individuals and institutions.

But the primary condition that now threatens the economy is the expectation that house prices will continue to decline, leading to more defaults and foreclosures. And those foreclosures will put more houses on the market, driving house prices down further.

This potential downward spiral reflects the fact that in the United States – unlike every other country in the world – home mortgages are "no recourse" loans. If someone stops paying his mortgage, the creditor can take the home but cannot take other assets or look to the individual's income to make up any unpaid balance. This no recourse feature gives individuals whose mortgages exceed the value of their homes an incentive to default and to rent until house prices stop falling.

Because defaults are now rising rapidly and are expected to go on increasing, financial institutions cannot value mortgage-backed securities with any confidence. That's what stops interbank lending and lending by financial institutions that cannot judge the value of their own capital.

The TARP

The actions of the Federal Reserve and the FDIC have done a lot to prevent a run-off of funds from the banks and the money market mutual funds and to maintain the commercial paper market. In contrast, I believe that the TARP itself has not done anything to resolve the basic problems of the financial sector.

The Treasury's original plan to buy impaired loans as a way of cleaning the banks' balance sheets simply could not work. Even $700 billion is not enough to deal with the more than $2 trillion of negative equity mortgages. The plan to buy impaired assets by a reverse auction also could not work because of the enormous diversity of these securities. And even if the Treasury had succeeded in removing all of the toxic assets from the banks' portfolios,, they would have done nothing to stop the flow of new impaired mortgages and the fear of more such toxic assets in the future. It was good that the Treasury abandoned this asset purchase plan.

Injecting capital into selected banks is also not a way to resolve the problem and get lending going again. A bank like Citigroup has a balance sheet of some $2 trillion. Injecting $25 billion of government capital does not provide a significant amount of loanable funds. Nor does it give anyone confidence that Citi would have enough capital to cover any potential losses on its mortgage-backed assets. Although it raises Citi's tier one capital, that is not the binding constraint on lending by Citi or on its ability to attract funds. It was good that the Treasury abandoned this equity infusion plan as well.

Last week the Treasury announced that it will now concentrate on propping up credit for student loans, auto loans, and credit cards. I do not know how it plans to do this. But doing so will not stop the lack of confidence caused by the expectd continuing meltdown of mortgage-backed securities that is driven by the process of defaults and foreclosures.

In light of this record, the Treasury's announcement yesterday that it will not seek any of the remaining $350 billion of the initial $700 billion TARP funding seems quite appropriate.

What Needs to be Done?

Stopping the financial crisis and getting credit flowing again requires ending the spiral of mortgage foreclosures and the expectation of very deep further house price declines. Doing this requires a new government policy that deals with homeowners who have positive equity and a different government policy for homeowners with negative equity. Here is a possible way of dealing with these two groups.

Consider first the problem of stopping homeowners with *positive* equity from falling into negative equity as house prices decline to the pre-bubble level. Earlier this year I suggested that the government offer all homeowners the opportunity to substitute a loan with a very attractive low interest rate, but with full recourse, for 20 percent of the homeowner's existing mortgage. This "mortgage replacement loan" would establish a firewall so that house prices would have to fall more than 20 percent before someone who now has positive equity would decline into negative equity. Since the mortgage replacement loan is essentially a swap of the homeowner's IOU for the government loan, it would involve no actual government spending and therefore no increase in the budget deficit. (For more details, see my Wall Street Journal article of March 7, 2008 "How to Stop the Mortgage Crisis.")

The key to preventing further defaults and foreclosures among the current *negative* equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other assets or a fraction of wages if the homeowner defaults. But the offer of a low interest rate loan is not enough to induce a homeowner with substantial negative equity to forego the opportunity to default and escape the existing debt.

Substituting a full recourse loan requires the inducement of a substantial write down in the outstanding loan balance. Creditors have an incentive to accept some write-down in exchange for the much greater security of a full recourse loan. The government can bridge the gap between the maximum write down that the creditor would accept and the minimum write down that the homeowner requires to give up his current right to walk away from his debt. (For more details, see my Wall Street Journal article of November 18, 2008 "How to Help People whose Home Values are Underwater.")

If these things are done, the financial sector would be stable and credit would again begin to flow. But while that is a necessary condition for getting the overall economy expanding again, it is not sufficient.

To achieve economic recovery the nation needs a program of government spending for at least the next two years to offset the large decline in consumer spending and business investment. To be successful, it must be big, quick, and targeted at increasing production and employment

I am a fiscal conservative. I generally oppose increased government spending and increased fiscal deficits. But I am afraid that that is now the only way to increase overall national spending and to reverse the country's economic downturn.

If these two things are done -- stopping the incentive to default on home mortgages and increasing government spending -- I will be much more optimistic about the ability of the economy to begin expanding before the end of 2009.

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OPINION
NOVEMBER 18, 2008

How to Help People Whose Home Values Are Underwater

The economic spiral will get worse unless we do something about negative equity.

By MARTIN FELDSTEIN

More than 12 million homeowners now have mortgage debt that exceeds the value of their homes. These negative-equity homeowners have an incentive to default because mortgages are generally "no recourse" loans. That means creditors can take the property if the individual defaults, but cannot take other assets or income to make up the difference between the unpaid loan balance and the lower value of the house. As a result, mortgage default rates are now rising rapidly and are expected to go much higher.

The no-recourse mortgage is virtually unique to the United States. That's why falling house prices in Europe do not trigger defaults. The creditors' ability to go beyond the house to other assets or even future salary is a deterrent.

The negative-equity homeowner's incentive to default and become a renter rises with the size of the gap between the mortgage and the value of the house. That gap is typically already very large. Half of the homeowners with negative equity now owe more than 120% of the value of their homes. If house prices continue to fall at the current rate for the next 12 months, as experts generally expect, the median loan-to-value ratio of negative-equity homeowners will increase to more than 135%. At that level, a very high fraction of negative-equity homeowners are likely to default.

The increased supply of homes for sale will create a vicious cycle, further depressing house prices, further raising the number of homes with negative equity, and weakening the balance sheets of financial institutions. This is the primary cause of the dysfunctional credit markets. None of the existing proposals to help homeowners with negative equity would eliminate the incentive to default.

In an earlier article on this page I proposed a plan to prevent declines of house prices back to the prebubble level from pushing current positive-equity homeowners into the negative-equity group. The essential feature of that plan is to replace 20% of the homeowner's existing mortgage with a separate, full-recourse loan from the government. That "mortgage replacement loan" would have a very attractive, low interest rate. Because it would be separate from the mortgage and would have full recourse, it would establish an important firewall. Even if house prices fall another 20%, all mortgages would still have positive equity. The mortgage-replacement loan would involve no actual government spending and therefore no increase in the budget deficit.

The key to preventing further defaults and foreclosures among current negative-equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other property or a fraction of wages. But the offer of a low-interest-rate loan is not enough to induce a homeowner with substantial negative equity to forego the opportunity to default and escape the existing debt. Substituting a full-recourse loan requires the inducement of a substantial write-down in the outstanding loan balance. Creditors have an incentive to accept some write-down in exchange for the much greater security of a full-recourse loan. The government can bridge the gap between the maximum write-down that the creditor would accept and the minimum write-down that the homeowner requires to give up his current right to walk away from his debt.

Here is an example of how that might work. Consider a homeowner with a $240,000 mortgage and a home that is worth only $200,000. The $40,000 gap between the mortgage and the appraised value could be divided with the government taking one-third, the creditor taking two-thirds, and the homeowner agreeing that the remaining $200,000 loan would have full recourse. The creditor would give up about $27,000 of potentially uncollectible debt but would avoid the extra loss of value that comes with selling a foreclosed property, and would achieve a much more secure loan. The homeowner would get to keep his house and would eliminate all of the excess debt.

With 12 million negative-equity homes and an average negative equity gap of $40,000, the total cost to the taxpayers of taking one-third of the losses would be no more than $156 billion. Alternative proposals to help negative-equity homeowners do not convert their mortgage debt to full-recourse loans and would not succeed in stopping the downward spiral of house prices.

The "Hope for Homeowners" legislation sponsored by Rep. Barney Frank and Sen. Chris Dodd offers a government guarantee of the mortgage if the creditor writes the loan down to 95% of the property's current value (as appraised by professionals hired by the banks). The Congressional Budget Office estimates that only 400,000 of the 12 million homes with negative equity would benefit, because creditors are unwilling to make such a large write-down without government assistance.

One recent proposal from the FDIC calls for creditors to reduce the monthly mortgage payment to a specified fraction of the homeowner's income by stretching out the repayment schedule of the mortgage, or providing a temporary reduction in the interest rate on the mortgage. The government would compensate the creditor for this reduced monthly payment by agreeing to pay part of any loss if the homeowner defaults. But even after the monthly mortgage payment is reduced, the homeowner with negative equity would still have an incentive to default, leaving the government with the cost.

Another current proposal from various academics would force the creditor to write down the mortgage debt to eliminate the negative equity and compensate the creditor with a share of the future appreciation when the house is sold. But any homeowner who receives that debt reduction has an incentive to sell the house as quickly as possible and buy another one so that he can keep all of the appreciation on the new home. Since the creditor would therefore receive no compensation for writing down the debt, there would be great reluctance to accept such a plan.

The prospect of a downward spiral of house prices is the major risk facing financial institutions. It is also a primary source of the further falls in household wealth that will reduce consumer spending and depress the economy. Providing an incentive to shift the current negative-equity loans to full-recourse mortgages -- while also injecting mortgage-replacement loans to stabilize the current positive-equity mortgages -- should be Barack Obama's highest priority as he seeks to stabilize the economy.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.

OPINION

How to Stop the Mortgage Crisis

By MARTIN FELDSTEIN
March 7, 2008; Page A15

The potential collapse of house prices, accompanied by widespread mortgage defaults, is a major threat to the American economy. A voluntary loan-substitution program could reduce the number of defaults and dampen the decline in house prices -- without violating contracts, bailing out lenders or borrowers, or increasing government spending.

The unprecedented combination of rapid house-price increases, high loan-to-value (LTV) ratios, and securitized mortgages has made the current housing-related risk greater than anything we have seen since the 1930s. House prices exploded between 2000 and 2006, rising some 60% more than the level of rents. The inevitable decline since mid-2006 has reduced prices by 10%. Experts forecast an additional 15% to 20% decline to correct the excessive rise. The real danger is that prices could fall substantially further if there are widespread defaults and foreclosures.

Irresponsible lending created new mortgages with LTV ratios of nearly 100%. By the end of 2006, the fall in prices caused 7% of mortgages to have LTV ratios above 100%. A further 20% of mortgages had LTV ratios over 80% and will shift to negative equity as prices decline.

Most mortgages are no longer held by originating lenders, but are securitized and sold to investors world-wide. More significant, mortgages are used to create complex, asset-backed securities that are central to current credit-market problems. Investors no longer own specific mortgages, but only have rights to certain conditional payment streams. So generally, it is no longer possible to prevent foreclosures by negotiations between borrowers and lenders.

The 1.8 million mortgages now in default have created substantial personal hardship. The 10% decline in house prices has cut household wealth by more than $2 trillion, reducing consumer spending and increasing the risk of a deep recession. Defaults also damage the capital of lending institutions, causing further declines in credit and economic activity.

Rising unemployment during a downturn will force more homeowners to default, driving house prices lower. Since mortgages are generally "no recourse" loans, when there is a default the mortgage lender can only collect the value of the property. The lender does not have the right to seize other property (a car, a boat, money in the bank) or to put a lien on future wages. Thus, a homeowner with a mortgage that exceeds the value of his house has a strong incentive to default, even if he can afford to make the monthly payments.

Optimists note that homeowners with negative equity have generally been reluctant to default in past years. That was sensible when house prices were rising. But with house prices falling, defaulting on the mortgage is the rational thing to do.

Limiting the number of such defaults, and preventing the overshooting of price declines, requires a public policy to reduce the number of homeowners who will slide into negative equity. Since house prices still have further to fall, this can only be done by a reduction in the value of mortgages.

None of the current mortgage-reduction proposals are satisfactory. Although bankers sometimes have the incentive to reduce mortgage-loan balances voluntarily in order to avoid a foreclosure, this is usually not possible because the syndication of mortgage loans means that there is generally not a single lender who can agree to the mortgage writedown.

Proposals to force creditors to accept write-downs of interest or principal violate their contractual rights, reducing the future availability of mortgage credit and raising the relative interest rate on future mortgages. Reviving the depression-era Home Owners' Loan Corporation would have the government use taxpayer money to pay off existing loans and become the largest mortgage lender in the country. This would require an enormous federal bureaucracy of appraisers and loan agents.

If the government is to reduce significantly the number of future defaults, something fundamentally different is needed. Although there is no perfect plan, a program of federal mortgage-paydown loans to individuals, secured by future income rather than by a formal mortgage, could reduce the number of mortgages with high LTV ratios and cut future defaults.

Here's one way that such a program might work:

The federal government would lend each participant 20% of that individual's current mortgage, with a 15-year payback period and an adjustable interest rate based on what the government pays on two-year Treasury debt (now just 1.6%). The loan proceeds would immediately reduce the borrower's primary mortgage, cutting interest and principal payments by 20%. Participation in the program would be voluntary and participants could prepay the government loan at any time.

The legislation creating these loans would stipulate that the interest payments would be, like mortgage interest, tax deductible. Individuals who accept the government loan would be precluded from increasing the value of their existing mortgage debt. The legislation would also provide that the government must be repaid before any creditor other than the mortgage lenders.

Although individuals who accept the loan would not be lowering their total debt, they would pay less in total interest. In exchange for that reduction in interest, they would decrease the amount of the debt that they can escape by defaulting on their mortgage. The debt to the government would still have to be paid, even if they default on their mortgage. Participation will therefore not be attractive to those whose mortgages that already exceed the value of their homes. But for the vast majority of other homeowners, the loan-substitution program would provide an attractive opportunity.

Although home owners may recognize that the national average level of house prices has further to fall, they do not know what will happen to the price of their own home. They will participate if they prefer the certainty of an immediate and permanent reduction in their interest cost to the possible option of defaulting later if the price of their own home falls substantially.

The loan-substitution program would decrease the number of homeowners who would come to have negative equity as house prices decline. That reduces the number of homeowners who will have an incentive to default, thereby limiting the risk of a downward spiral of house prices.

Since individuals now have the right to prepay any part of their mortgage debt, the 20% reduction in the mortgage balance would not violate mortgage creditors' rights. Creditors should welcome the mortgage paydowns, because they make the remaining mortgage debt more secure. The 20% repayments to creditors would also create a major source of funds that should stimulate all forms of lending.

The simplest way to administer the new loans would be for the current mortgage servicer to collect on behalf of the government and remit those funds to Washington. There would be no need for a new government bureaucracy, for new appraisals, or for negotiations in bankruptcy. The program could be up and running within months after the legislation is passed.

The government would fund these loans by issuing new two-year debt and rolling over the debt until the loans are fully repaid, thus eliminating any net cost to the government. The government loans would not add to the budget deficit or to the net debt of the nation. Gross government debt would rise by the amount of the new government lending, but this would be balanced by the asset value of those loans.

The current possibility of widespread defaults is a cloud over all mortgage-backed securities, and over credit markets generally. The uncertainty about the future value of such asset-backed loans has been a primary reason credit markets have become dysfunctional. And without a flow of credit, the economy cannot expand.

To lower the risk of a downward spiral of house prices and to revive the frozen credit markets, the government must move quickly to reduce the potential number of mortgage defaults. A loan substitution program may be the best way to achieve that.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.

TESTIMONY OF THE HON. D. CAMERON FINDLAY
EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL
AON CORPORATION

ON BEHALF OF
THE COUNCIL OF INSURANCE AGENTS AND BROKERS

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

REGARDING:

OVERSIGHT OF IMPLEMENTATION OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 AND OF GOVERNMENT LENDING AND INSURANCE FACILITIES; IMPACT ON ECONOMY AND CREDIT AVAILABILITY

TUESDAY, NOVEMBER 18, 2008
10:00 a.m.
2128 RAYBURN HOUSE OFFICE BUILDING

Introduction

Thank you, Chairman Frank, Ranking Member Bachus, ladies and gentlemen of the Committee. I am Cam Findlay, Executive Vice President and General Counsel of Aon Corporation, and I am pleased to testify today on behalf of the Council of Insurance Agents and Brokers.

The Council represents the nation's leading insurance agencies and brokerage firms, including Aon. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place more than 80 percent – well over $200 billion – of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked to secure innovative solutions and create new market opportunities for its members at home and abroad.

Aon Corporation is the leading global risk management services provider, insurance and reinsurance brokerage, and human capital consulting firm. With 36,000 professionals worldwide, Aon delivers distinctive client value through innovative and effective risk management and workforce productivity solutions. We handle approximately $60 billion in annual insurance premiums, more than any other insurance broker in the world.

Insurance plays a fundamental role in the operation of the world's financial markets. Any coordinated effort to combat the turbulence roiling those markets should consider the potential for an insurance component.

Less than a week ago, Secretary Paulson announced that the Treasury Department would not exercise recently acquired authority to directly purchase troubled assets. So, the U.S. Treasury will not be exercising the authority that only six weeks prior was said by some to be the optimal way to restore liquidity to the U.S. financial marketplace.

Treasury has already infused hundreds of billions of dollars of capital into financial institutions, and has indicated that further infusions are coming. However, this approach does not address a primary cause of the liquidity problem – the hundreds of billions of dollars of *illiquid* assets that reside on the ledgers of America's financial institutions.

As long as the problems created by depressed valuation of these assets in the capital markets remain, no mater the volume of capital infusions, financial intuitions will have a difficult time playing their critical role in the functioning of our economy.

That is why the Council of Insurance Agents and Brokers and its members believe that the Department of Treasury should vigorously exercise the authority granted to it in Section 102 of the Emergency Economic Stabilization Act, and establish a program to insure the value of troubled and illiquid financial instruments.

During the frenzied September effort to craft emergency legislation urgently needed to stabilize the financial markets, some parties expressed skepticism regarding the idea of insuring troubled assets. However, the little hindsight afforded by the six weeks that have passed since the bill's enactment have already provided ample evidence that this Committee exercised great foresight by including the authorities outlined in Section 102.

An Insurance Program Solution

One approach, drawing on the precedents established in dealing with other seeming insurmountable risks, including the Price-Anderson Nuclear Industries Indemnity Act, would implement an insurance program that would use a combination of risk retention, risk pooling and government backstop liquidity. Such an approach would benefit taxpayers, financial institutions saddled with illiquid assets, and homeowners. Aon has submitted a proposal to Treasury supporting such an approach.

Such a plan, largely self-funding and drawing inspiration from the Price-Anderson program, involves the sharing of risk by participants in an entity that we refer to as the "asset stabilization pool." Participants in the asset stabilization pool would have a portion of the principle and interest from specific, illiquid assets guaranteed.

Thus, the program would insulate an asset holder from the decline in value resulting from the non-payment, or expected non-payment, of principal and interest. Asset holders would be required to retain a small percentage of the shortfall of principal and interest, subject to a maximum annual payout per asset. Asset holders would be reimbursed from the pool for a shortfall in principal or interest once such amounts exceed their retained amount in a single year.

To receive the benefit of such coverage, participating institutions would have to pay premiums into the pool. Each year, actuaries would calculate the level of premium needed to fund the guarantee payments for the following year. Premium payments to the pool would be capped by the government.

In the event that payments from the pool exceeded premium collections, the government would lend the pool the funds needed to make good on the guarantees. The government would be reimbursed by premium collections in subsequent years. And the Treasury Department could calibrate liquidity by speeding up or slowing down the collection of premiums.

Consider the holder of $1 million in mortgage backed assets. The current lack of confidence in the liquidity of these assets has dropped the market value to, for example, $600,000. This results in a $400,000 loss on the ledgers of the asset holder. This drop in value is a result of the lack of confidence in the ability to measure the true intrinsic value of mortgage related investment income during the current period of correction in the housing market. Hence market value has fallen well below expected intrinsic value.

Let's assume, for our example, that the expected intrinsic value is $800,000. Under certain accounting treatments, an insurance pool that guarantees the principle and interest from specific assets would result in a restatement of the asset holder's loss from $400,000 to only $200,000. Additionally, the out of pocket cash flow from asset holders would be limited to the premium assessed to cover a single year's expected shortfall on principle and interest. In this example, that would suggest that the full $200,000 loss is amortized on a cash flow basis over the life of the mortgage underlying the asset.

Nobel Prize-winning economist Harry M. Markowitz recently published a paper in which he referred to this crisis not as a liquidity crisis but as a transparency crisis. The core of the problem, in his opinion, is the lack of information needed to price illiquid assets. Markowitz recognizes the ultimate resolution of the liquidity crisis to be the development of information and methods needed to accurately price risk.

