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FEDERAL RESERVE PERSPECTIVES ON FINANCIAL REGULATORY REFORM PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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FEDERAL RESERVE PERSPECTIVES ON FINANCIAL REGULATORY REFORM PROPOSALS

Thursday, October 1, 2009

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

The committee met, pursuant to notice, at 9 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Gutierrez, Velazquez, Watt, Sherman, Meeks, Moore of Kansas, Hinojosa, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Ellison, Klein, Wilson, Foster, Carson, Speier, Minnick, Kosmas, Grayson, Himes, Peters, Maffei; Bachus, Castle, Royce, Manzullo, Jones, Biggert, Miller of California, Capito, Hensarling, Garrett, Price, McHenry, Campbell, Bachmann, McCotter, Posey, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order. The photographers will disburse.

This hearing convenes with Chairman Bernanke. We had a hearing earlier with the regulators. We had Treasury Secretary Geithner, and then we had the other regulators, the bank regulators. We were not able to have Chairman Bernanke at that time because the Federal Open Market Committee was meeting. And so this now completes the—oh, I don't know—30th or 40th round of hearings that we have had in general.

We will be proceeding to more legislative hearings. We had one, as members know, yesterday on consumer affairs, and then Mr. Kanjorski convened one on various aspects of the Capital Markets Subcommittee's jurisdiction, including the rating agencies.

We will be going forward on Tuesday with a hearing on a draft that will be released today on enhanced investor protections and market integrity protections for the SEC. It will deal with requirements of hedge funds and private equity and other pools of capital to register.

Let me say in advance, because I like to avoid flurries, if there can be, we on the Majority side, and I believe members on the Republican side as well, are fully supportive of the law of venture capital, and we do not plan to treat venture capital the same way we treat hedge funds. There are, obviously, definitional differences. But I think members will see in the draft an appropriate regard for the role of venture capital, and we are working in consultation

with people in the venture capital field. I do not think there will be anything in there that they will regard as hindering them and that will interfere.

Otherwise, there will be significant increases in consumer protections in terms of registration requirements, in terms of duties imposed on broker dealers, etc. That will be a legislative hearing, but this is the last of the hearings in which we will hear in general from the regulators.

Mr. Bernanke, we welcome you, and, as I noted previously, this is probably, I guess, the 39th time in this Congress that we have had representation from senior members of the Federal Reserve, yourself more than anyone else, but the Vice Chair and other members of the Board of Governors, Ms. Duke, for instance, and Mr. Cohen and Mr. Alvarez and others. So we appreciate it.

I now want to begin the clock, please. I will take 4 minutes. The gentleman from North Carolina will take 4 minutes. We have an 8-minute time rule for Cabinet-level people.

I want to talk about what seems to be an anomaly in some of the discussion on the Consumer Protection Agency. The Federal Reserve has been subject to a lot of criticism, much of which I think has been unfair