After some experience working with the proposed asset stabilization pool, we believe actuaries should be able to use the accumulated data about the performance of the insured assets to develop ever-more-accurate premium pricing models, reflecting the intrinsic value of the underlying securities. In this way, the insurance plan would build a bridge to the future.

An insurance mechanism for illiquid assets would also assist homeowners. The plan would create a mechanism for spreading the cost of mortgage defaults among participants over time. In turn, another precondition of participation would be the acceptance of a compulsory loan-modification provision. The government could provide guidance to financial institutions for renegotiating terms or writing-down of individual mortgages.

Benefits of an Insurance Program to Taxpayers, Financial Institutions and Homeowners

An insurance program would have significantly lesser short-term cash requirements than capital infusions, and because such an insurance plan would be largely funded by its direct beneficiaries, it would restore liquidity without requiring massive outlays of government funds to the benefit of taxpayers.

The insurance of illiquid assets would also protect financial institutions and the economy. As an insurance program would provide asset holders the option to hold assets until maturity or until economic conditions permit the restoration of the assets' value, it would not flood the market with distressed assets, which could have the effect of further depressing asset values.

An insurance program would also prevent opportunistic purchases of depressed assets by predatory investors. Furthermore, the plan provides a framework for managing risks from the securitization of assets to helping the financial services sector avoid similar crisis in the future.

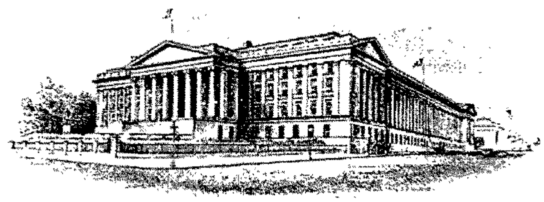
Finally, our plan provides a mechanism for the government to restructure individual mortgages with an emphasis on decreasing the number of foreclosures.

Conclusion

On behalf of the CIAB, I want to thank you again for the opportunity to testify today. Aon and the CIAB commend the Committee for demonstrating the leadership and vision to include in the EESA the authority to create an asset guarantee program

Your diligent work on this issue is critical to our clients and most importantly the Nation. I know Aon and the CIAB look forward to working with you and your staff on developing an innovative and sustainable solution to the challenge facing our economy.

I look forward to your questions.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 9:30 a.m., November 18, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

TESTIMONY BY TREASURY SECRETARY HENRY M. PAULSON, JR. BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES

Washington, DC— Good morning and thank you for the opportunity to testify this morning on implementation of the Emergency Economic Stabilization Act. I am grateful and everyone in this country should be grateful, for the efforts of Chairman Frank, ranking member Bachus, this committee and other members of Congress toward adoption of the financial rescue legislation, which created critically important authorities and financial capacity to stabilize our financial system. Before Congress provided these tools, we were facing a financial crisis without the authorities and resources necessary to meet the challenge. At the risk of oversimplification, the financial rescue package is about restoring confidence – restoring the confidence of depositors and investors in our financial institutions, and restoring the confidence that our financial institutions need so that they will get back to normal lending practices.

This law has already allowed us to take decisive action to prevent the collapse of our financial system. But more needs to be done, and it is my responsibility to use the authorities Congress provided to protect and strengthen the financial system, and in so doing, protect the taxpayer.

Let me summarize what the U.S. financial system has had to digest in just a few months' time. We have not in our lifetime dealt with a financial crisis of this severity and unpredictability. We have seen the failures, or the equivalent of failures, of Bear Stearns, IndyMac Bank, Lehman Brothers, Washington Mutual, Wachovia, Fannie Mae, Freddie Mac, and AIG – institutions with a collective $4.7 trillion in assets when this year began. Each of these failures would be tremendously consequential in their own right under normal market conditions – but our economy and our financial system faced them in succession while at the same time the economy was weakening. Other large financial institutions were under significant pressure and market participants around the world were speculating about which institution would be next to fall.

And as you well recall, in September, after 13 months of market stress, the financial system essentially seized up and we had a system-wide crisis. Our markets were frozen, banks had pulled back very substantially from interbank lending. Confidence in our financial system and a number of our financial institutions had been seriously compromised. That was the background against which Chairman Bernanke and I met with the Congressional bipartisan leadership to explain the need for emergency legislation.

Our objectives in asking Congress for a financial rescue package were to first stabilize a financial system on the verge of collapse, and then to get lending going again to support the American people and businesses. We warned that the frozen credit markets were already severely damaging the U.S.

economy and costing jobs. If the financial system were to collapse, it would significantly worsen and prolong the economic downturn that was already underway.

We needed the financial rescue package so we could intervene, stabilize our financial system, and minimize further damage to our economy. The rescue package was not intended to be an economic stimulus or an economic recovery package; it was intended to shore up the foundation of our economy by stabilizing the financial system, and it is unrealistic to expect it to reverse the damage that had already been inflicted by the severity of the crisis.

During the two weeks Congress worked on the legislation, market conditions worsened significantly. Many Americans look at the stock market as an indicator of the economy, and during this period they saw tremendous volatility. The Dow Jones Industrial Average fell more than 700 points on one single day, and over 9 percent during the two weeks the legislation was debated – stock market losses amounted to slightly more than $2 trillion.

But we were focused on the credit markets because they provide our basic economic fuel – borrowing and lending capital – that supports and creates jobs. The confidence in banks and of banks continued to diminish, as did the flow of funds between them. Interbank lending rates relative to policy rates were at the highest level this decade, indicating banks' lack of confidence in one another and in the financial system.

And the problems extended well beyond the banks. Corporate bond spreads continued to increase, as did corporate credit default spreads and overall market volatility. Industrial company access to all aspects of the bond market was dramatically curtailed. For example, blue chip industrial companies were frequently unable to issue commercial paper with maturities greater than a few days as the commercial paper market became severely impaired. We received reports of small and medium-sized companies, with no direct connection to the financial sector, losing access to the normal credit needed to meet payrolls, pay suppliers and buy inventory.

Investor concerns became most evident in the "flight to quality" in the Treasury market, with short-term Treasury bill yields dropping to near zero.

During that same period, the government intervened to protect the financial system. The FDIC acted to mitigate the failure of Washington Mutual by facilitating its sale, and made clear that it would intervene to prevent Wachovia's failure. And turmoil had developed in European markets. In a two-day period at the end of September the governments of Ireland, the UK, Germany, Belgium, France and Iceland intervened to prevent the failure of one or more financial institutions in their countries.

By the time legislation had passed on October 3, the global market crisis was so broad and so severe, we knew we needed to move quickly and take powerful steps to stabilize our financial system and to get credit flowing again. Our initial intent had been to strengthen the banking system by purchasing illiquid mortgages and mortgage-related securities. But by this time, given the severity and magnitude of the situation, an asset purchase program would not be effective enough, quickly enough. Therefore we exercised the authority granted by Congress in this legislation to develop and quickly deploy a $250 billion capital injection program, fully anticipating we would follow that with a program for troubled asset purchases.

There is no playbook for responding to turmoil we have never faced We adjusted our strategy to reflect the facts of a severe market crisis always keeping focused on Congress's goal and our goal – to stabilize the financial system that is integral to the everyday lives of all Americans.

By mid-October, our actions, in combination with the FDIC's guarantee of certain debt issued by financial institutions, helped us to accomplish the first major priority, which was to immediately stabilize the financial system. And, as we worked to hire contractors and prepare our mortgage asset purchase plan for implementation, we continued to assess the economic and market conditions here and around the world.

As we had seen and communicated to Congress and the American people, much damage had already been done to our economy. The economic data since the legislation passed underscored the challenges we were facing: On October 31, third quarter GDP showed negative 0.3 percent growth. Jobs data showed a rise in the unemployment rate to a level not seen in 15 years, and a loss of 240,000 jobs in October alone. Data released on October 28 showed that through August, home prices in 10 major cities had fallen 18 percent over the previous year, demonstrating that the housing correction had not abated.

The slowing of European economies has been even more dramatic, as have the actions taken to rescue failing European banks and nationwide banking systems such as those in Iceland and Hungary.

Throughout this period, we continued to assess how best to use the remaining TARP funds, given the uncertainties around the deteriorating economic situation in the U.S. and globally, and the continuing financial market stresses. We have always said that the housing correction is at the root of the economic downturn and our financial market stress. And as the economy slows further, it threatens to prolong the housing correction, as well as the stress on our financial institutions and financial markets.

We recognized that a troubled asset purchase program, to be effective, would require a massive commitment of TARP funds. It became clear that, while in mid-September, before economic conditions worsened, $700 billion in troubled asset purchases would have had a significant impact. Half of that sum, in a worse economy, simply isn't enough firepower.

If we have learned anything throughout this year we have learned that this financial crisis is unpredictable and difficult to counteract. So early last week, we concluded it was only prudent to reserve our TARP capacity, maintaining not only our flexibility, but that of the next Administration.

We have identified other priorities that I believe the government will need to address through the TARP and other existing authorities. In particular, by investing only a relatively modest share of TARP funds in a Federal Reserve liquidity facility, we can improve securitization in this market and have a significant impact on the availability of consumer credit.

And we need to continue our efforts to use a variety of authorities to reduce avoidable foreclosures. The government has made substantial progress on that front, through HUD programs, through the FDIC's program with IndyMac, through our support and leadership of the HOPE NOW Alliance, and through the new GSE servicer guidelines announced last week that will set a new standard for the entire industry. While I understand the interest in spending TARP resources on other approaches, the efforts already underway will do more to prevent foreclosures than might have been achieved through very large purchases of mortgage-related securities through the TARP.

Although we are not planning to initiate another capital program beyond those already announced, an emphasis on capital seems to us to be the better strategy going forward. In the weeks since enactment of EESA, we have seen that capital purchases are clearly powerful in terms of impact per dollar of investment, which is a major advantage under the current circumstances. More capital enables banks to take losses as they write down or sell troubled assets. And stronger capitalization is also essential to increasing lending which, although difficult to achieve during times like this, is essential to economic recovery.

Our current Capital Purchase Program for banks and thrifts has already dispersed $148 billion, and we are processing many more applications. And yesterday we posted the term sheet for participation for non-publicly traded banks, another important source of credit in our economy. We are developing a matching program for possible future use which could apply to banks and/or non-bank financial institutions.

Recently I've been asked two questions. First, Congress gave you the authorities you requested, and the economy has only gotten worse. What went wrong and why won't you use this authority for other industries? Second, if housing and mortgages are at the root of our economic difficulties, why aren't you addressing this?

The answer to the first is that the purpose of the financial rescue legislation was to stabilize our financial system and to strengthen it. It is not a panacea for all our economic difficulties. The crisis in our financial system had already spilled over into our economy and hurt it. It will take a while to get lending going and repair our financial system, which is essential to an economic recovery. This won't happen as fast as any of us would like, but it will happen much, much faster than it would have had we not used the TARP to stabilize our system. Put differently, if Congress had not given us the authority for TARP and the Capital Purchase Program and our financial system had continued to shut down, our economic situation would be far worse today.

The answer to the second question is that the most important thing we can do to mitigate the housing correction and reduce the number of foreclosures is to increase access to lower cost mortgage lending. The actions we have taken to stabilize and strengthen Fannie Mae and Freddie Mac, and through them to increase the flow of mortgage credit, together with our bank capital program, are powerful actions to promote mortgage lending. We are also working actively to reduce preventable foreclosures.

In summary, I am very proud of the decisive actions by Treasury, the Fed and the FDIC to stabilize our financial system. We have done what was necessary as facts and conditions in the market and economy have changed, adjusting our strategy to most effectively address the urgent crisis and preserving the flexibility of the President-elect and the new Secretary of the Treasury to address the challenges in the economy and capital markets they will face in the coming months.

While difficult challenges lie ahead, the new administration will begin with two significant advantages: a significantly more stable banking system where the failure of a systemically relevant institution is no longer a pressing concern rattling the markets; and the resources, authorities, and potential programs available to deal with the future capital and liquidity needs of credit providers. Deploying these new tools and programs to restore our financial institutions and financial markets is critical to restoring the flow of lending and credit - which will determine, to a large extent, the speed and trajectory of our economic recovery. I am confident in a successful outcome, because our economy is flexible and resilient, rooted in the entrepreneurial spirit and productivity of the American people. And of course, I will focus intensely on the challenges before me and on making this a seamless transition during my remaining nine weeks.

Thank you again for your efforts and for the opportunity to appear today.

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Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Committee on Financial Services

United States House of Representatives

Testimony of Edward L. Yingling

On Behalf of the American Bankers Association

Before the

Committee on Financial Services

United States House of Representatives

November 18, 2008

Chairman Frank and members of the Committee, my name is Edward L. Yingling. I am President and CEO of the American Bankers Association (ABA). ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2.2 million men and women.

We appreciate the opportunity to testify on the current status of the Emergency Economic Stabilization Act, and more specifically, the Troubled Asset Relief Program (TARP). The TARP Program has served to calm the financial markets and does have promise to promote renewed economic growth. However, it is also a source of great frustration and uncertainty to banks. Much of the frustration and uncertainty is because of the significant and numerous changes to the program and misperceptions that have resulted on the part of the press and the public.

This confusion is understandable given what has happened, but it is potentially very harmful. It can lead to misdirected public policy and public perceptions. There is a broad consensus that the crisis grew out of a housing bubble fed by mortgage loans that never should have been made, which were securitized and sold to investors who did not properly analyze or understand the risk. Excess leverage on Wall Street and in other financial centers greatly exacerbated the crisis. There were many other contributing factors such as: regulatory gaps; lack of transparency; breakdowns in the ratings process; and, ABA strongly believes, the application of mark-to-market accounting in dysfunctional markets.

ABA greatly appreciates the consistent statements by members of this committee, and particularly its leadership, that the regulated banks were not the cause of the problem and have generally performed well. Not only did the regulated banks not cause the problem, they are the primary solution to the problem as both regulation and markets move toward the bank world. Thousands of banks across the country did not make toxic subprime loans, are strongly capitalized, and are ready to lend; but they cannot do so if misguided policies increase their regulatory costs and provide disincentives to lend. Banks already face significantly higher costs from deposit insurance premiums. And banks are already receiving contradictory government signals about lending, being told to use capital to make new loans and, in some cases, being told by bank examiners not to because the risk is too great.

As I detail in my statement, the emergency program was driven by severe problems at firms that were ***not*** banks, such as Bear Stearns, Fannie Mae and Freddie Mac, and AIG. The U.S. actions were also responding to foreign governments acting to support institutions that were far less capitalized than U.S. banks. However, commentators often failed to realize the situation was different: the vast majority of U.S. banks were well-capitalized and had nothing to do with making toxic mortgage loans. Unfortunately, when the capital program was announced, the headlines read "Bank Bailout" when clearly it was not. To my knowledge, no one in the banking industry requested a capital program, and the ABA certainly did not.

Now that the program is in place, there are additional actions that need to be taken to improve it. Just last week, Treasury Secretary Paulson announced other likely uses of TARP funds in addition to the current Capital Purchase Program (CPP). To a large degree, these are policy choices for the Congress and the current and future Administrations. However, several comments are in order:

First, we urge the Treasury to ensure that sufficient money remains to fully fund the CPP for community banks accepted into the program. It would be most unfair, and would result in competitive inequality, for the community bank program not to be fully funded.

Second, ABA supports further action to directly address the housing market (which has not stabilized and is the root cause of the problem) and foreclosures (which are so harmful to communities). The ABA supports a four-pronged approach to the housing and foreclosure issues:

- ***Use Some TARP Funding for Distressed Homeowners***

  The ABA supports use of some TARP funding to help distressed homeowners and lessen the number of foreclosures. Such a program would have to be carefully crafted. One great concern to bankers is that any foreclosure prevention program should minimize the risk that more borrowers will be encouraged to default. It is a very difficult balance, but a very important one. An approach that provides lenders additional tools, such as guarantees in case of a second default, appears to be worth pursuing. However, we would suggest that such a program first be carefully vetted with lenders to make sure it is going to be used and that it does not result in more borrowers defaulting in order to receive write-downs they do not need.

- ***Address Foreclosures Connected with Securitized Mortgages***

  The ABA supports addressing foreclosures of loans that have been securitized. As was amply demonstrated in last week's hearing before this committee, it is often much more difficult to create a system for modifying loans that are securitized because so many parties may be involved and because of the fear of litigation. ABA would be pleased to work with the Committee on ways to address this issue.

- ***Take Action to Lower Interest Rates on Mortgage Lending***

  While other interest rates have come down as the Federal Reserve lowered short-term interest rates, mortgage rates have not. There is a severe dislocation between mortgage rates and other interest rates, caused in part by market uncertainty and skittishness with respect to Government Sponsored Enterprises' (GSE) securities. If the traditional relationship between mortgage rates and other rates could be restored, there would be a dramatic impact on housing and on the ability to refinance troubled borrowers.

- ***Use Part of Any Stimulus Package to Directly Address Housing Problems***

  We would encourage Congress to use part of any stimulus package to directly address housing. Two programs deserve consideration: (1) an effective temporary tax credit for the purchase of a house by someone who will live in it – the current program is too small and complicated to be effective; and (2) a tax incentive, such as a more robust depreciation allowance to encourage entrepreneurs to buy properties and rent them out. While bousing markets may still be overpriced in some areas, many buyers are sitting on the sidelines because they read that there will be more price decreases. Buyers need to be encouraged to buy in the near term.

Finally, I would like to reiterate the points in my last testimony before this committee concerning mark-to-market accounting. Since TARP is now focused on creating additional capital, it must be noted that the misapplication of mark-to-market accounting in today's situation, when there is no functioning market, has unnecessarily destroyed billions of dollars in capital. ABA greatly appreciates your comments, Mr. Chairman, at the last hearing, and the recent letter from Ranking Member Bachus on the mark-to-market issue.

On a related matter, the recent action by the Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) to address the concept of "Other Than Temporarily Impaired" (OTTI) was very inadequate. The SEC attempted to resolve this issue, but FASB's interpretation muddled it again. As a result, banks may be required to write down securities – which have no threat to principal or to cash flow – because the markets are dysfunctional.

Mark-to-market accounting badly needs to be addressed in the short-term. Furthermore, ABA once again urges this committee to address the way accounting rules are made in its regulatory restructuring legislation next year.

To further address the subject of this hearing, I would like to make several key points:

- **Greater clarity is needed regarding TARP to assure that banking institutions and the public understand how the program works and how it will meet the objectives of strengthening our financial system.**

- **The TARP should allow all healthy banks, regardless of their corporate structure or charter type, to participate.**

- **Banks continue to lend, and the TARP Program can help to further stimulate expanded banking services by healthy banks.**

- **The TARP program must work in tandem with other programs so as to avoid conflicting messages and incentives to lend.**

Greater clarity is needed regarding TARP to assure that banking institutions and the public understand how the program works and how it will meet the objectives of strengthening our financial system.

There is great confusion about TARP, particularly with the public. More clarity is needed. The confusion is understandable, as this program has had more twists than a mountain road.

As the crisis developed, the government was forced, in different ways, to support the acquisition of Bear Stearns, put Fannie Mae and Freddie Mac into a government supported conservatorship, and rescue AIG. Lehman Brothers was allowed to fail. ***None of these are banks.*** Bank failures have been handled through the bank-funded FDIC. Money market mutual funds for the first time were given a federal guarantee.

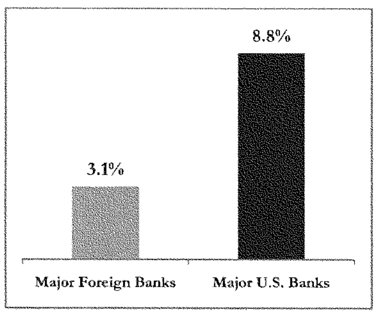
Then, on September 19, 2008, in response to a total loss of confidence in the international financial markets that led to a freezing of the world's credit markets, the Treasury and the Federal Reserve suddenly proposed what became TARP. After improvements made by Congress, TARP was passed. While provisions were added by Congress to allow capital infusions, almost all the justification for TARP was based on asset purchases.

Then in a matter of days, everything changed. After some European countries announced that governments were going to put capital in banks and, apparently, foreign government pressure for the U.S. to do the same, overnight tbe policy shifted to putting capital in U.S. banks. As is widely known, the leaders of nine large banks were called to Washington with no notice and "requested" to take the capital. These nine hanks had not asked for the capital and several of them had just raised private capital.

To my knowledge, no one in the banking industry requested a capital program; the ABA certainly did not. The announcement of the program really harmed the perception of our banking industry over the next few days. Commentators jumped to the conclusion that many banks must be capital deficient and in trouble. They did not understand that U.S. banks were much more heavily capitalized than the European banks receiving capital, nor that about 95 percent of the U.S. banks were well capitalized. Also, the purpose of the program, as announced at that time, was to unfreeze the international credit markets, particularly the interbank lending market. The idea of increasing domestic lending was not at the forefront.

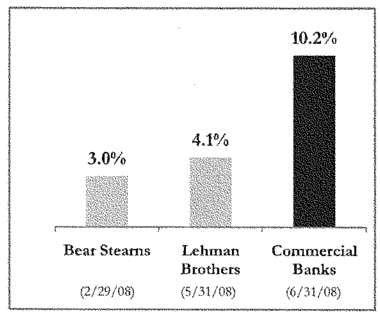
Equity Capital to Assets Comparisons

Foreign and Domestic Banks



Source: FDIC & SEC

Investment and Commercial Banks



Source: FDIC & SEC

As the program was extended beyond the initial nine banks to other banks, it gradually became clearer that the program was to focus on ***healthy*** banks and its purpose was to ***promote the availability of credit***. ABA was extremely frustrated by the lack of clarity and said so in a letter to Secretary Paulson. The press, the public, Members of Congress, and banks themselves, were confused. Many people, understandably, did not differentiate between this voluntary program for solid institutions and "bailouts." Bankers, for a few days, were not sure of the purpose; although they were sure their regulators were making it clear it was a good idea to take the capital.

Now, of course, Treasury has announced that there may be additional uses of TARP money, but that asset purchases – the original purpose – are unlikely to take place. It is quite possible that the latest iteration of the program is its best use, but it has once again created enormous confusion.

Put yourself in the place of a community banker. You are well capitalized and profitable. Your regulator is calling you to "suggest" taking CPP capital is a good idea. You can see that it might be put to good use to support lending growth. But you have many questions about what could well be a decision that dramatically impacts the future of your bank. For example:

- ***What will my customers think?*** Will they be mad that I took government capital, thinking it is not fair? Or if I do not take the capital, will they think I am too weak to qualify? If I do not take it and my competitors do, will customers think those banks must be stronger than mine because the government invested in them or, conversely, that those banks needed government help?

- ***What will the markets think?*** Will there be an advantage to higher capitalized banks (at levels above "well-capitalized"), even if the extra capital came from the government?

- ***What restrictions will be added?*** I can see what is on the table now, but how can I be sure that there will not be changes that severely damage my bank through increased regulatory costs, or counter-productive dividend restrictions, or even attempts to push me to make unsafe loans? The people running the program now will not even be in charge in two months.

  This confusion is compounded by the fact that the Treasury purchase agreement contains a clause, 5.3, which basically allows the Congress to add anything it wants after the fact. This clause will cause a number of banks to avoid participating and should be dropped.

More than anything, bankers need to know exactly what the program is, what its purpose is, and what restrictions and requirements will apply. And they need the public to have a better understanding as well. Everyone concerned – including Members of Congress, the regulators, and the banking industry – must try to put the current actions in context. Otherwise, the absence of clarity in this volatile environment exposes banks to the risk of runs from customers who misperceive a bank as either so weak that it needs a "bailout" or too weak to receive one.

The TARP should allow all healthy banks, regardless of their corporate structure or charter type, to participate.

Another aspect of the program that needs to be addressed is the fact that it is still unavailable to the majority of banks. While we understand a term sheet is soon to be released for private C corporations (and, we presume, for the non-exchange traded public companies), term sheets for many other banks, including S corporation banks and mutual institutions, have not been issued. This is unfair to these banks, and it undermines the effectiveness of the program.

As these corporate structures may not be well understood by some policymakers, let me describe briefly the structure of them. Take private C corporation banks, for example. They generally have fewer than 500 shareholders and are, therefore, not required to become a public company subject to SEC periodic reporting requirements. In addition, while these banks have issued common stock to their shareholders, they may or may not have the authorization to issue preferred stock. As a result, those institutions not authorized to issue preferred stock will need time to obtain shareholder approval to issue preferred stock as required under the TARP. Further, and in order not to push them over the 500 shareholder level, these institutions need assurances that they and their shareholders will have a right of first refusal to purchase both the preferred and the common stock underlying the warrants before Treasury sells the securities into the marketplace.

Many smaller community banks, that are public but not traded on a national securities exchange, face some of the same issues that the private C corporations do. For example, they may not be authorized to issue preferred shares and, like the private C corporations, will have to seek shareholder approval. Because they are a public company, however, they must comply with the SEC's proxy rules, which will add time to the process of gaining shareholder approval.

Finally, because there is either no or a very thinly traded market for the common stock in private C corporations and non-exchange traded public companies, respectively, these institutions have questioned how the initial exercise price for the warrants will be set.

S corporations are subject to many restrictions, including on the number of shareholders, which is limited to 100, and on the type of stock they may issue. S corporations may only issue a single class of stock. The senior preferred stock that Treasury has requested would constitute a second class of stock, so S corporations would not be able to participate. ABA proposes that Treasury allow S corporation banks to issue a different type of debt obligation with non-deductible interest, so that it would be on the same level as other participants. This would allow many more institutions to participate in the program.

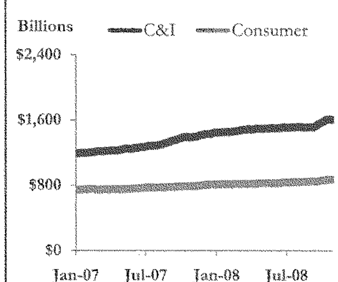
There are about 735 banks organized under mutual ownership, of which about 175 are in the form of mutual holding companies. Those without mutual holding companies cannot issue shares. Some mutual holding company structures have issued minority shares, but must retain a majority interest in the hands of the mutual ownership interest if they are to remain mutually owned. Even if they have the capacity to issue additional preferred shares, they may not be able to comply with requirements established by Treasury for exchanged-traded, SEC filing companies. Finally, a majority of mutual holding companies has not been authorized to issue minority shares, and cannot comply with the terms currently available under the TARP. We propose two alternatives. Instead of preferred stock, subordinated debt could be used as a replacement investment with some type of redemption fee. Alternatively, mutual capital certificates could be used. Mutual capital certificates are subordinate to all deposit accounts and debt obligations, and are entitled to be paid dividends.

Regardless of the corporate structure, all banks provide vital services to their communities. It would be patently unfair to exclude healthy institutions from having the choice of whether or not to use the TARP capital to enhance their banking services. And it would potentially increase the risk of hostile takeover bids by participating institutions for those who are left out.

Banks continue to lend, and the TARP Program can help to further stimulate expanded banking services by healthy banks.

First, it is important to dispel the misperception that banks are not lending. Banks are lending (see the Federal Reserve chart on bank business lending). In fact, many banks have said that they are seeing borrowers that used to rely on non-bank financing or Wall Street coming to their doors. This would be expected with the severe problems in credit markets, including securitization. Thus, many of the stories about the lack of credit

Bank Lending Continues to Grow

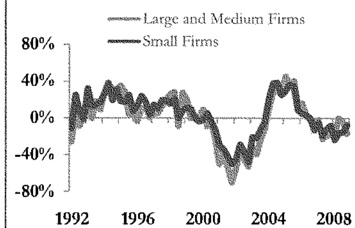


Source: Federal Reserve

are due to the weakness of non-bank lenders. Naturally banks are following prudent underwriting standards to avoid losses in the future. But even with more careful underwriting, only 6 percent of small businesses (according to an October survey by the National Federation of Independent Businesses) reported problems in obtaining the financing they desired.

Borrowers are also being more careful, and the overall demand for loans is declining, although this varies by market. However, as the economy starts to grow again, the growth will be stunted if adequate credit is not available. As experience has shown in previous economic slowdowns, it is the banks that end up providing most of the needed credit to support a recovery. Banks are anxious to meet the credit needs of businesses and consumers, and we know that such capital is vital to an economic recovery in communities large and small across the country.

C&I Loan Demand: Net Percentage of Banks Reporting Higher Demand



Source: Federal Reserve

The availability of capital through the Capital Purchase Program provides added flexibility to help assure these borrowing needs are met. There is so much confusion about the program that it may be helpful to provide some simplified examples as to how it can work to increase lending, which both Treasury and Congressional leaders have said is the purpose of the program. In these examples, I will use hypothetical community banks with $100 million in assets and $10 million in capital. The hypothetical banks will then sell $2 million in equity to the government.

In these examples, it is important to note several factors where there is a great deal of misperception. First, as a general rule, only strongly capitalized, healthy banks are eligible, as noted previously. This is the exact opposite of the capital injection programs in Europe and elsewhere; it is also the opposite of other uses of TARP and other government funds.

Second, the government money is a capital injection; it is not money that is used directly for lending. What capital does do is to allow banks to employ the deposits of their customers more fully. In fact, banks are able to support $10 of assets with $1 of capital. Even though loan losses have increased, which has caused capital ratios to fall somewhat, the vast majority of banks are still well-capitalized, which is the highest rating the regulators can give. In fact, the FDIC stated in its second quarter 2008 report (the latest available) that "despite the slowdown in capital growth and the erosion in capital ratios at many institutions, 98.4 percent of all institutions (accounting of 99.4 percent of total industry assets) met or exceeded the highest regulatory capital requirements at the end of June [the most recent data available]." Certainly, this number has gone down somewhat since then as the economy has weakened and loan losses increased. Under normal circumstances, banks would go to the private capital markets for additional capital, but those markets are now extremely tight. Thus, without additional capital to back more loans, banks might not be able to grow lending; others might even shrink lending in order to boost the capital-to-assets ratio.

Example 1: Well-Capitalized Bank With Growing Loan Demand

Consider a well capitalized bank in a market where loan demand is currently growing. That growth is a combination of some economic growth and the fact that, in current markets, other non-bank sources of credit have dried up. Additional deposits to fund lending can also be acquired as money is seeking the safer haven of insured deposits. There are a large number of banks in this category, although the level of local economic growth can obviously vary.

This bank starts with $100 million in assets and 10 percent capital. After obtaining $2 million in additional CPP capital, the bank can grow to $120 million and still have 10 percent capital. This shows how $2 million in capital can support $20 million in additional lending. If there are lending opportunities available, as there are in our example, the extra credit can be made available fairly quickly. However, as discussed further later, there are two caveats here. One, this example assumes that regulatory capital ratios are not increased. We are concerned that a number of banks are being told that their capital ratio should be increased above previous requirements. While that may be appropriate in individual circumstances, a general move in that direction will negate the CPP program. Note that if the regulatory capital level in this example is raised to 12 percent, the new capital will not support any increase in lending. Two, the bank must apply sound credit standards to its lending programs; there should be no pressure to push out loans as that will just lead to more defaults.

Example 2: Well-Capitalized Bank with Shrinking Loan Demand

Like the bank in Example 1, this bank is well-capitalized but is in an area where the economy is not growing or is shrinking. There are, of course, many areas of the country that look like this. Here, a well-capitalized bank could also increase loans by 20 percent, but it would be unsafe to do so quickly as there are just not that many creditworthy borrowers available. This bank may not be able to grow its deposits to fund the loans rapidly either, as job loss may be high and income growth low. However, importantly, with additional capital this bank is now in a position to fund loans as the local economy begins to grow and thereby ***accelerate*** the economic recovery.

Example 3: A Solid Bank With Losses Affecting Capital

The great majority of banks are covered in the first two examples. However, there are some banks that are still in good financial shape, but that have taken a capital hit. For example, some banks that were well capitalized and profitable took a hit when the value of their preferred shares in Fannie Mae and Freddie Mac were virtually wiped out overnight. In this example, our bank had to write off a $2 million loss, and therefore its capital level was reduced to 8 percent. Since it cannot raise capital in current markets, this bank must ***shrink*** to get back to 10 percent. In fact, it will have to shrink to $80 million in assets, which means it will generally stop making loans – including not rolling over loans to existing customers and reducing lines of credit. The bank may even try to sell loans, which, in this market would be difficult to do. If this bank had $2 million in new CPP capital, it would not have to stop making loans and would be able to continue meeting the needs of its local businesses.

Example 4: A Strong Bank Would Use Capital to Acquire a Weak Bank

This example is one that has raised some controversy. It is clearly not the intent of Congress that the TARP funds be used to support acquisitions generally. However, when there are banks that are weak enough that they cannot increase or even maintain lending levels, facilitating their acquisition may well increase overall lending. In this example, a well capitalized $100 million bank with 10 percent capital is interested in acquiring a weak bank of the same size in a neighboring town. However, in acquisitions, the value of the assets of the acquired bank must generally be immediately written down. In our example, we assume a $2 million write-down. (This is another area where current applications of accounting rules are causing problems.) Instead of 10 percent capital, this acquired bank will only have 8 percent. Thus the combined entity will have only 9 percent capital on its $200 combined assets. The acquisition will probably not take place. If $2 million in CPP capital are infused into the acquiring bank to help facilitate the merger, the new combined entity will have 10 percent capital, the acquisition can take place, and lending can be maintained in the neighboring town.

The point of these four examples is to show that there are many ways that the capital infusion can be effectively deployed by the accepting banks. While different, all have the effect of stabilizing credit availability, expanding lending in the near-term to meet demand, and making credit available as the economy turns the corner and new business opportunities arise for bank customers. Treasury needs the flexibility to invest in banks like those in the examples and banks need the ability to deploy this capital in the most appropriate way to facilitate economic growth in their communities. Most banks in this country have been in existence for decades, and often for more than a century. They expect to be in those communities for the next 100 years and understand the needs for credit to promote economic growth. The TARP program can help each participating bank in its own way.

However, misperceptions need to be addressed if the TARP program is to succeed. As previously noted, a major cause of the misperceptions has been the ever-changing nature of the TARP program. Another cause has been the failure to distinguish between the bank CPP program ***– a voluntary program for healthy banks*** – and the use of TARP and other program funds for direct bailouts of failing institutions, like AIG, in other parts of the financial sector. It is important to note that the great, great majority of banks that will receive CPP capital never made the toxic subprime loans, are strongly capitalized, are well regulated, and are being requested by their regulators to participate in the program. ***Requirements and restrictions that may be appropriate for other companies that are being saved are not appropriate in these cases.*** They would be unfair and counterproductive.

In our examples, the CPP capital funds go into the capital accounts of the banks. This money is not directly lent. Rather, it allows greater use of deposits gathered by banks. The increase in capital can support up to ten times the amount in additional loans. There has been a lot of talk about banks possibly using this money for dividends or bonuses. That is just not the way that the system would function.

The CPP capital would go into a capital account and raise the capital ratio – in our example from 10 percent to 12 percent. That percentage would then come back down, as loans grow, to 10 percent. ***Dividends and compensation are paid out of the income earned from the bank, not from capital.*** That will be the case for the great majority of participating banks. It is possible that in a few cases, there could be a temporary period where income does not cover all costs and, therefore, there would be a temporary dip into capital accounts However, banks are heavily regulated and such a situation would be allowed by the regulators only temporarily. If it goes on for several quarters, or if regulators believe it will, then the bank will be required to undertake a program, among other things, to raise capital and/or cut dividends. Excess compensation would also not be allowed if it would caused capital to be impaired. The regulators have reiterated in clear form this traditional banking policy in last week's guidance, and ABA supports this regulatory approach.

It is important that banks not be cut off from reasonable dividend and compensation policies. These policies are necessary to support the stock price and business of the bank. Many banks joining the program have been paying regular dividends for years – even decades – without interruption. Dividends are particularly important for bank stocks, which are known for paying solid dividends. That is why many people in retirement and pension plans often invest in bank stocks. These investors should not be punished by having the dividends needlessly cut out. Furthermore, the dividend supports the stock price and the ability to raise capital, and eliminating it would be exactly contrary to the purpose of the CPP program. Finally, the taxpayers would be hurt because the value of the warrants would be undermined.

Bonus compensation systems are widely used in the private sector to attract and keep good employees and to incentivize success. While we recognize that there are legitimate questions and concerns about the way some compensation programs have been structured on Wall Street and elsewhere, the TARP program already addresses this. In addition, the recent guidance for the banking agencies addresses these issues specifically for banks.

The fact is that the great majority of banks would not participate in the CPP if prohibited from paying dividends or reasonable compensation, including bonuses. Again, it is essential that policy makers distinguish between capital infused in healthy banks and money provided to weakened institutions outside the banking industry, where such restrictions make sense.

Banks of all sizes, shapes and locations will be participating in the program. The only things they will have in common are that they are strongly regulated and are solid, not weak, banks. The recent regulatory guidance, building on traditional regulatory principles, provides the right roadmap and flexibility to address concerns about dividends, compensation, and other issues. We strongly urge Congress not to put additional restrictions on banks participating in the CPP after those banks, which did not ask for the program, have already signed up. To do so would be unfair and counterproductive.

Another misperception is that this program will be very costly to the government. In fact, this is an investment by the government in healthy banking institutions that will be the engines of the economic recovery. The Treasury has allocated $250 billion to invest in bank preferred stock. The preferred stock will pay a dividend rate of 5 percent for the first 5 years and then go to 9 percent. It is highly likely that almost every bank will try to exit the program, substituting private capital, within five years.

To finance the purchase of the stock, the Treasury will have to issue debt. Assuming the debt matures in five-years and a yield of 2.51 percent (the rate on the 5-year Treasury bond on November 10, 2008), the net cash inflow to the Treasury from Treasury's investment would equal almost $31.4 billion. Additionally, publicly traded institutions that participate in the CPP will have to issue warrants to purchase common stock within the next 10 years, and we expect non-publicly traded institutions to have to issue instruments that yield comparable economic benefits for Treasury. These warrants have a positive value. We conservatively estimate that the value of these warrants could range between $10 billion to $15 billion. Thus, in total, the government's return on this investment is likely to range between $40 billion and $45 billion. This, of course, does not include the benefit to small and large businesses (and indirectly, the taxpayers) that will have available credit and will continue to make money, pay taxes and keep people employed.

In this regard, we would request that TARP funds used for the banking institutions be segregated from other uses for record-keeping purposes. It is important that the government and public know the costs of various parts of the program.

The TARP program should work in tandem with other emergency programs so as to avoid conflicting messages and incentives to lend.

Given the decision to adopt TARP and the CPP, and the goal to support availability of credit, ABA supports last week's regulatory guidance. We do emphasize, however, that it should not become an additional regulatory burden on banks or be applied in some one-size-fits-all fashion.

The guidance basically reiterates the approach that banks are already taking toward capital, dividends, compensation, and lending; and the normal examination and reporting process is sufficient to monitor bank compliance with guidance. For example, to saddle thousands of community banks that do not have material foreclosure issues with policies designed for large institutions dealing with thousands of foreclosures makes no sense.

However, we must add that, not only have banks been receiving ***confusing*** messages, they have been receiving ***conflicting*** messages. As has often been the case, there may well be a disconnect between the regulatory headquarters in Washington and the examiners in the field. It is a matter of achieving the right balance between making sure banks are following sound policies and discouraging innovation and lending. Regulators certainly should be carefully reviewing banks and their capital, borrowing, and lending policies. However, our members have informed us of several problematic areas:

- ***Capital:*** As previously discussed, some banks have basically been told that current definitions of well-capitalized no longer apply. It has been strongly "suggested" that higher capital levels should be reached, even in the case of banks that far exceed the threshold of well capitalized. For banks that received such suggestions, this additional capital from the CPP would be required to be used to support the higher ratio on ***existing*** levels of assets, not to support new assets (loans). Certainly additional capital is appropriate in some circumstances, but there are cases where this will unnecessarily curtail lending.

- ***FDIC's Guarantee Program of Senior Unsecured Debt and Transaction Accounts:*** The ABA recognizes the importance of taking action to address the financial disruptions that have occurred in the last several months and appreciates the FDIC's involvement in the process. The actions taken represent a significant departure from the traditional role of the FDIC. The systemic risk exception has been used in a way that no one would have anticipated, and while it is available to deal with such extraordinary circumstances, we believe that the actions taken should not become a permanent facility. As the banking industry must bear the costs of these initiatives, it is important that the risk be closely monitored, the pricing be subject to change so that those that participate pay a fair price to cover costs (and not impose costs on those that choose not to participate), and the program be unwound in a way that is least likely to be disruptive or create additional problems or costs for the industry.

Moreover, because the program and its implementation have occurred so quickly, it is highly likely that there will be negative unintended consequences. It is very important, for example, that the changes adopted do not create competitive imbalances that would favor banks of different sizes or types. Moreover, those that choose not to participate in the program should not be disadvantaged or punished in any way for that decision. Because of these concerns, ABA is urging the FDIC to be flexible and make adjustments to improve the program and quickly correct any problems that arise. This would include both the flexibility to change the elements of the guarantee (including debt covered, pricing, and terms) and the ability of banks to participate or not in the program.

- ***The Danger of a Regulatory Overreaction:*** A natural reaction in the current economic environment is to intensify the scrutiny of commercial banks' lending practices. However, a regulatory overreaction that signals to banks to stop certain types of lending – particularly commercial real estate lending – will only exacerbate the credit crunch. Just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious economic consequences.

  Accounting rules and excessive regulatory demands are acting together to limit the ability of banks to make loans and in some cases to continue existing funding arrangements. For example, we hear that some banks are being asked to obtain new appraisals on properties for fully ***performing*** loans, i.e., loans where the borrowers are current and meeting their obligations to the bank. The revaluations and downgrades discourage banks from lending for similar projects.

  In other instances, we hear of examiners forcing banks to mark the value of collateral to current market values even though there is little expectation that the bank will be relying on the collateral for repayment of the loan. As these asset mark-downs are reflected on a bank's books, the bank's capital is reduced. As I have stated above, this has the consequence of reducing lending in order to improve the capital-to-assets ratio.

- ***Doubling of FDIC Premiums*:** Our members understand the importance of having a financially sound FDIC insurance fund. Banks are prepared to meet their obligation to keep the fund strong. The industry expects that the premium assessment schedule will rise in the short run in order to pay for current bank failures; provide reserves for the future; and in general rebuild the fund's reserve ratio. Since banks are responsible for the fund's financial health, the ultimate cost to the industry will be virtually the same no matter what recapitalization plan is implemented. At issue is the ***timing*** of payments to rebuild the fund. It is critical to achieve the right balance so that the fund can remain strong without pulling funds unnecessarily from banks that need them to support loans in their communities.

At the end of June (the most recent quarter for which data are available) the FDIC fund was $45 billion – which reflected the losses for IndyMac and other bank failures for the first half of this year. Thus, there are considerable resources available to cover losses, without excessive increases in premium costs. Under the FDIC's plan, which doubles premiums for most banks, about $10 billion will be sent to Washington in 2009, taking valuable resources away that could have supported lending. Certainly, some additional premiums are needed, but ABA believes that premium rates should be lower than what is proposed. In fact, Congress specifically gave FDIC the authority to extend the recapitalization plan under "extraordinary circumstances." A phased-in increase in the assessment schedule over the next few years may be appropriate, considering that the present economic recession and financial turmoil will likely ebb in the future.

- ***Discouraging the Use of Federal Home Loan Bank Advances***: The lack of liquidity has been central to the credit crunch problem and the focus of Congressional and regulatory resolution efforts. One critical source of funding for many banks – both during and well before the current financial crisis – has been Federal Home Loan Bank advances. These are stable sources of liquidity that allows banks to manage the overall cost of funding. FHLB advances often are a cost effect way to raise funds, help banks manage interest rate risk by match-funding to the term of the loan, and often facilitate community development loans. Under the FDIC's proposal to raise premiums, there will be a significant penalty for some institutions that use advances. This simply raises the cost of funding with no change in the risk of assets that are funded.

- ***Discouraging Retention of Local Deposits:*** The FDIC proposes to charge higher premiums to banks that use elevated levels of brokered deposits. While some recently failed or troubled banks have used brokered deposits to grow rapidly and fund risky assets, the FDIC proposal fails to distinguish among ***different*** types of brokered deposits. This is critical as some so-called "brokered deposits" are designed to maintain relationships with customers and provide safe, stable and low-cost funding for banks. For example, many banks participate in networks of banks that exchange deposits in order to provide greater deposit insurance protection for their customers. These reciprocal deposit programs allow banks to maintain relationships with their customers and keep funds within the local community. Other banks regularly sweep cash from a brokerage account to a deposit account within the same organization. These are considered "brokered" yet they help customers manage their money and helps banks maintain the customer relationship.

  Unfortunately, these and reciprocal deposits are currently defined as "brokered deposits" and have been unfairly painted with the same brush as "hot money" deposits. These are very stable deposits. In fact, without programs like these, depositors are likely to withdraw money from local banks and spread it on their own or through brokers to banks that truly are higher risk and paying high interest rates. Thus, it is unfair to include reciprocal deposits and deposits swept from affiliates in with other, more volatile, forms of brokered deposits. Most importantly, doing so would only serve to increase the cost of funding loans and encourage funds to leave local markets – which reduce the ability of banks that use these products to make loans.

There are two other issues that are hurting the effectiveness of the CPP. First, the deadline should be extended. Given the changing nature of the program, and its complexity, many banks did not have adequate time to apply. Second, the SEC needs an expedited program to approve the process a number of banks must take to achieve needed approvals to comply with the CPP – for example, shareholder approval to issue the preferred stock. We have heard from banks that the SEC is causing delays and imposing needless requirements, treating these actions individually rather than as a common approach to a government program.

Conclusion

Mr. Chairman, we appreciate the opportunity to present the views of the American Bankers Association today on the emergency legislation. While the actions taken are positive and promise to have the desired effect of simulating credit availability, there are improvements that are very much needed to enhance their effectiveness. It is also important that any initiatives be consistent and not send conflicting messages or undermine the effort to extend new credit. Finally, the system of banking regulation, while certainly stressed, has shown great resilience and is the model for reform. The banking industry has strong supervisory oversight, a method of handling problems and failures (paid for by the industry), and emergency provisions in the event of a systemic problem. It is no wonder that the problems in other financial industry sectors have led firms to seek out a banking charter. As policymakers continue to evaluate what further actions need to be taken, it is critical that the healthy banking institutions that had nothing to do with the current crisis not suffer additional regulatory burdens that will inevitably lend to less credit and fewer services to local communities.

To: Barney
From: John (x63175) and Michael (x63893)
Date: November 17, 2008
Re: TARP—Treasury's Loan Modification Authority

Note: FDIC is relying on Section 109 to get Treasury to use TARP funds for its loan mod program.

General authority to purchase troubled assets (e.g., residential mortgages and MBS):

Sec. 3. DEFINITIONS.

(9) TROUBLED ASSETS- The term 'troubled assets' means--
(A) **residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages**, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and
(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

SEC. 101. PURCHASES OF TROUBLED ASSETS.

(a) Offices; Authority-
(1) AUTHORITY- The Secretary is authorized to establish the Troubled Asset Relief Program (or 'TARP') to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.

General authority to insure troubled assets:

SEC. 102. INSURANCE OF TROUBLED ASSETS.

(a) Authority-
(1) IN GENERAL- **If the Secretary establishes the program authorized under section 101, then the Secretary shall establish a program to guarantee troubled assets originated or issued prior to March 14, 2008, including mortgage-backed securities.**
(2) GUARANTEES- In establishing any program under this subsection, the Secretary may develop guarantees of troubled assets and the associated premiums for such guarantees. Such guarantees and premiums may be determined by category or class of the troubled assets to be guaranteed.
(3) EXTENT OF GUARANTEE- Upon request of a financial institution, the Secretary may guarantee the timely payment of principal of, and interest on, troubled assets in amounts not to exceed 100 percent of such payments. Such guarantee may be on such

terms and conditions as are determined by the Secretary, provided that such terms and conditions are consistent with the purposes of this Act.

(b) Reports- Not later than 90 days after the date of enactment of this Act, the Secretary shall report to the appropriate committees of Congress on the program established under subsection (a).

Specific authority to provide loan guarantees to facilitate loan mods:

SEC. 109. FORECLOSURE MITIGATION EFFORTS.

(a) Residential Mortgage Loan Servicing Standards- To the extent that the Secretary acquires mortgages, mortgage backed securities, and other assets secured by residential real estate, including multifamily housing, the Secretary shall implement a plan that seeks to maximize assistance for homeowners and use the authority of the Secretary to encourage the servicers of the underlying mortgages, considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program under section 257 of the National Housing Act or other available programs to minimize foreclosures. **In addition, the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.**

(b) Coordination- The Secretary shall coordinate with the Corporation, the Board (with respect to any mortgage or mortgage-backed securities or pool of securities held, owned, or controlled by or on behalf of a Federal reserve bank, as provided in section 110(a)(1)(C)), the Federal Housing Finance Agency, the Secretary of Housing and Urban Development, and other Federal Government entities that hold troubled assets to attempt to identify opportunities for the acquisition of classes of troubled assets that will improve the ability of the Secretary to improve the loan modification and restructuring process and, where permissible, to permit bona fide tenants who are current on their rent to remain in their homes under the terms of the lease. In the case of a mortgage on a residential rental property, the plan required under this section shall include protecting Federal, State, and local rental subsidies and protections, and ensuring any modification takes into account the need for operating funds to maintain decent and safe conditions at the property.

(c) Consent to Reasonable Loan Modification Requests- Upon any request arising under existing investment contracts, the Secretary shall consent, where appropriate, and considering net present value to the taxpayer, to reasonable requests for loss mitigation measures, including term extensions, rate reductions, principal write downs, increases in the proportion of loans within a trust or other structure allowed to be modified, or removal of other limitation on modifications.

Hortatory foreclosure mitigation language:

SEC. 110. ASSISTANCE TO HOMEOWNERS.

(a) Definitions- As used in this section--

(1) the term 'Federal property manager' means--

(A) the Federal Housing Finance Agency, in its capacity as conservator of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation;

(B) the Corporation, with respect to residential mortgage loans and mortgage-backed securities held by any bridge depository institution pursuant to section 11(n) of the Federal Deposit Insurance Act; and

(C) the Board, with respect to any mortgage or mortgage-backed securities or pool of securities held, owned, or controlled by or on behalf of a Federal reserve bank, other than mortgages or securities held, owned, or controlled in connection with open market operations under section 14 of the Federal Reserve Act (12 U.S.C. 353), or as collateral for an advance or discount that is not in default;

(2) the term 'consumer' has the same meaning as in section 103 of the Truth in Lending Act (15 U.S.C. 1602);

(3) the term 'insured depository institution' has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); and

(4) the term 'servicer' has the same meaning as in section 6(i)(2) of the Real Estate Settlement Procedures Act of 1974 (12 U.S.C. 2605(i)(2)).

(b) Homeowner Assistance by Agencies-

(1) IN GENERAL- To the extent that the Federal property manager holds, owns, or controls mortgages, mortgage backed securities, and other assets secured by residential real estate, including multifamily housing, the Federal property manager shall implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program under section 257 of the National Housing Act or other available programs to minimize foreclosures.

(2) MODIFICATIONS- In the case of a residential mortgage loan, modifications made under paragraph (1) may include--

(A) reduction in interest rates;

(B) reduction of loan principal; and

(C) other similar modifications.

(3) TENANT PROTECTIONS- In the case of mortgages on residential rental properties, modifications made under paragraph (1) shall ensure--

(A) the continuation of any existing Federal, State, and local rental subsidies and protections; and

(B) that modifications take into account the need for operating funds to maintain decent and safe conditions at the property.

(4) TIMING- Each Federal property manager shall develop and begin implementation of the plan required by this subsection not later than 60 days after the date of enactment of this Act.

(5) REPORTS TO CONGRESS- Each Federal property manager shall, 60 days after the date of enactment of this Act and every 30 days thereafter, report to Congress specific information on the number and types of loan modifications made and the number of actual foreclosures occurring during the reporting period in accordance with this section.

(6) CONSULTATION- In developing the plan required by this subsection, the Federal property managers shall consult with one another and, to the extent possible, utilize consistent approaches to implement the requirements of this subsection.

(c) Actions With Respect to Servicers- In any case in which a Federal property manager is not the owner of a residential mortgage loan, but holds an interest in obligations or pools of obligations secured by residential mortgage loans, the Federal property manager shall--

(1) encourage implementation by the loan servicers of loan modifications developed under subsection (b); and

(2) assist in facilitating any such modifications, to the extent possible.

(d) Limitation- The requirements of this section shall not supersede any other duty or requirement imposed on the Federal property managers under otherwise applicable law.

National Credit Union Administration

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Office of the Chairman

November 14, 2008

The Honorable Barney Frank
Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank:

Last month, thanks to your good work, Congress enacted the Emergency Economic Stabilization Act of 2008. As you well know, Title I of the Act established the Troubled Assets Relief Program, or TARP, providing the Secretary of the Treasury with the authority to buy distressed assets from financial institutions, including credit unions. As Chairman of the National Credit Union Administration, I am one of the five agency officials with whom the Secretary is to consult in exercising this authority.

It therefore was disappointing to learn that Secretary Paulson had determined that Treasury would not use funds authorized by Congress to purchase troubled assets. This concerns me deeply, not only because Congress was specific in the legislation that this was a primary purpose of the rescue package, but also because this provision (in addition to the share insurance coverage increase) was welcomed by credit unions and seen as a mechanism which would enable many of them to remain safe, solvent, and secure. While the majority of credit unions are not in need of such relief, there are some which may require its use.

I have written to Secretary Paulson to respectfully request that he reconsider his position and make a portion of the TARP funds available for the purchase of illiquid assets from credit unions and other financial institutions. I am asking for your continued support in this effort.

Thank you for your consideration and your leadership.

Sincerely,

Michael E. Fryzel

Michael E. Fryzel
Chairman

1775 Duke Street—Alexandria, VA 22314-3428—703-518-6300—703-518-6319-Fax

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November 17, 2008

The Honorable Barney Frank
Chairman
Committee on Financial Services
2129 Rayburn HOB
Washington, DC 20515

Dear Chairman Frank:

I write to commend you for your leadership in addressing the foreclosure crisis and repairing its effects on neighborhoods and to outline what I believe are the insufficient efforts of the Department of Treasury to combat the crisis. When the magnitude of the subprime and Alt-A mortgage crisis threatened the entire financial system, you led Congressional efforts in negotiating and drafting the Emergency Economic Stabilization Act of 2008 (EESA) to achieve the twin objectives of unfreezing capital markets and preventing unnecessary foreclosures. Giving the Department of Treasury broad latitude, EESA nonetheless explicitly authorized the purchase of troubled mortgage assets by the Troubled Asset Relief Program (TARP), to be accompanied by a plan to minimize foreclosures on those properties. Unfortunately, the Department of Treasury has not exercised its authority properly.

On November 12, 2008, Treasury Secretary Henry M. Paulson, Jr. announced that TARP would not acquire troubled mortgage assets, as Congress had envisioned. My Subcommittee held a hearing on November 14, 2008, where we heard testimony from Interim Assistant Secretary for Financial Stability Neel Kashkari, the top Treasury official in charge of the TARP, as well as a number of noted industry, academic, and legal experts. It was clear from Interim Assistant Secretary Kashkari's testimony that, contrary to Congressional intent, the Treasury Department has not and does not intend to use TARP for foreclosure prevention. In addition to breaking with Congressional intent, Secretary Paulson's policy reversal contradicts public assurances previously made by the Treasury Department and leaves the federal government without an adequate mechanism to stem the rising tide of home foreclosures. Because the Treasury Department refuses to spend the resources Congress made available for foreclosure prevention, I recommend that we inform the President that we will withhold the second installment of $350 billion until a new administration takes office.

The Honorable Barney Frank
November 17, 2008
Page 2

Treasury Profoundly Misunderstands the EESA and the Mortgage Crisis

At the hearing, Interim Assistant Secretary Kashkari demonstrated a profound misunderstanding of both the purposes of EESA and the mortgage crisis underlying the financial crisis. Mr. Kashkari testified that the TARP must be limited to "investments" rather than other uses, such as the proposal by Chairman Sheila Bair of the Federal Deposit Insurance Corporation for federally guaranteed loan modifications. Not only is his interpretation inconsistent with the clear statutory authority granted the Treasury Department in EESA,[1] it is inconsistently applied by Mr. Kashkari. As Ranking Minority Member Darrell Issa pointed out at the hearing, the Treasury Department's use of TARP to make preferred equity purchases under its Capital Purchase Program hardly qualify as pursuing an investment strategy with TARP funds, if investment is understood as a means of maximizing profit. Mr. Kashkari was forced to admit that the equity purchases were subsidies, rather than investments: "our objective was to create a program that would encourage thousands of banks across our country to voluntarily apply... so we intentionally made it attractive for them to want to apply."

Second, Mr. Kashkari displayed a misunderstanding of the cause of and solution to the mortgage crisis. For instance, he testified, "[B]ringing mortgage rates down for borrowers is the best thing we could do to try to help homeowners avoid foreclosure and stabilizing our housing sector." While low interest rates would help to stimulate home sales and new home construction, they would neither protect current borrowers from imminent foreclosure nor provide certainty to lenders or the secondary market about the true cost of existing toxic mortgage assets, a crucial building block to restoring mortgage lending.

Third, Mr. Kashkari employed a verbal sleight of hand to create the impression that the EESA was being implemented to help prevent foreclosures, when in fact it was not. Mr. Kashkari often referred to "Treasury" to discuss foreclosure prevention efforts, when the subject of his testimony and his relevant job responsibilities is "TARP." We know, of course, that these terms relate to distinct entities and are not interchangeable. TARP is an asset acquisition fund, a subdivision of Treasury Department, created by EESA. Treasury, meanwhile, is the overarching regulator of the financial services industry and chief interpreter of the nation's tax laws. The Treasury Department issued three Revenue Procedures in the past year aimed at encouraging mortgage servicers to perform more loan modifications. TARP was created by Congress after those Revenue Procedures failed on their own to effect a sufficient increase in loan modifications.

Fourth, Mr. Kashkari argued that TARP's primary function was reestablishing liquidity and stability to the financial system. It is commonly known, however, that the troubles of the broader financial system trace their roots to millions of troubled subprime and Alt-A mortgages. Without addressing the underlying damage posed by troubled mortgage assets, Mr. Kashkari's strategy cannot accomplish the stabilization goal of EESA.

[1] *See* EESA, Section 109(a) ("[T]he Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.").

The Honorable Barney Frank
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Reducing Principal is the Necessary Federal Objective

TARP is being misused from the standpoint of EESA's twin objectives of unfreezing credit markets and preventing foreclosures. Loan modifications, rather than low interest rates, hold the key to realizing EESA's objectives. Indeed, as Professor Anthony Sanders testified, "[I]t is clear

that home preservation and solving system risk problems can be accomplished with a sensible loan modification template of Treasury decides to deploy it." Treasury should be pursuing mechanism by which troubled mortgage loans can be modified in large numbers to achieve the twin goals simultaneously.

However, not all loan modifications are equal. Research by Credit Suisse demonstrates that traditional loan modifications, including extensions of term, temporarily lower interest rate, and forbearance have high redefault rates, indicating that many borrowers are not more able to make mortgage payments after receiving traditional loan modifications.[2] However, two kinds of modifications demonstrated much lower redefault (higher success) rates: interest rate freezes for loans facing imminent reset of an adjustable rate mortgage, and principal reduction modifications for loans in default.

There is ample evidence that so-called "reset modifications" are being aggressively deployed by mortgage servicers. According to Credit Suisse, the real growth in loss- mitigation activity is largely attributable to reset modifications,[3] while other traditional modifications that result in a lower monthly payment—including forbearance, repayment plans, extension of loan terms, lower interest rate—have also grown to a lesser extent. Notably, the servicing industry increased its performance of reset modifications after Treasury issued a Rev. Proc. 2007-72, creating a safe harbor from loss of the REMIC tax status for performance of reset modifications.

Principal reductions are seen by experts as solving both a borrower's inability to make mortgage payments and unwillingness to make mortgage payments when the loan greatly exceeds the value of the house. Providing for a solution to this latter problem is extremely significant, especially in large portions of the nation where housing prices inflated fastest and longest. As Professor Sanders testified, "[W]e are in unchartered territory to the extent that there has never been a period in our history where homeowners could be as much as 50% upside down on the mortgage."

However, the mortgage servicing industry has not moved toward making large numbers of principal modifications. In fact, all but a few servicers avoid performing principal modifications. Only one company, Ocwen, accounted for 70 percent of all principal modifications found by

[2] Credit Suisse, *Subprime Loan Modifications Update,* (October 1, 2008).

[3] *Id.*, at Exhibit 3.

Credit Suisse.[4] In spite of Rev. Proc. 2008-28, which created a safe harbor for principal modifications,[5] they remain a rarely exercised option by mortgage servicers.[6]

Thus, principal reduction must be at the centerpiece of a program of loan modifications, and the role of the Federal government should be to facilitate massive numbers of them. Clearly, the private market is unable or unwilling to perform principal modifications in sufficient numbers, and the Treasury Department's rulemaking is not an adequate stimulus on its own. In addition, the federal government should learn lessons from mortgage servicers that have distinguished themselves for aggressively performing principal modifications. Mr. Larry Litton, Chairman, Litton Loan Servicing LP, and one of the nation's leading performers of principal modifications, testified that while principal modifications are necessary, they are not sufficient if they do not go far enough to make the loan affordable to the borrower. In an effort to curb redefault rates among loans receiving principal modifications, his company is now aiming toward reducing enough principal to result in a debt-to-income ratio of 31%, down from 39%. Many others also believe that modified loan-to-value ratio should not exceed 100% to 110%.

Options for the TARP to Prevent Foreclosures

Witnesses at the Subcommittee's hearing testified to a number of ways to use TARP to facilitate a massive program of principal modifications. For example, Professor Michael Barr's written testimony outlined a mechanism where the Treasury Department would use TARP to purchase whole troubled mortgages out of securitized trusts. While there are a number of technical challenges to doing this, testimony at my hearing made clear that the industry believes they can be overcome. Indeed, Mr. Tom Deutsch of the American Securitization Forum, a trade association representing all parties to asset-backed securitizations, testified that the barriers are surmountable and investors would be willing to sell troubled assets to the government at a discount from face value. TARP funds could be used to guarantee home mortgages meeting Treasury Department guidelines, similar to a recent proposal by FDIC. This idea was effectively disqualified by the Treasury Department for violating the fictitious "investment" rule. Professor

[4] *Id.*, at 7.

[5] Rev. Proc. 2008-28 allows principal write-downs for residential mortgage loans on dwellings of less than 5 units. Treasury imposes a relatively loose standard allowing servicers considerable latitude: the servicer "reasonably" believes that the loan faces a "significant risk of foreclosure," and "reasonably" believes his loan modification is less risky than the terms of the original loan. Treasury goes on to explain that "[t]his reasonable belief may be based on guidelines developed as part of a foreclosure prevention program similar to that described in ... this revenue procedure or may be based on any other credible systematic determination." Rev. Proc. 2008-28's effective duration is until December 2010.

[6] Three month rolling average of principal modifications, as a percent of total modifications, has risen from 1.4% in September 2007, to 3.9% in August 2008. Source: Staff calculations from Credit Suisse data.

The Honorable Barney Frank
November 17, 2008
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Barr also recommended that TARP could find a way to pay servicers to restructure loans according to Treasury Department guidelines.

Conclusion

It is also possible that a new Treasury Department and Congress will want to consider further rulemakings and legislation. Barring some acute financial breakdown, I believe Congress should withhold the second installment of $350 billion for the TARP, and that we should inform the President before his administration requests it. In fact, every expert that testified in front of my

Subcommittee last Friday agreed that it would be prudent of Congress to preserve these resources pending the new Administration. Withholding the second installment would preserve the ability of the incoming administration to reconsider Secretary Paulson's policy reversal, and allow Congress to legislate further, while preserving a significant portion of the funds Congress has already made available for the purpose of preventing foreclosures.

If you have any questions, please contact Jaron Bourke, Staff Director, at (202) 225-6427.

Sincerely,

Dennis J. Kucinich

Dennis J. Kucinich
Chairman
Domestic Policy Subcommittee

cc: Darrell Issa
Ranking Minority Member

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STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

SUBMITTED TO THE

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

HEARING REGARDING

"OVERSIGHT OF IMPLEMENTATION OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 AND OF GOVERNMENT LENDING AND INSURANCE FACILITIES; IMPACT ON ECONOMY AND CREDIT AVAILABILITY."

ENTITLED

"4-POINT PLAN FOR STIMULATING NEW HOME SALES AND STABILIZING HOUSING VALUATIONS"

NOVEMBER 18, 2008

On behalf of 1.2 million members of the National Association of REALTORS® (NAR), we present our views regarding how best to reduce foreclosures and mitigate the erosion of housing values. NAR represents a wide variety of housing industry professionals committed to making the American dream of homeownership affordable for those who seek it.

REALTORS® are frustrated with the current mortgage lending environment that places barriers in the path of consumers wishing to complete short sales, and with current underwriting standards that prevent high FICO score borrowers with substantial down payments from making a home purchase. These are just two effects of the current credit crisis on the housing market, and if they continue unabated, any anticipated housing recovery will be delayed thwarting a speedy national economic recovery.

NAR's 4-Point Housing Stimulus Plan

The current economic crisis is, at its core, the result of problems in the nation's housing and mortgage markets. This circumstance, along with the fact that housing has always lifted our economy out of downturns, makes it imperative that efforts be taken immediately to foster a housing recovery, so that a recovery of the overall economy can occur.

NAR has developed a plan that includes:

1. A consumer-driven provision that eliminates repayment of the first-time homebuyer tax credit and expands it to all homebuyers,

2. Makes the higher FHA and GSE mortgage loan limits permanent,

3. Gets the Troubled Asset Relief Program (TARP) back on track by targeting funds for mortgage relief through a federal mortgage interest rate buy-down program, and

4. Prohibits banks from entering into real estate.

NAR strongly believes that inclusion of these priorities in a stimulus package is imperative to move our nation out of this economic crisis.

Make the First-Time Homebuyer Tax Credit Permanent. NAR supports making the $7500 first-time homebuyer tax credit available to all buyers and eliminate repayment requirements. The credit's limited availability and repayment requirement severely limit the credit's use and effectiveness.

The housing market has a staggering supply of product and limited demand. In order to facilitate a recovery, all efforts must be utilized to move the cautious housing consumer off the sidelines and back into the market. A tax credit that is available to all homebuyers, first-time or repeat / trade-up buyers, will increase demand for the existing housing supply and kick-start the housing market.

Make the 2008 FHA, Fannie Mae and Freddie Mac loan limits permanent. NAR believes that making the 2008 FHA and GSE loan limits permanent will expand mortgage affordability in a time when home sales and refinance activity are required to stabilize the housing market and move it towards recovery. As other sources of mortgage capital have dried up, FHA and the GSEs have grown in importance.

Current law will reduce the agency's limits at the end of 2008. This will create a situation where some borrowers will find themselves facing potentially higher mortgage interest rates, more adverse terms and conditions, or unable to secure funding because they are in an area that is suddenly above the GSE and FHA loan limits. These significant changes in loan limits will act to amplify the existing problems within the housing market.

Making the 2008 limits permanent will assure that a wide range of borrowers will have access to fair and affordable mortgages, including those residing in high cost areas.

Create a Federal Mortgage Interest Buy-Down Program. NAR supports getting TARP back on track by targeting funds to mortgage relief through the creation of a federal mortgage interest buy-down program. This program will make below-market interest rates available to housing consumers, thus stimulating home sales activity that will effectively stabilize home prices.

Daily, REALTORS® indicate that they meet and speak with thousands of credit-worthy housing consumers who are ready to jump into the market, except they are afraid that neither the housing market nor the economy has reached bottom. Lower mortgage rates, facilitated by a federal mortgage interest rate buy-down, would be the impetus to encourage these consumers to enter the housing market.

Upon entering the housing market, these consumers will stimulate existing and new home sales which will reduce housing inventories and begin to stabilize prices. Ultimately, the impact of rising home sales will spill into the overall economy as new homeowners increase purchases of items related to housing (i.e. furniture, household appliances, etc.).

Permanently Bar Banks From Engaging In Real Estate. NAR supports a permanent ban on banks engaging in real estate brokerage or management. The banks have proven they have enough to do to simply manage the loan process. If banks had been allowed to engage in real estate brokerage, the current economic crisis would be much more severe.

Banks engaging in real estate brokerage create an unlevel playing field and inherent conflicts of interest. Banks benefit from federally chartered advantages that are not afforded to their real estate brokerage competitors. The real estate brokerage industry is already characterized by fierce competition, market efficiencies, and ease of entry so that there is nothing gained for consumers by permitting banks' entrance. Allowing banks with inherent advantages to own real estate brokerage companies would stifle competition, limit consumer choices and predictably raise consumer costs.

Therefore, proposals to permit commercial firms to acquire banks, or vice versa, should be defeated. Allowing banking conglomerates to engage in commercial activities would create anti-competitive and anti-consumer concentrations of power within the financial services sector, an unlevel playing field among commercial competitors, and conflicts of interest. In the current economic environment, further consolidation of power would only act to build more business concerns that the American taxpayer would be on the hook to "not let fail".

Conclusion

Our nation continues to face a significant challenge in dealing with the economic turmoil in today's housing market. We can only overcome this threat if we pursue avenues that will motivate the frightened and cautious housing consumer to enter the marketplace. NAR believes that the 4-Point Housing Stimulus Plan contains the tools necessary to encourage potential homebuyers, first-time and repeat, to enter the marketplace. Only then can the housing recovery begin, and only then can our nation's economy begin the long road home to stability.

We thank you for the opportunity to share our thoughts. The National Association of REALTORS® remains ready to assist Congress and our industry partners to implement a stimulus plan, containing these points that will restore order to the housing market and the economy.

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA

COMMITTEE ON
FINANCIAL SERVICES

CHAIRMAN
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON OVERSIGHT AND
GOVERNMENT REFORM

WASHINGTON OFFICE:
2188 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-3811
(202) 225-6511

Website: http://kanjorski.house.gov
E-mail: paul.kanjorski@mail.house.gov

Congress of the United States
Washington, DC 20515-3811

October 9, 2008

DISTRICT OFFICES:
THE STEGMAIER BUILDING
7 NORTH WILKES-BARRE BOULEVARD
SUITE 400 M
WILKES-BARRE, PA 18702-5283
(570) 825-2200

546 SPRUCE STREET
SCRANTON, PA 18503-1808
(570) 496-1011

102 POCONO BOULEVARD
MOUNT POCONO, PA 18344-1412
(570) 895-4176

TOLL FREE HELP-LINE
(800) 222-2346

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW, Room 2046
Washington, DC 20551

Dear Chairman Bernanke:

During Tuesday's Oversight and Government Reform Committee hearing regarding the "Causes and Effects of the AIG Bailout," we learned that American International Group (AIG) hosted an eight-day junket for life insurance sales agents, their friends, and a number of AIG employees just five short days after securing an $85 billion loan from the Federal Reserve. Some have called this error in judgment "a colossal act of arrogance." I wholeheartedly agree. The Federal Reserve must therefore take immediate action to reclaim every penny spent by AIG at the St. Regis Monarch Beach Resort.

To think that AIG could turn to the Federal government in a "desperate need" for funds to continue its very existence and then turn around a few short days later and spend $443,343.71 on spa treatments, golf rounds, ocean view rooms, and surfing lessons is simply appalling. It defies logic, and it demonstrates a lack of common sense.

The facts regarding the event at Monarch Beach as presented by AIG's Chairman and Chief Executive Officer Edward M. Liddy in a recent letter to Treasury Secretary Paulson that "not a single corporate executive from AIG headquarters attended" and that the event was held by "one of AIG's insurance subsidiaries" for "independent life insurance agents – not for AIG employees" and that such trips are "standard practice" are all irrelevant. The only relevant facts are that AIG sought government help for its very survival, received this help under extraordinary conditions, and still decided it was appropriate to send some of its key money-makers and their friends and family on an all-expense paid vacation at a lavish resort.

To add fuel to the fire, just yesterday the Federal Reserve provided AIG and its subsidiaries with access to an additional $37.8 billion, even after it learned of this extravagant spending. The American taxpayers have now agreed to support AIG with as much as $122.8 billion of their own money. They deserve to get all of that money back as soon as possible. In my view, the $443,343.71 spent by AIG at Monarch Bay should have been used to pay down its government loan or, at least, cover 24 minutes of the interest that it would owe the government on the entire amount of the original loan under its original terms.

Like the hard-working middle class American families now postponing, delaying, and canceling their dream vacations to Disney Land as a result of the current economic crisis, AIG's executives, workers, representatives, brokers, and agents must also learn to sacrifice. AIG must cut back on its extravagant junkets to ocean-side hangouts, desert spas, mountain ski resorts, gambling casinos, and exclusive golf courses.

Accordingly, I am very troubled about further reports in the media that AIG plans to go ahead with similar exclusive holiday excursions at places like the Ritz Carlton in Half Moon Bay, California and the Marriott Marquis in Atlanta, Georgia in the weeks ahead. While the small businesses and towns around the country suffer from a lack of credit, the corporations receiving government assistance cannot be allowed to squander hundreds of thousands of dollars at the beach, in a cocktail lounge, or out on the green.

Moreover, in the Emergency Economic Stabilization Act that just became law, the Congress insisted on curbing excessive pay, prohibiting golden parachutes, and clawing back faulty bonuses for the executives at the companies helped by the government. The situation with AIG should be no different. The Congress played no role in the decision to bail out AIG, but the Federal Reserve must take swift action to apply these compensation standards to AIG if it has not already done so.

In order to address this troubling situation quickly, please provide me with answers to the following questions no later than close of business on Thursday, October 16:

- What actions does the Federal Reserve plan to take to investigate these matters and reprimand officials at AIG for the decision to proceed with the Monarch Beach event?
- How will the Federal Reserve seek reimbursement from AIG, its executives, and other appropriate parties to compensate the American people for the Monarch Beach trip?
- How does the Federal Reserve plan to prevent AIG and similarly situated companies from hosting extravagant junkets and profligate parties in the future?
- Will the Federal Reserve apply the same standards to AIG regarding executive pay, golden parachutes, and faulty bonuses as provided for in the new Troubled Assets Relief Program administered by the Treasury Department? If so, when?

In closing, thank you in advance for your attention to these important matters. I look forward to receiving your response.

Sincerely,

Paul E. Kanjorski

Paul E. Kanjorski
Member of Congress

cc: The Honorable Henry Paulson, Jr.
Secretary
U.S. Department of the Treasury

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA

COMMITTEE ON
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WASHINGTON OFFICE:
2188 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-3811
(202) 225-6511

Website: http://kanjorski.house.gov
E-mail: paul.kanjorski@mail.house.gov

Congress of the United States
Washington, DC 20515-3811

October 20, 2008

DISTRICT OFFICES:

THE STEGMAIER BUILDING
7 NORTH WILKES-BARRE BOULEVARD
SUITE 400 M
WILKES-BARRE, PA 18702-5283
(570) 825-2200

546 SPRUCE STREET
SCRANTON, PA 18503-1808
(570) 496-1011

102 POCONO BOULEVARD
MOUNT POCONO, PA 18344-1412
(570) 895-4176

TOLL FREE HELP-LINE
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The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, NW, Room 2046
Washington, DC 20551

Dear Chairman Bernanke:

Late last week, New York Attorney General Andrew Cuomo and American International Group (AIG) reached an agreement on immediate actions that AIG will take with regard to corporate expenditures and executive compensation. As you will recall, because the Federal Reserve was the entity that agreed to lend nearly $123 billion in taxpayer's money to stave off AIG's bankruptcy, I had previously made a similar request to you on October 9. You unfortunately have yet to take any public action on these matters.

As I understand, AIG has agreed to provide the New York Attorney General's office with an accounting of all compensation paid to its senior executives. It has also agreed to assist the Attorney General's office in recovering any illegal expenditure found under New York's law to protect creditors, and it has halted a $10 million severance payment to a former financial officer. AIG has additionally agreed to establish a Special Governance Committee to institute new management controls. And, effective immediately, AIG is cancelling all junkets and perks.

Last week, however, we also learned of yet more frivolous excursions that AIG paid for after the federal government assisted the flailing company. Among these trips, executives and customers were flown on a private jet to England for a partridge hunt. According to news reports, this overseas outing cost almost $100,000. During this trip, an undercover reporter recorded one of the participating AIG executives as saying, "The recession will go on until about 2011, but the shooting was great today and we are relaxing fine." This attitude is shocking.

AIG has behaved like a pig at the taxpayer's trough, and it must stop. On October 9, I requested that you to seek reimbursement for AIG's expenses from the $440,000 junket at an ocean-side resort and to impose on AIG the executive pay reforms contained in the Emergency Economic Stabilization Act (ESSA). This recapture should be expanded to all unnecessary perks paid by AIG since the time it sought and received government assistance. The Federal Reserve must also now review Attorney General Cuomo's agreement, compare it to the executive compensation standards in EESA, and impose the stricter of the two on AIG or any other company that receives a direct loan from the Federal Reserve in the future.

Lastly, I ask that the Federal Reserve create an ombudsman to deal with consumer complaints relating to AIG, its affiliates and subsidiaries, and any other company receiving assistance from the Federal Reserve. Last Friday, I received a call from a constituent, a retiree who was involved in a car accident. An AIG company insured the driver at fault, and the retiree is now being told that AIG does not have the money to pay the claim. We both know this information is false, and even if the company were in bankruptcy, state guarantee funds are in place to provide payment on all legitimate insurance claims. There is, however, confusion in the public's mind on these matters and the Federal Reserve should create an office to deal with such situations, as well as to collect complaints about excessive and unnecessary expenditures by AIG and other similarly situated entities.

Please respond to my latest concerns and requests regarding AIG as soon as possible.

Sincerely,

Paul E. Kanjorski

Paul E. Kanjorski
Member of Congress

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

November 17, 2008

The Honorable Paul E. Kanjorski
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you for your letters of October 9 and 20, 2008, concerning an event sponsored in September 2008 by American International Group, Inc. (AIG), a large diversified financial services company, at a California resort. The event was sponsored by AIG for independent life insurance agents and a small number of employees of one of AIG's regulated insurance subsidiaries. This event occurred several days after the Federal Reserve committed to lend to AIG. In order to prevent a disorderly failure of AIG that could add to already significant levels of financial market fragility and other adverse consequences, the Federal Reserve agreed on September 16, 2008, to lend up to $85 billion to assist AIG in meeting its obligations as they come due and facilitate the orderly disposition of its businesses.

You have asked about the Federal Reserve's plans to investigate AIG's sponsorship of the resort event and to prevent similar kinds of expenses in the future. Although, as a lender, the Federal Reserve is not in a position to review or approve all of the specific expenditures related to the ongoing business operations of AIG and its subsidiaries, we have made clear to AIG's management our deep concern about the recent reported incidents of corporate spending and the questions surrounding certain executive compensation. We strongly support the response of AIG's new CEO to these issues, which includes new expense controls, cancellation of numerous conferences and events, and a review of executive compensation. As a lender to AIG, the rights of the Federal Reserve regarding the governance and oversight of the company are limited and are reflected in the credit agreement with AIG relating to the loan. As is usual in commercial lending transactions involving distressed borrowers, the Federal Reserve has certain rights as a creditor, such as the right to require that overall corporate governance be acceptable to the Federal Reserve. These rights will allow the Federal Reserve to work to stabilize the financial condition of AIG to enable it to repay the loan by the sale of its assets in an orderly manner. The Federal Reserve does not supervise AIG as it would, for example, a bank holding company.

The Federal Reserve has taken a number of actions in our role as a creditor of AIG to carry out our governance and oversight role regarding the loan. The Federal Reserve has staff on-site at various offices of AIG to make sure that we are adequately

The Honorable Paul E. Kanjorski
Page Two

informed on funding and cash flow, valuation of assets, risk management across the company, and the divestiture process. Federal Reserve staff meet daily with the senior management of the company and attend meetings of the board of directors in an observer capacity. In addition, because we are not specialists in the insurance business or asset sales, the Federal Reserve has retained qualified advisors to assist us in performing these functions.

AIG remains obligated to repay the full amount of the loan from the Federal Reserve with accrued interest. To assure repayment, the Federal Reserve is secured by the pledge of a substantial portion of the assets of AIG and its primary non-regulated subsidiaries, including AIG's ownership interest in its regulated U.S. and foreign subsidiaries. We expect that the orderly disposition of certain of these assets will provide the funds for the loan repayment.

On November 10, 2008, the U.S. Treasury agreed to purchase $40 billion of preferred stock of AIG under the Troubled Asset Relief Program established under the Emergency Economic Stabilization Act of 2008. As part of this investment, the Treasury has imposed standards governing executive compensation on AIG that are more wide ranging than those established by the Secretary under the Capital Purchase Program established for banking organizations. The Federal Reserve supports these limits on compensation of AIG executives.

Finally, you ask that the Federal Reserve create an ombudsman to deal with consumer complaints relating to AIG and any other company receiving assistance from the Federal Reserve, including complaints arising from possible confusion by the public about the nature of the federal government's assistance to the company. The Federal Reserve provides detailed information about its financial assistance to AIG and other entities on its public websites and in a variety of public forums and routinely responds to requests for public information about these transactions. Accordingly, we believe that the formal designation of an ombudsman would duplicate many channels already available to the public for obtaining relevant information about the Federal Reserve's transactions relating to AIG.

We hope this information has been helpful.

Sincerely,

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

November 17, 2008

The Honorable Steven LaTourette
United States House of Representatives
Washington, DC 20515

Dear Mr. LaTourette:

I am responding to your letter to Secretary Paulson, dated October 30, 2008, requesting information concerning possible government efforts to facilitate the acquisition of National City Bank by PNC Financial Services. As we informed your staff last week, we have reviewed the application files of Treasury's Office of Financial Stability, and were unable to locate records reflecting an application by National City Bank for funding under Treasury's Capital Purchase Program.

Our records do reflect an application for funding by PNC Financial Services, which has been given preliminary approval. Under the Capital Purchase Program, preliminary approval and funding are based on the applicant's risk-weighted assets as set forth in its regulatory filings. If an applicant has entered into a merger agreement, the applicant may receive conditional approval for funding based on its projected risk-weighted assets after the merger. However, that approval is conditional and funding at that level will only be provided if the merger is consummated. If the merger is not consummated, the applicant will only receive funding based on its own pre-merger risk-weighted assets. In accordance with this policy, PNC would be eligible for funding based on the combined risk-weighted assets of PNC and National City, but only if that merger is consummated. If the merger is not consummated, PNC will be eligible for funding based on its current risk-weighted assets.

As our general counsel's office has discussed with your staff, the PNC application consists of documents received from the Office of the Comptroller of the Currency (OCC), and contains information designated by the OCC as confidential supervisory information. As such, we must defer to the OCC to respond to your request for copies of these documents, or other similar confidential supervisory information related to PNC or National City.

Sincerely,

Kevin I. Fromer
Assistant Secretary for Legislative Affairs

cc: Honorable John Dugan

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

October 28, 2008

Honorable Steven C. LaTourette
United States House of Representatives
Washington, D.C. 20515

Dear Congressman LaTourette:

I am writing to respond to allegations in your October 27 letter to Treasury Secretary Paulson regarding my role in the proposed acquisition of National City Corporation by PNC Financial Services Group. Your letter suggests that decisions regarding that acquisition and access to capital under the Troubled Asset Relief Program or TARP administered by the Treasury Department were influenced by PNC having been a client while I was in private law practice, before I took office as Comptroller of the Currency.

This suggestion is absolutely baseless, and I am astonished that you would make such sweeping allegations without checking the facts. In my years in private law practice, I represented many banks, including both National City and PNC, although PNC was not a client of mine "just before" I became Comptroller. Since becoming Comptroller, I have scrupulously followed all ethics rules regarding those relationships. Any actions that I have taken in my current position have been intended to serve the best interests of the national banking system that my agency supervises, and of which both National City and PNC are part, as well as the broader U.S. financial system. Past client associations have had no effect whatsoever on my activities in this or any other matter.

With respect to this particular transaction, I would underscore two points. First, in terms of eligibility for capital investments under the TARP program, the Department of Treasury establishes the criteria and makes final decisions about which institutions receive capital. Second, the OCC 's communications with the banks involved in this matter relayed our best supervisory judgments, based on confidential supervisory information available to us. These communications themselves were also confidential, fully in keeping with regulatory requirements and the OCC's supervisory relationship with national banks.

Sincerely,

John C. Dugan

John C. Dugan
Comptroller of the Currency

Schedule RC-R - Regulatory Capital

Dollar amounts in thousands			
1. Total equity capital (from Schedule RC, item 28)	RCFD3210	18,412,517	1.
2. Net unrealized gains (losses) on available-for-sale securities	RCFD8434	-76,312	2.
3. Net unrealized loss on available-for-sale equity securities	RCFDA221	0	3.
4. Accumulated net gains (losses) on cash flow hedges	RCFD4336	125,956	4.
5. Nonqualifying perpetual preferred stock	RCFDB588	0	5.
6. Qualifying minority interests in consolidated subsidiaries	RCFDB589	132,974	6.
7. Not available			7.
a. Disallowed goodwill and other disallowed intangible assets	RCFDB590	4,465,029	7.a.
b. Cumulative change in fair value of all financial liabilities accounted for under a fair value option that is included in retained earnings and is attributable to changes in the bank's own creditworthiness	RCFDF264	0	7.b.
8. Subtotal	RCFDC227	14,030,818	8.
9. Not available			9.
a. Disallowed servicing assets and purchased credit card relationships	RCFDB591	280,782	9.a.
b. Disallowed deferred tax assets	RCFD5610	0	9.b.
10. Other additions to (deductions from) Tier 1 capital	RCFDB592	-1,643	10.
11. Tier 1 capital	RCFD8274	13,748,393	11.
12. Qualifying subordinated debt and redeemable preferred stock	RCFD5306	3,700,783	12.
13. Cumulative perpetual preferred stock includible in Tier 2 capital	RCFDB593	0	13.
14. Allowance for loan and lease losses includible in Tier 2 capital	RCFD5310	1,743,216	14.
15. Unrealized gains on available-for-sale equity securities includible in Tier 2 capital	RCFD2221	176	15.
16. Other Tier 2 capital components	RCFDB594	0	16.
17. Tier 2 capital	RCFD5311	5,444,175	17.
18. Allowable Tier 2 capital (lesser of item 11 or 17)	RCFD8275	5,444,175	18.
19. Tier 3 capital allocated for market risk	RCFD1395	0	19.
20. Deductions for total risk-based capital	RCFDB595	0	20.
21. Total risk-based capital	RCFD3792	19,192,568	21.
22. Average total assets (from Schedule RC-K, item 9)	RCFD3368	151,157,728	22.
23. Disallowed goodwill and other disallowed intangible assets (from item 7 above)	RCFDB590	4,465,029	23.
24. Disallowed servicing assets and purchased credit card relationships (from item 9.a above)	RCFDB591	280,782	24.
25. Disallowed deferred tax assets (from item 9.b above)	RCFD5610	0	25.
26. Other deductions from assets for leverage capital purposes	RCFDB596	0	26.
27. Average total assets for leverage capital purposes	RCFDA224	146,411,917	27.
28. Not available			28.
a. Adjustment to Tier 1 capital reported in item 11	RCFDC228	4,894	28.a.
b. Adjustment to total risk-based capital reported in item 21	RCFDB503	9,788	28.b.
29. Adjustment to risk-weighted assets in item 62	RCFDB504	7,432	29.
30. Adjustment to average total assets in item 27	RCFDB505	11,231	30.

Schedule RC-R - Regulatory Capital

Dollar amounts in thousands	(Column A) Percentage (Banks with Financial Subsidiaries)		(Column B) Percentage (All Banks)		
31. Tier 1 leverage ratio	RCFD7273	0.093876	RCFD7204	0.093902	31.
32. Tier 1 risk-based capital ratio	RCFD7274	0.100239	RCFD7206	0.10027	32.
33. Total risk-based capital ratio	RCFD7275	0.139911	RCFD7205	0.139975	33.

Schedul RC-R - Regulatory Capital

Dollar amounts in thousands			
1. Total equity capital (from Schedule RC, item 28)	RCFD3210	16,437,412	1.
2. Net unrealized gains (losses) on available-for-sale securities	RCFD8434	-133,333	2.
3. Net unrealized loss on available-for-sale equity securities	RCFDA221	32	3.
4. Accumulated net gains (losses) on cash flow hedges	RCFD4336	146,884	4.
5. Nonqualifying perpetual preferred stock	RCFDB588	0	5.
6. Qualifying minority interests in consolidated subsidiaries	RCFDB589	147,711	6.
7. Not available			7.
a. Disallowed goodwill and other disallowed intangible assets	RCFDB590	3,109,021	7.a.
b. Cumulative change in fair value of all financial liabilities accounted for under a fair value option that is included in retained earnings and is attributable to changes in the bank's own creditworthiness	RCFDF264	0	7.b.
8. Subtotal	RCFDC227	13,462,519	8.
9. Not available			9.
a. Disallowed servicing assets and purchased credit card relationships	RCFDB591	245,892	9.a.
b. Disallowed deferred tax assets	RCFD5610	0	9.b.
10. Other additions to (deductions from) Tier 1 capital	RCFDB592	-1,324	10.
11. Tier 1 capital	RCFD8274	13,215,303	11.
12. Qualifying subordinated debt and redeemable preferred stock	RCFD5306	3,656,181	12.
13. Cumulative perpetual preferred stock includible in Tier 2 capital	RCFDB593	0	13.
14. Allowance for loan and lease losses includible in Tier 2 capital	RCFD5310	1,654,928	14.
15. Unrealized gains on available-for-sale equity securities includible in Tier 2 capital	RCFD2221	0	15.
16. Other Tier 2 capital components	RCFDB594	0	16.
17. Tier 2 capital	RCFD5311	5,311,109	17.
18. Allowable Tier 2 capital (lesser of item 11 or 17)	RCFD8275	5,311,109	18.
19. Tier 3 capital allocated for market risk	RCFD1395	0	19.
20. Deductions for total risk-based capital	RCFDB595	0	20.
21. Total risk-based capital	RCFD3792	18,526,412	21.
22. Average total assets (from Schedule RC-K, item 9)	RCFD3368	148,019,449	22.
23. Disallowed goodwill and other disallowed intangible assets (from item 7 above)	RCFDB590	3,109,021	23.
24. Disallowed servicing assets and purchased credit card relationships (from item 9.a above)	RCFDB591	245,892	24.
25. Disallowed deferred tax assets (from item 9.b above)	RCFD5610	0	25.
26. Other deductions from assets for leverage capital purposes	RCFDB596	0	26.
27. Average total assets for leverage capital purposes	RCFDA224	144,664,536	27.
28. Not available			28.
a. Adjustment to Tier 1 capital reported in item 11	RCFDC228	4,892	28.a.
b. Adjustment to total risk-based capital reported in item 21	RCFDB503	9,785	28.b.
29. Adjustment to risk-weighted assets in item 62	RCFDB504	7,428	29.
30. Adjustment to average total assets in item 27	RCFDB505	11,412	30.

Schedule RC-R - Regulatory Capital

Dollar amounts in thousands	(Column A) Percentage (Banks with Financial Subsidiaries)		(Column B) Percentage (All Banks)		
31. Tier 1 leverage ratio	RCFD7273	0.091325	RCFD7204	0.091351	31.
32. Tier 1 risk-based capital ratio	RCFD7274	0.100234	RCFD7206	0.100265	32.
33. Total risk-based capital ratio	RCFD7275	0.140495	RCFD7205	0.140561	33.

Global Markets Research

North America United States
Financial Banks

Deutsche Bank

22 October 2008

National City

Reuters: NCC.N Bloomberg: NCC UN Exchange: NYS Ticker: NCC

3Q08 Loss but Flat Loan Losses

Mike Mayo, CFA
Research Analyst
(+1) 212 250-2007
mike.mayo@db.com

Hunter Murchison
Research Associate
(+1) 212 250-3088
hunter.murchison@db.com

3Q08 Loss but Flat Loan Losses

NCC reported a 3Q08 loss due to still high loan losses, though relative to 2Q08 loan losses were flattish, and other areas were mostly stable (spread revenues, margin, deposits, capital). A new expense program targets savings of $240 mil. in '09 and $500-$600 mil. by 2011 or about $400-$500 mil. after charges (on est. 14% less employees). We are lowering our 2009 est. to reflect these results and maintain our Buy rating given above peer capital and below peer price/tang. book valuation.

The main issue is credit

Problem assets increased 14%, less than peer given already a high base of NPAs. Core loan losses were flattish (2.67% of loans) given improvement in the Exit Portfolio (17% of loans but 65% of losses) mitigated by higher losses in the core portfolio of about 1/3rd (to 1.28% of loans) given worse performance in commercial and commercial real estate, which needs to be monitored. Management indicated that its outlook for loan losses ($2.5-2.9 bil. for 2008) is unchanged and that it may use the new government program which we feel will benefit NCC as much as any bank.

Capital and funding still strong

National City maintained a peer leading Tier 1 ratio (11%) and 8.93% tangible equity ratio of 8.93%. Avg. deposits were down 3% annl. and period end balances were down slightly more, but the number of new accounts in the retail bank increases across most products and it seems deposits have increased during October.

Valuation & risks

Because we do not expect positive earnings in 2009, our target price is based on our calculation of National City's franchise value ($9E) and its avg. with tangible book value (previously just Franchise Value was used), which we believe accurately reflects the inherent value of the bank after the new capital raise. Risks include worse-than-expected market conditions, which may include increased competition or worse economic conditions, higher loan losses than expected (especially in residential real estate), and a slower mortgage banking recovery. See page 2 for details.

Year End Dec 31	2007A	2008E	2009E
1Q EPS[1]	0.50	**-0.27A**	–
2Q EPS	0.60	**-2.43A**	–
3Q EPS	-0.03	**-5.85A**	–
4Q EPS	-0.53	**-0.18**	–
FY EPS (USD)	0.51	**-6.29**	-0.45
OLD FY EPS (USD)	0.51	**-2.05**	0.05
Dividend yield (%)	5.2	**8.0**	1.5

Source: Deutsche Bank estimates, company data

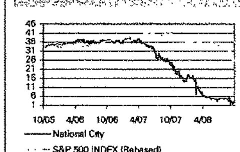
[1] Includes the impact of FAS123R requiring the expensing of stock options.

Recommendation/Estimate

Buy

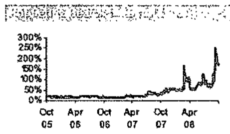
Price at 21 Oct 2008 (USD)	2.99
Price Target (USD)	7.00
52-week range (USD)	24.49 - 1.36

Target Price	9.00 to 7.00	↓	-22.2%



Performance (%)	1m	3m	12m
Absolute	*-46.7*	*-32.0*	*-87.3*
S&P 500 INDEX	*-21.5*	*-21.8*	*-34.3*

Market Cap (USD)	3,191.6
Shares outstanding (m)	1,067.4
Free float	98
Avg. daily volume ('000)	99,962,000
Option volume (und. shrs., 1M avg.)	7,446,986



Deutsche Bank Securities Inc.

National City Corp (NCC)

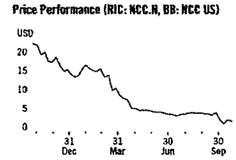
Change in opinion ☑
Rating change ☑
Target price change ☑

Sold In Takeunder To PNC – Downgrade To Hold and Remove from Top Picks Live

- **Great Deal For PNC, But Not For NCC** — PNC will be acquiring National City at a substantial discount to its stated tangible book value, and we estimate the deal has an IRR of 17-18% and can be up to 25% accretive to PNC's earnings in year 3 with full run rate of cost savings. NCC shareholders will receive 0.0392 PNC shares for each share of NCC, which is essentially worth $2 based on PNC's closing price today. As a result, we are downgrading NCC to Hold from Buy and removing from Top Picks Live. Target price to $2.25.
- **Why Sell?** — National City just released 3Q earnings, which showed credit deteriorating in line with our expectations and some deposit stress, but recent deposit trends seemed to have shown that deposits had stabilized. So on face value, there was no immediate catalyst that would force them to sell since NCC had sufficient capital and liquidity – in our view, it is possible there was a change in management's outlook or a push from the government, though we have no confirmation of either scenario.
- **TARP Changes The Landscape** — While we viewed the TARP plan to inject capital into the banks as a strong incremental positive for the group, we believe it also in a perverse way pushed/forced NCC's mgmt to sell the bank into a buyers' market. There is speculation in the media that the Fed will be publishing a list for the next group of banks that will have access to TARP, and we think it likely that NCC was not going to be on that list. While NCC did not need capital, the risk was that by not being on the list, it was leaving itself open to a possible unfavorable outcome, leaving itself open to market perception that it is "not a survivor" would lead to further deposit outflows and give it less palatable options. The only reason that we can see that mgmt would choose this route (especially given we just saw the 3Q results) is that it wanted to control its own destiny, and sell now and recognize some value for its shareholders.
- **New Money Ideas** — For new money, we believe BAC is a top pick since TARP issuance is known, and in our view offers superior value relative to other "safe haven" names such as JPM and USB. Among the regional banks, KEY seems to offer most value at current levels, and seems to be a safer play on it receiving TARP funding.

Hold/Medium Risk	**2M**
from Buy/High Risk	
Price (24 Oct 08)	US$2.05
Target price	US$2.25
from US$7.00	
Expected share price return	9.8%
Expected dividend yield	2.0%
Expected total return	**11.7%**
Market Cap	US$4,305M

Price Performance (RIC: NCC.N, BB: NCC US)



Keith Horowitz, CFA
+1-212-816-3033
keith.horowitz@citi.com

Steve Foundos
steve.foundos@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

CUNA
Credit Union National Association
cuna.org

601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-638-5777 | FAX: 202-638-7734

November 17, 2008

The Honorable Barney Frank
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairmen Frank and Ranking Member Bachus,

On behalf of the Credit Union National Association (CUNA), I applaud you for calling tomorrow's hearing on "Oversight of Implementation of *Emergency Economic Stabilization Act of 2008* and Government Lending and Insurance Facilities: Impact on Economy and Credit Availability." CUNA represents approximately 90% of America's 8,200 state and federally chartered credit unions and their 90 million members.

The Department of Treasury announcement last week to abandon the purchase of troubled assets from financial institutions in favor of greater emphasis on capital infusions into financial institutions causes us concern. Although the *Emergency Economic Stabilization Act* explicitly includes America's credit unions among the institutions eligible to participate under the plan, the implementation of the program thus far has not included credit unions, and the Treasury's announcement makes it unclear how credit unions will be included. Credit unions could have been covered under a troubled asset purchase plan; however, because of the credit union capital structure, credit unions may not be eligible for the capital infusion under current law. In addition, an asset purchase program would have helped to establish values for some of these troubled assets in today's dysfunctional markets.

As the attached letter indicates, we have urged Treasury to consider a set aside of funds to be used by Main Street financial institutions including credit unions. However, given the cooperative nature of our movement, we believe that credit unions should be able to turn to the National Credit Union Administration (NCUA) for assistance, so that credit union funds can help credit unions solve their own problems, with backup funding from Treasury if necessary. With that in mind, we have also urged NCUA to implement a program for credit unions – by credit unions – that accomplishes the intent of the *Emergency Economic Stabilization Act* for the movement. We believe that NCUA has sufficient authority under the *Federal Credit Union Act* to do so.

We hope that no credit union will need to turn to Treasury or NCUA for assistance. However, should the need arise, it is critical that the mechanisms Congress has put in place through the enactment of the *Emergency Economic Stabilization Act* work for credit unions as well as banks and other entities. We applaud your leadership on this issue and look forward to working with you going forward.

Sincerely,

Daniel A. Mica

Daniel A. Mica
President & CEO

America's Credit Unions
OFFICES: | WASHINGTON, D.C. | MADISON, WISCONSIN

CUNA
Credit Union National Association
cuna.org

601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-638-5777 | FAX: 202-638-7734

DANIEL A. MICA
PRESIDENT & CEO

November 14, 2008

The Honorable Henry Paulson
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Paulson,

I regret I must write to you again, but on behalf of the Credit Union National Association I want to express my deep concerns following your announcement yesterday that you will not pursue a plan to purchase troubled assets from financial institutions.

I appreciate that for the vast majority of financial institutions, a capital purchase approach might be more efficient than the purchase of troubled assets. However, from our perspective, this decision is very troubling. Without the federal government's purchase of problem assets, how much value they retain will remain unsettled. As a result, the problem of undervalued mortgage assets held by many institutions, which has been exacerbated by fair value accounting, will continue for an indeterminable period of time.

Also, as I believe you are aware, there are some natural person and corporate credit unions that as a result of the economic crisis may need financial assistance. As the capital purchase program is structured, credit unions -- which have no access to secondary capital -- are not eligible to participate in the program. With this latest announcement that devalued assets won't be purchased, credit unions are left without any access to assistance under the Emergency Economic Stabilization Act, controverting the spirit and language of the act.

As I have stated in my previous letters to you, we believe credit unions' needs should first be met within our system, without having to draw on taxpayer dollars. We urge Treasury to work with the National Credit Union Administration to achieve this outcome. We continue to believe, however, that because no one knows the extent of the financial crisis, credit unions should, as Congress intended, be able to call upon the resources available under EESA, if the reserves of the National Credit Union Share Insurance Fund prove to be insufficient.

The Honorable Henry Paulson
November 14, 2008
Page Two

Even if Treasury is not willing to establish a broad asset purchase program, I urge you to coordinate with NCUA to develop such an approach for credit unions. If credit union assets were purchased at a price above their market value, it would not only remove these assets from credit unions' balance sheets, but also provide a net worth contribution to affected credit unions achieving the same purpose that the capital purchase program does for other institutions.

In that connection, we also urge Treasury to work with NCUA to specifically designate and set aside the appropriate level of funds that would be available to purchase credit union assets or provide direct capital infusions, should the need for such assistance from Treasury materialize.

We are talking with NCUA about these solutions and with key offices on Capitol Hill. I urge you to work with NCUA to assure access to reasonable assistance for credit unions is provided in a timely manner. Meanwhile, discussion of our concerns and the details of our recommendations with the appropriate Treasury officials is needed, and I respectfully request such a dialogue as soon as it can be arranged.

Treasury has taken several steps to help guide the country during these difficult times, but there is much more to be done. This includes providing access to assistance under EESA for those credit unions that need it, as Congress intended.

Sincerely,

Daniel A. Mica

Daniel A. Mica
President & CEO

NAFCU
National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
(703) 522-4770 • (800) 336-4644 • Fax (703) 522-2734

Fred R. Becker, Jr.
President and CEO

November 14, 2008

The Honorable Barney Frank
Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank and Ranking Member ~~Bachus~~ Mr. Chairman

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions (FCUs), I am writing in regards to the hearing on the "Oversight of the Implementation of the Emergency Economic Stabilization Act of 2008." NAFCU welcomes this important hearing and would like to offer some comments.

NAFCU maintains grave concerns regarding Secretary Paulson's announcement last week that the Treasury Department will not be honoring its Congressionally-mandated commitment to purchase illiquid mortgage-related assets from financial institutions, as originally intended for the $700 billion Troubled Assets Relief Program (TARP). Instead, these taxpayer funds will be largely directed toward capital infusions in bank and non-bank institutions through the Capital Purchase Program (CPP).

NAFCU strongly opposes this drastic shift in policy. Section 101 of the Emergency Economic Stabilization Act (EESA) is clear. There can be no question that Congress intended for these taxpayer dollars to "purchase, and to make and fund commitments to purchase, troubled assets from any financial institution." Use of TARP funds for anything other than intended by Congress would be an egregious abuse of the American taxpayer funds.

Furthermore, Treasury's redirection of TARP funds will create an uneven playing field, to the advantage of the bad actors whose unscrupulous practices are at the root of this financial crisis. As Chairman Frank has stated, credit unions were not the cause of the current turmoil in the mortgage market, which has led to the nation's deepening financial crisis. Nevertheless, with the passage of the EESA, lawmakers ensured that credit unions and their approximately 90 million members were provided parity in treatment with other financial institutions. Because the CPP

E-mail: fbecker@nafcu.org • **Web site:** www.nafcu.org

Chairman Frank and Ranking Member Bachus
November 14, 2008
Page 2

will not allow for the participation of member-owned cooperative institutions, credit unions will be unfairly constrained in their ability to address the economic challenges that they now face through no fault of their own. NAFCU strongly urges Congress to uphold this mandate and force Treasury to adhere to the clear intent of this legislation by allocating equal funding to the purchase of mortgage-related troubled assets as is being allocated to the CPP. Doing so would not only help credit unions, but also help bring TARP relief to Main Street and not just Wall Street.

NAFCU also remains concerned regarding the potential misuse of any capital infusion from the federal government's TARP fund for the direct funding of acquisition activities, or for the individual benefit of shareholders and executives. NAFCU firmly objects to taxpayer dollars being used in any such manner, which is clearly contrary to the express statutory purpose of "provid[ing] authority for the Federal Government <u>to purchase and insure certain types of troubled assets for the purposes of providing stability to and preventing disruption in the economy and financial system, and protecting taxpayers</u> . . ." NAFCU believes strongly that any capital infusion from the federal government should be used to restore liquidity to the U.S. financial markets as opposed to the pursuit of acquisition opportunities, or any unlawful purposes. We appreciate you holding this important hearing and look forward to working with the Committee on ways to ensure that the implementation and execution of the Trouble Assets Relief Program and the Capital Purchase Program coincide with the intent of the Congress that approved these relief measures.

Should you have any questions or would like to discuss this issue further, please call me or Dan Berger, NAFCU's Senior Vice President for Government Affairs, at (703) 522-4770 or (800) 336-4644, extension 203.

Sincerely,

Mr. Chairman -
Thanks so much for your leadership on this critical issue!

Fred R. Becker, Jr.
President/CEO

cc: Members of the House Financial Services Committee

Response to questions from the Honorable Lincoln Davis
by Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation

Q.1. Although much focus has been placed on increasing bank lending, according to Monday's Wall Street Journal, banks are lending at record levels, up 15% from a year earlier. Home equity loans are up 21% from last year. If bank lending is rising, the real problem seems to be the decline of the securities market. Do you agree with this assessment, and if so, what are the precise steps that we can take to stimulate this market?

A.1. Rising credit losses and heightened risk aversion have contributed to major disruptions of U.S. and global credit markets in recent months, including private asset-backed securitization, interbank lending, and other commonly used funding markets. For example, issuance of private mortgage-backed securities, which topped $1 trillion in 2006, slowed to virtually zero in the third quarter of 2008.

Amid these difficulties, federally-insured depository institutions stand out as a relatively reliable source of credit for the U.S. economy. While banks and thrifts have certainly experienced credit losses that have led to sharply reduced earnings for the industry as a whole, the industry's reliance on insured deposits and relatively high overall capital ratios have lent stability to bank funding and the supply of bank credit. Policy interventions undertaken since late September, including the Treasury's Capital Purchase Program, the FDIC Temporary Liquidity Guarantee Program, and the various Federal Reserve liquidity programs, have done much to strengthen the industry's capital position and access to funding, thereby ensuring that banks will be in a position to take up the slack for market-based funding vehicles, where the disruptions have been much more severe.

Nevertheless, there is no question that as the economy has slowed, overall demand for credit to finance consumer spending and business investment also has slowed. As banks have moved to recognize losses, they also have become more selective in granting credit. These are normal reactions to the decline in business conditions and credit quality, and are likely to push down the overall volume of bank credit growth from what it was during the economic expansion. However, we recognize the urgent need for banks to use the federal resources that have been offered them to preserve the availability of business and consumer credit to the maximum possible extent. Accordingly, federal regulators released supervisory guidance on November 12 reminding banks of their obligation to "fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." In coming months, we will continue to closely monitor the progress of the industry in meeting this obligation.

With regard to recent growth in overall bank lending and home equity lending, I would note that on-balance-sheet holdings of loans are influenced to a significant degree by factors such as the ability to sell and securitize loans, the obligation to bring sold and securitized loans back onto the balance sheet, and the propensity of borrowers to draw on existing lines of credit. In the present environment, we expect that all of these factors are contributing to what may be termed "involuntary" loan growth. These represent factors that we will need to account for as we make an overall assessment of bank lending patterns in coming months.

Q2. The FDIC's newly modified home mortgage modification plan is a concerted effort to modify home mortgages, but why do you believe that servicers will be willing to breach their servicing contracts in order to restructure these loans?

A2. In the present environment of rising mortgage foreclosures, the FDIC has been advocating a more systematic approach to modifying mortgages based on the program we have already instituted at IndyMac Federal Bank, where we are conservator. At IndyMac, the FDIC has already modified over 8,500 loans where we found that modification, rather than a policy of foreclosure, led to a greater expected financial return. Modifications based on this analysis have been undertaken both for loans that IndyMac services for its own portfolio and for loans it services for outside investors. Based on this experience and our reading of most pooling and servicing agreements (PSAs) that govern third-party mortgage servicing, we believe that modifications of this type that enhance value and do not require the write down of principal are generally permissible, and therefore do not breach the servicing contracts. In our opinion, it is the wide permissibility of this approach that makes it the best way to effect modifications on a large enough scale to achieve a significant reduction in the number of expected foreclosures and begin to restore a measure of order to U.S. housing markets.

Q3. What has been the most problematic structural hurdle to this point in implementing the Emergency Economic Stabilization Act? What would you do differently?

A3. The rather broad mandate created by the EESA legislation has led to three main types of proposed assistance.

The original intent, to purchase troubled assets on the open market by way of reverse auctions, has not been actively pursued. The second approach, to purchase preferred shares in depository institutions, is now well underway, with capital purchases totaling approximately $181 billion at 350 institutions. The third approach, as advocated by Members of Congress and suggested by the FDIC, is to use a portion of the appropriated funds to provide incentives for mortgage servicers to engage in a program to systematically modify past due loans and prevent unnecessary foreclosures.

With regard to a program to purchase troubled assets, The FDIC believes that the original intent of the TARP -- to remove problem assets from the balance sheets of banks and related entities -- continues to be vitally important. Such a program is necessary to expand banks' balance sheet capacity to undertake new lending as well as to attract private equity investment. Even with the various forms of government assistance that have been provided by the regulators and through EESA, troubled asset relief will still be necessary to enable financial institutions to address their inventories of troubled assets so that they can return to more normal lending activity. This program should be made available to banks of all sizes, rather than just large financial institutions, to address financial stresses that may be occurring at the regional and local levels.

In the current market conditions, uncertainty about the potential losses embedded in the balance sheets of financial institutions is constricting lending between institutions and dissuading investors from providing the new capital essential to a recovery. In addition, government acquisition of troubled residential mortgages would facilitate action to restructure these loans and improve the performance of housing-related assets, providing the foundation both for a greater flow of credit and the investment of new capital into the financial system. However, because of the sheer volume of troubled mortgages, as well as the large number which are locked in securitization trusts, it is also vital to institute a specific program aimed at foreclosure prevention.

With respect to the Capital Purchase Program, the federal bank regulators expect banks to actively seek ways to use this assistance by making sound loans to household and business borrowers. The FDIC recognizes that banks will need to make adjustments to their operations, even cutting back in certain areas, to cope with recent adverse credit trends. However, the goal of providing government support is to ensure that such cut-backs and adjustments are made mostly in areas such as dividend policy and management compensation, rather than in the volume of prudent bank lending. These considerations are consistent with the precept that the highest and best use by banks of CPP capital in the present crisis is to support prudent lending activity.

Over 1,600 community financial institutions have applied to this program. In participating in the CPP program, as well as in launching the TLGP, it was the FDIC's express understanding that $250 billion would be made available for bank capital investments and that all eligible institutions, large and small, stock and mutual, would be able to participate. We strongly encourage both the Treasury Department and the Congress to make sure adequate funding is available for community bank participation. The FDIC also remains concerned that Subchapter S and mutual institutions have the opportunity to participate in this program. At present, these institutions do not have a corporate structure that would fit under the Capital Purchase Program's term sheets.

We also believe it is important for the CPP to be implemented in a manner that encourages and rewards private capital investments to be made alongside TARP capital. Private capital investments serve as a powerful vote of confidence in the viability of a financial institution over the long term and that viability is enhanced by programs that match private funds with TARP capital.

To this point, the difficulty with regard to mortgage loan modification has been designating TARP funds to provide incentives for servicers to modify loans at the least possible cost and with the fewest unintended consequences. We continue to work with our counterparts at other federal agencies and to discuss this issue with Members of Congress in the hope that these issues can be resolved quickly so that a workable plan can be implemented in early 2009.

Response to question from the Honorable Joe Donnelly
by Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation

Q1. We need strong oversight to make sure that TARP funds are used to free up the credit markets and increase lending activity. What steps are in place to ensure that the institutions that receive TARP funds are using this money to increase lending activity? Have we seen a measurable increase in lending by recipients of TARP funds?

A1. It is crucial that banking organizations track the use of the funds made available through federal programs and provide appropriate information about the use of these funds. The FDIC has issued a Financial Institution Letter advising insured institutions that they should track their use of capital injections, liquidity support, and/or financing guarantees obtained through recent financial stability programs as part of a process for determining how these federal programs have improved the stability of the institution and contributed to lending to the community. Equally important to this process is providing this information to investors and the public. As a result, this Financial Institution Letter advises insured institutions to include information about their use of the funds in public reports, such as shareholder reports and financial statements.

Internally at the FDIC, we have issued guidance to our bank examiners for evalnating participating banks' compliance with EESA and the CPP securities purchase agreements. Importantly, this examiner guidance will focus on banks' use of TARP CPP funds and how their capital subscription was used to promote lending and encourage foreclosure prevention efforts. The banking agencies will measure and assess participating institutions' success in deploying TARP capital and other financial support from various federal initiatives to ensure that funds are used in a manner consistent with the intent of Congress and participants are held accountable.

FDIC examiners will be reviewing the expectations that we have established in the recent Financial Institution Letter for banks participating in the CPP, including:

- Establishment of a monitoring process for the use of TARP proceeds and a clear strategy from the institution's board of directors for deploying the capital subscription;
- Increased lending efforts in the institution's market since receiving a TARP Capital Purchase Program subscription;
- Down-streaming subscription proceeds to the insured depository institution (if a holding company structure is in place) to ensure that TARP funds can be intermediated into loans and bank capital is augmented;
- Engagement in mortgage loan modification or foreclosure prevention efforts that rely on systematic, proactive approaches that enhance the net present value of individual mortgage loans versus foreclosure;

- Utilization of executive compensation programs that exemplify good corporate governance and conform with EESA and other requirements; and

- Implementation of the goals of the November 12 interagency statement to meet the needs of creditworthy borrowers in the institution's market area.

During examinations, our supervisory staff will be reviewing banks' efforts in these areas and will make comments as appropriate in FDIC Reports of Examination. Our examiners will also be considering these issues when they assign CAMELS composite component ratings.

Response to questions from the Honorable Kenny Marchant
by Sheila C. Bair, Chairman
Federal Deposit Insurance Corporation

Creditors have experienced some difficulties in dealing with FDIC receivers subsequent to a receivership action.

Q1. If the receiver holds a construction loan that is current, and the project is under development, what policies or guidelines are in effect to ensure the project is completed?

A1. There are no policies in place that stipulate the Federal Deposit Insurance Corporation as receiver for a failed financial institution must ensure that all construction projects (whether current or in default) that were originated by the failed financial institution will continue to be funded to ensure project completion following the failure. As receiver, the FDIC has a statutory responsibility to the depositors and creditors of a failed bank to minimize losses by obtaining the maximum recovery from the assets of the receivership. The FDIC's Division of Resolutions and Receiverships (DRR) carries out these statutory responsibilities. A principal concern of DRR during its resolutions and disposition activities is to minimize adverse effects on the economic stability and well being of the impacted region or state, to the extent possible. However, it is our practice to review each construction loan funding request on a case-by-case basis and to make prudent business decisions based on the best interests of the receivership estate.

The loans acquired by the FDIC following the financial institution failure are owned by the estate of the failed bank, and many of our asset disposition activities are similar to those of a bankruptcy trustee in that funds we recover benefit other creditors of the estate as well. We try to carry out those responsibilities in a way that balances our obligation to maximize recoveries and minimize losses to the Deposit Insurance Fund, with the desire to work with borrowers as they repay their loans. In this regard, the FDIC is willing to work with borrowers, whenever possible, to resolve their indebtedness.

At times, the statutory responsibilities temporarily delay funding of construction draws for builders and developers as our receivership staff determine the value and viability of the construction project as well as the companies that have pledged to repay those loans. In some cases, following a detailed review of the project and after reviewing current financial information from the company and/or guarantors, the receiver will make difficult business decisions that continued funding of the project will not minimize loses nor maximize recovery for the receivership estate and consequently will terminate funding.

Q2. Does a receivership have authority to provide additional funding under existing lines of credit? How does a receiver provide such funds?

A2. Yes. Delegations of Authority to act within clearly defined parameters, including budgetary matters, are issued by the FDIC Board of Directors. As a result of this process, FDIC receivership personnel from our Division of Resolutions and Receiverships are given the authority to extend additional funding as necessary when the issuance of such monies is beneficial to the receivership estate. In other words, if the advancement of funds for construction purposes will result in a net increase in the underlying collateral value or such funds will protect, preserve, or allow for build-out so that marketing of the real estate project can immediately begin, the FDIC as receiver may advance such funds. The receiver provides these funds from an account established specifically for each failed bank receivership.

The overarching goal of the receiver is to wind up the affairs of the failed financial institution. In order to achieve that goal, the receiver is given the right under 12 U.S.C. Section 1821(e) to repudiate undertakings entered into by the failed financial institution where it finds such undertakings to be burdensome and where such repudiation will promote the orderly administration of the failed financial institutions affairs.

Accordingly, our receivership personnel seek to balance making financial decisions that are in the best interests of the receivership estate while, at the same time, being cognizant of business decisions that may have an adverse financial impact upon construction companies, real estate developers, small business enterprises, and those they employ.

Q3. Is the receiver obligated to seek the highest return on assets, even if it means continued funding of a project under development?

A3. As receiver for a failed institution, the FDIC has a legal responsibility to maximize the recovery for the benefit of depositors and creditors who may have lost money when the institution failed. In accordance with this responsibility and within the context of a real estate market in decline, the FDIC must carefully analyze any requests for funding construction projects as well as evaluate the risks associated with the proposed transaction to determine whether the funding will provide the best opportunity to achieve the highest possible recovery for the failed institution's receivership estate.

THE BANK OF NEW YORK MELLON

Robert P. Kelly
Chairman and Chief Executive Officer

November 6, 2008

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Other than Temporary Impairment of Investment Securities

Dear Chairman Cox:

The Bank of New York Mellon, Inc. (the "Company"), a global financial institution with over $260 billion of assets, is concerned that the IFRS accounting for investment securities that may be other than temporarily impaired has created an "unlevel playing field" vs. U.S. financial institutions. This puts us at a competitive disadvantage, and U.S. accounting treatment contributes to the current market disruption.

We believe that when investment securities are not expected to make required contractual payments, the securities should be impaired based on the expected loss of principal. The model used in the United States for loan reserves and other asset impairments would be useful in establishing impairments. We do not believe that a fair value/liquidation model is relevant for assets for which an enterprise has no current intention of liquidating. The core underlying accounting concept that an enterprise is a going concern is contradicted by the present accounting standards requiring writedowns of impaired investment securities to what are often deeply discounted "fair values" arising from trades by distressed sellers in illiquid markets. We believe this accounting is contributing to the global financial crisis by causing reported earnings and capital to be artificially lowered.

IFRS standards allow held to maturity investment impairment charges through the income statement to reflect only credit losses. Changes in values due to illiquidity or distressed markets are excluded from impairment losses. We are aware that the International Accounting Standards Board (the "IASB") is about to reconsider the accounting for the impairment of available-for-sale financial instruments as a part of its Global Preparers Forum next week which will address the impact of the credit crunch on IFRS. We expect they will make accounting for available for sale securities consistent with held to maturity. The IASB moved rapidly on October 13, 2008 to issue changes to IAS 39 to permit an entity to reclassify certain debt and equity financial assets out of the 'fair value through profit or loss' and 'available-for-sale' categories if the asset is no longer held for the purpose of selling in the near term.

The Honorable Christopher Cox
November 6, 2008
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We are aware of several European banks having made sizeable reclassifications out of trading assets and assets available for sale into loans and that these transfers were permitted to be backdated to July 1, 2008. In effect these banks are now put at a competitive advantage with other banks that do not apply IFRS.

We urge the SEC to stand firm against concerns over due process and move quickly to level the playing field with IFRS and adopt accounting that does not contribute to the current disruption in the financial markets. We have discussed this with a number of our major investors and believe most would be supportive.

We urge you to move rapidly to amend U.S. GAAP so that impairment charges are based only on expected loss of principal.

In the interest of superior transparency, I would only suggest one addition to the IFRS approach. Disclosure each quarter what the additional illiquidity expense would have been under the prior method, so analysts have the option of adjusting their models, if desired.

I appreciate your consideration of our requests and invite you to call me at 212-635-1030 if you have any questions.

Sincerely,

Bob Kelly

909 Third Avenue
New York, NY 10022

November 12, 2008

Mr. Conrad Hewitt
Office of the Chief Accountant
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. 4-573, Request for Consideration to Amend the US GAAP Impairment Guidelines for Available-for-Sale and Held-to-Maturity Debt Instruments

Dear Mr. Hewitt:

Citigroup strongly believes that fair value information is useful to financial statement users. However, as envisioned in the Sections 132 and 133 of the Emergency Economic Stabilization Act (the Act) we believe that the application of fair value accounting should be appropriate in the public interest and consistent with the objectives of the investors. We believe the current application and interpretation of Statements 157 and 115 to Banking Institutions whose primary business model is to operate as a going concern with a longer term time horizon has resulted in unintended consequences. The strict restrictions on transferability and the requirement to measure impaired securities for which the institution has no immediate plans for sale on a liquidation or "exit" price notion is more relevant to active traders versus financial institutions such as Banks. Therefore, we feel that certain targeted amendments to the US GAAP impairment guidelines for available-for-sale (AFS) and held-to-maturity (HTM) debt instruments should be considered. Our proposals would not only help converge US GAAP with IFRS, but make the application of fair value accounting consistent with the objectives of the Act This letter summarizes the current guidelines in US GAAP and IFRS and proposes targeted amendments to US GAAP to achieve those objectives.

<u>When an AFS Debt Instrument is Considered Impaired</u>

US GAAP

FASB Staff Position No. 115-1, *The Meaning of Other-Than-Temporary-Impairment and Its Application to Certain Investments*, significantly expanded the situations where impairment charges are required to be recorded in earnings. FSP FAS 115-1 requires an institution to assert its positive intent and ability to hold debt securities for a period of time sufficient to allow for any anticipated recovery in fair value, even for unrealized losses due solely to changes in interest rates (including liquidity and risk premiums). Prior guidance and industry practice required such impairments to be recorded in earnings only when it was probable that the institution would be unable to collect principal and interest when due (credit impairment) or the institution intended to sell the security in the near term. FSP FAS 115-1 forces institutions to record impairment charges in earnings for debt securities that may never be sold, but where the institution is unable to forecast and assert to long-term plans for the security. Such long-term plans and definitive assertions are especially difficult to substantiate in today's uncertain economic environment. In practice, the guidance in FSP FAS 115-1 has resulted in institutions asserting to very long holding periods under current market conditions. Thus, at present

More reflective of the expected cash flows to be generated by the investor
Because of current market dislocations, the difference between the entire decline in fair value (which includes components such as liquidity and other risk premiums) and the amount of credit impairment is often quite significant. The estimated credit impairment provides a much better reflection of the expected cash flows to be generated by the investor. Recording the entire decline in fair value for AFS debt instruments or HTM debt instruments where the investor does not intend to sell the security in the near term overstates the amount of the loss expected to be incurred.

Refer to the Appendix for an example of a real situation encountered by Citigroup. We believe this example is consistent with situations faced by many financial institutions and other investors today, and highlights the significant difference between estimated credit impairment and the entire decline in fair value due to current market conditions.

More consistent with the overall accounting models for AFS and HTM debt instruments
Our proposal is more consistent with the overall accounting models for AFS and HTM debt instruments:

- For AFS debt instruments, the remaining *unrealized* losses would continue to be reported in Other Comprehensive Income. Unlike credit impairment, those losses will reverse with the passage of time. Financial institutions currently make transparent disclosures about unrealized losses (and gains) on AFS debt instruments, and could supplement those disclosures for instruments with objective evidence of impairment.
- For HTM debt instruments, the remaining *unrealized* losses would not be reported in the financial statements.[3] Unlike credit impairment, other changes in fair value for HTM debt instruments will reverse with the passage of time. Because of the restrictions precluding the sale of HTM debt instruments other than in rare circumstances, institutions do not expect to ever realize the other changes in fair value due to liquidity and other risk premiums.

Impairment measurement model for loans is well developed and more applicable to many debt instruments today
The impairment measurement model for loans is well-known, has been consistently applied for many years, and is currently applied to large portions of financial institutions' balance sheets. As shown in the Appendix, the judgments and estimates we make to assess AFS or HTM debt instruments for credit impairment are almost identical to the requirements for loans. Note that these judgments and estimates are required not only to determine if credit impairment has occurred and to measure credit impairment, but also as an input to measure *fair value* in today's illiquid and distressed markets.

Initial basis of conclusions in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
When the FASB originally issued FAS 115, it stated the primary reason for not making the impairment model for AFS and HTM debt instruments consistent with that for loans was "the relatively greater and easier availability of reliable market prices for securities, which makes it more practical and less costly to require use of a fair value approach" (see paragraph 113 of

[3] FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, currently requires disclosures about fair value of HTM debt instruments. The FASB could supplement those disclosures for HTM debt instruments with objective evidence of impairment.

Appendix – Example of Difference Between Decline in Fair Value and Credit Impairment

The following example is a real situation encountered by Citigroup. We believe this example is consistent with situations faced by many financial institutions and other investors today, and highlights the significant difference between estimated credit impairment and the entire decline in fair value due to current market conditions.

In April 2006, Citigroup purchased residential mortgage-backed securities (RMBS) backed by residential mortgages originated by a leading mortgage lender and located primarily in California (55%) and Florida (16%). The RMBS was rated AAA by the rating agencies at the date of purchase, has a contractual maturity date of May 2036, and an original weighted average life of 3.4 years. Full principal pay-down using assumed prepayment rates was expected to be February 2013. The RMBS had a purchase price of $147.8 million and was recorded as AFS.

At the end of the third quarter 2008, the fair value of this RMBS was estimated at $71.6 million (approximately 49% of original cost), resulting in an unrealized loss recorded in Other Comprehensive Income of $76.2 million. The RMBS continues to be rated AAA. As part of the Other Than Temporary Impairment review, this position was reviewed to assess for possible credit impairment. Credit impairment is assessed using a cash flow model that estimates the cash flows on the underlying mortgages, using the collateral and transaction structure. We use actual cash flows on the bond through the current period, and then project remaining cash flows using a number of assumptions, including default rates, prepayment rates, and recovery rates (on foreclosed properties). Assumptions are developed using as much market participant data as possible, including internal estimates of future delinquency and default rates (as well as published estimates by rating agencies), and various assumptions regarding recovery rates – again, both published estimates and internal estimates of market participant assumptions. We believe that the assumptions incorporate and reflect fairly pessimistic views of future performance, and the default rates and recovery rates are significantly worse than have ever been historically experienced. These models have predicted, given these forward looking assumptions, that it is probable that the RMBS would suffer net principal losses as a result of default on the underlying mortgages of 10.27% throughout its contractual life. The present value of these principal losses, net of recoveries, results in a present value credit impairment of approximately 13%.

We estimate that the fair value of this RMBS reflects:

Credit impairment (discounted at the original effective yield)	13%
Losses due to other market factors including illiquidity and risk premiums	36%
Total decline in fair value	49%

As required by US GAAP, Citigroup recorded an impairment charge in earnings of $76.2 million. If the impairment guidelines were amended as proposed in this letter, Citigroup would have recorded an impairment charge in earnings of $19.2 million, while the remaining unrealized loss of $57.0 million would still be recorded in Other Comprehensive Income. We believe the impairment charge that reflects the estimated credit impairment is a much better reflection of the losses we expect to incur (and have incurred) on this RMBS position.

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

November 13, 2008

Florence E. Harmon, Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

SEC Study of Mark-to-Market Accounting, File No. 4-573

Dear Ms. Harmon:

The Center for Audit Quality ("CAQ")[1] is pleased to have the opportunity to comment on the study of "mark-to-market accounting" being undertaken, at the request of Congress, by the Securities and Exchange Commission ("SEC" or "Commission").[2] The CAQ supports the SEC's involvement in the study on the use of fair value measurements in financial reporting, and believes that the SEC can bring an investor-focused voice to the study. Some have argued that using fair value measurements can, in some circumstances, distort the value of certain assets, and that such use has exacerbated the current financial crisis.[3] The CAQ believes that blaming the current crisis on the use of fair value measurements in financial reporting, the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 157 ("FAS 157"), or the application of FAS 157, misreads the fundamental economic and regulatory underpinnings of the crisis, and inhibits efforts to address the crisis effectively. Therefore, although further clarification and improvement of how fair value measurements are made and presented in the financial statements may be beneficial, the CAQ believes that (1) the current use of fair value measurements for financial instruments in the

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1 The CAQ is an autonomous, nonpartisan, nonprofit group based in Washington, D.C. It is governed by a Board that comprises leaders from the public company auditing firms, the American Institute of CPAs and the investor and issuer communities. The CAQ was created to serve investors, public company auditors, and the markets by fostering confidence in the audit process and by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ is affiliated with the American Institute of CPAs.

2 *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) [hereinafter "EESA"]. Specifically, EESA § 133 states that the SEC "shall conduct a study on mark-to-market accounting standards as provided in Statement Number 157 of the Financial Accounting Standards Board. . . ."

3 *See, e.g.*, Newt Gingrich, *Suspend Mark-To-Market Now!*, Forbes.com, Sept. 29, 2008, http://www.forbes.com/2008/09/29/mark-to-market-oped-cx_ng_0929gingrich.html. Similar views were espoused by several participants at the SEC's October 29 Roundtable on Mark-to-Market Accounting [hereinafter "October 29 Roundtable"], including William Isaac (former Chairman of the Federal Deposit Insurance Corporation) as well as Aubrey Patterson (Chairman and CEO of BancorpSouth, Inc.) and Bradley Hunkler (Vice President and Controller of Western & Southern Financial Group).

U.S. standards-setting process, including the process of issuing authoritative interpretive implementation guidance, and the role played by each participant are appropriate."[7] The CAQ supports that conclusion.

CIFR, in its final report to the Commission, found that five steps could improve FASB's standards-setting process: (i) increase consideration of investor perspectives; (ii) enhance governance and oversight; (iii) improve process; (iv) clarify the role of interpretations; and (v) improve standard design.[8] The CAQ believes that CIFR's recommendations are generally substantively appropriate. The SEC should endorse CIFR's conclusions and should work with FASB toward continued implementation of these findings.

The CAQ firmly believes, however, that any changes to the standards-setting process should enhance, or at least be consistent with, the most important characteristic of any standards-setting process: independence. The CAQ strongly supports an independent standards-setting process, subject to public scrutiny and free of undue pressures. The urgency of the economic crisis only increases the need for procedural safeguards to protect against interventions that, while well-intentioned, are ultimately misplaced. Procedure and independence are important to ensure the legitimacy of the standards-setting process, and to protect the goals of transparency, relevance, and usefulness in financial reporting that have been hallmarks of decades of standards-setting efforts in the United States. Unconsidered actions could have unintended consequences, such as a divergence between U.S. GAAP and international accounting standards that would set back years of progress toward the ultimate goal of a single set of high-quality, globally accepted accounting standards.

II. Fair Value Serves Investor Interests In Transparency

The greater use of fair value measurements for financial instruments in the financial statements, also called "mark-to-market" accounting, along with related disclosures, has been a key part of the movement toward greater relevance, usefulness, and transparency in financial reporting that has taken place over the last thirty years. The CAQ believes that this movement is appropriate and should not be reversed. The use of fair values for financial instruments provides users of financial statements with useful and relevant information.[9] Specifically, when a company presents the fair value of certain financial assets and liabilities within its financial statements, rather than their historical cost, investors are given an additional insight into the risks to which the company may be exposed in achieving its current earnings and the potential liquidity issues that the company could face if it were to need to sell securities rather than to hold them for the longer term. The movement towards greater use of fair value measurements has resulted in the

[7] *See* CIFR, Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission Ch. 2 (Aug. 1, 2008).

[8] *Id.* at 56.

[9] The CFA Institute has asserted that fair value is the *most* relevant and useful information that can be provided to investors and creditors *See, e.g.*, CFA Institute, A Comprehensive Business Reporting Model 8 (July 2007), *available at* http //www.cfapubs org/doi/pdf/10.2469/ccb.v2007 n6.4818.

In recent years, while FASB added fair value requirements in a number of new accounting standards as a step toward greater transparency for investors, no common methodology for conducting the valuations was provided prior to the issuance of FAS 157. The result was a muddle of "fair value" methods and computations that changed from asset to asset, from liability to liability, and from company to company. This contributed to "inconsistencies that added to the complexity in applying GAAP."[14]

III. FAS 157's Use Of "Exit Value" Is An Appropriate Way To Calculate Fair Value

FASB sought to address the difficulties caused by multiple fair value methodologies with FAS 157, which "defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements."[15] Stated differently, FAS 157 itself does not prescribe any particular accounting treatment or require fair value accounting. Rather, it provides a consistent measurement methodology for applying existing fair value requirements, centralized in one standard. In addition, FAS 157 "simplifies and codifies related guidance within generally accepted accounting principles (GAAP)"[16] and requires increased disclosure of the methods and inputs used in fair value measurements of a company's assets and liabilities.

These improvements were intended to "result in increased consistency and comparability in fair value measurements" as well as "provide users of financial statements with better information about the extent to which fair value is used to measure recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period."[17] Thus, FAS 157 combines fair value's transparency with greater comparability across companies and classes of assets and liabilities, permitting investors to better assess for themselves the reliability of the fair value measurements that a company presents in its financial statements.

To accomplish this goal, FAS 157 establishes an "exit price" objective for fair value measurements.[18] This "exit price" of the asset or liability must be established between a willing buyer and a willing seller who would put it to its highest and best use.[19] The use of the exit price provides an appropriate objective for fair value measurements that can be applied consistently.

This objective is embedded in FAS 157's three-level system of inputs into valuation techniques. Assets and liabilities measured at fair value are to be valued using Level 1 inputs—quoted prices in active markets for identical assets or liabilities—where available. If Level 1 inputs are not available, Level 2 inputs are used: quoted prices for similar assets or liabilities in active markets, quoted prices for identical assets or liabilities in inactive markets, inputs other than quoted prices

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[14] FAS 157, Summary—Reason for Issuing This Statement.

[15] *Id.* at ¶ 1.

[16] *Id.*

[17] Id. at Summary—How the Changes in This Statement Improve Financial Reporting

[18] *Id.* at ¶ 7.

[19] *Id.* at ¶¶ 10, 12

inconsistent and unverifiable results. With either of these alternatives, the result would be diminished transparency and comparability for investors, and would more generally represent an abandonment of the last thirty years of improvements in financial reporting.

Although the last few months have been undeniably painful for this country as well as for the global financial system, the use of fair value measurements for applicable financial instruments simply reported changes in values as they occurred. Even if fair value measurements under today's standards are not perfect, the use of fair value measurements for financial instruments as required by existing standards continues to provide investors with more relevant and useful information than any of its alternatives.

V. Potential Improvements To FAS 157

Although FAS 157 implements an appropriate methodology for fair value measurements, it is no surprise that a new standard such as FAS 157 could be improved through additional clarifications. The SEC and FASB, as well as the IASB, have recently released additional guidance in this area.[23]

However, additional guidance may be needed, particularly in the following situations:

- First, FAS 157 does not provide clear guidance about the circumstances in which it is appropriate to shift from Level 2 to Level 3 inputs when valuing an asset in a time of changing or disrupted market conditions. Guidance to aid in determining when a market is active or inactive, or when a particular transaction would be considered a "distressed" or "forced" sale not constituting evidence of fair value, would assist in exercising judgment in this area.

- Second, while FAS 157 creates a valuation method based on first principles and provides certain examples in its appendices, providing more specific examples of the fair value measurements of various types of assets and liabilities under varying assumed market conditions would be very useful.

- Third, additional guidance on presenting, in financial statements and notes, the periodic changes in asset valuation would be helpful to provide more useful information to investors.[24]

By suggesting that additional guidance may be useful in limited situations, the CAQ does not intend to imply that the current emphasis on accountant and auditor judgment embodied in FAS

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[23] *See* FASB, FASB Staff Position No. FAS 157-3 (Oct. 10, 2008); *see also* SEC Office of the Chief Accountant and FASB Staff Clarification on Fair Value Accounting, Press Release (Sept 30, 2008), IASB Expert Advisory Panel, Measuring and disclosing the fair value of financial instruments in markets that are no longer active (Oct. 2008). Some of this guidance dates back to March 2008, when the SEC's Division of Corporation Finance sent 30 letters to CFOs that address disclosures in Management's Discussion and Analysis about fair value measurements in increasingly illiquid markets. (A sample letter is available at http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm.) Similar follow-up letters were sent in September 2008. (A sample letter is available at http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm.) The CAQ also would urge FASB to complete proposed FASB Staff Position 157-c to provide guidance on the valuation of financial liabilities.

[24] *See supra* note 7; *see also infra* Section VII

In sum, financial reporting is undertaken primarily for the benefit of investors.[29] Where a presentation for investors is not entirely suitable for regulatory use, it is the prudential regulators who have the power and flexibility to adjust their formulae or information requirements to meet their regulatory mandate. It is thus the prudential regulators, and not investors—who are largely dependent on information provided under rules established by others such as the SEC and FASB—who should make the necessary adjustments. Moreover, inasmuch as regulatory capital ratios are disclosed in the financial statements, the application of new regulatory filters to accounting information could increase transparency by providing another lens through which investors may view the financial statement data.

VII. Potential Improvements To Accounting Standards, Including The Financial Statement Presentation Model

The accounting and reporting issues in today's turbulent markets highlight some of the challenges inherent in the current mixed attributes model. As long as some financial instruments are reported at amortized cost (adjusted for incurred losses) and others are reported at fair value, there will be questions about the proper relationship of the two. Such questions include determining when one method is appropriate for a particular class of assets or liabilities, and determining what rules will define a particular class of assets or liabilities.

Standards setters—including both the FASB and the IASB (acting jointly, if appropriate)—should review carefully potential changes that will address these issues. Those changes may range from minor adjustments to more extensive changes to U.S. accounting standards. Any such changes should be pursued on a coordinated global basis, to the extent possible, and in concert with the roadmap for the international convergence of standards.

As stated above, the CAQ supports the principles of fair value accounting, and does not believe that fundamental changes in fair value accounting are desirable or warranted. Some CAQ member firms have indicated, however, that in the near term there are several initiatives regarding accounting and reporting for loans and debt securities, presented in greater detail below, that could be considered without compromising the core principles of fair value measurement.

A. Align the accounting guidance for loan impairments with the accounting guidance for impairments of debt securities

Under GAAP, the requirements for measurement and recognition of impairment losses are different for loans than for investments in debt securities—even though the underlying cash

[29] *See supra* note 9, at 6. "Investors and creditors need timely, relevant, complete, accurate, understandable, comparable, and consistent information . . . to evaluate the potential risk and return properties of securities and to determine appropriate valuations for them. The purpose of audited financial statements, prepared according to high-quality financial reporting standards, is to provide the needed information." *Id.* However, because investors and creditors are "generally not in a position to be able to command the information they need to evaluate and value potential investments," securities regulators require the provision of financial statements as a condition of registration. *Id.*

the fact that some securitized beneficial interests, such as residual interests, do not have contractual cash flows and possess a high degree of variability in cash flows because of factors such as credit losses, prepayments, and changes in interest rates. To the extent that those beneficial interests are not accounted for at fair value through profit and loss (e.g., under FAS 155), an impairment model similar to EITF 99-20 could be developed to cover those types of assets. Alternatively, the scope of EITF 99-20 could be reconsidered.

In addition, consistent with the comments above about reporting changes in fair value, the CAQ suggests that consideration may be given to whether FAS 115 (and SAB 59) could be further revised such that OTTI would be recognized at the time a credit loss becomes probable—i.e., when it becomes probable that an investor will not receive the contractual cash flows on its investment. Also, the CAQ suggests that consideration be given to eliminating the "ability and intent to hold to recovery" test under FAS 115 and SAB 59, which was never intended to address credit risk, and replacing it with a requirement to recognize an impairment loss (to fair value) in income when it becomes probable an investor will sell an otherwise impaired security. Accordingly, OTTI would be recognized only (1) when there is a credit loss impairment (and then only for probable losses of contractual or expected cash flows); or (2) when it becomes probable that an investor will sell an otherwise impaired security.

Finally, the CAQ supports the SEC's request that FASB address the appropriate impairment model for hybrid securities, such as perpetual preferred stocks, and encourages FASB to complete that project as soon as practicable.

C. Modify the approach for reporting periodic changes in fair value

Under current GAAP, changes in fair value from period to period are generally reported either in income or in accumulated other comprehensive income, depending upon the nature of the item. Standards-setters could consider modifying this model in the following ways:

- Consider separating, for accounting and reporting purposes, the periodic changes in fair value into two components: (i) probable credit losses (incurred or expected, per the discussion above) in income; and (ii) all other changes in fair value (including, for example, liquidity discounts) in other comprehensive income until it becomes probable that the asset will be sold or the asset matures.

- Consider changes in the format of the income statement to allow for (i) more visibility to the income effects of items reported at fair value and (ii) the inclusion of other comprehensive income on the face of the statement.

These actions could help enhance transparency and usefulness by providing a more consistent framework for recognizing impairment losses, and by reporting all changes in fair value-measured items in a single financial statement.

D. Further enhance and improve transparency through disclosures

The concerns expressed about the application of FAS 157 in distressed or illiquid markets could be addressed, at least in part, through clear and transparent disclosures. These disclosures could

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The CAQ again thanks the Commission for the opportunity to comment on the Commission's study on fair value accounting, and we would be pleased to discuss our comments with the Commission or its staff at their convenience.

Very truly yours,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality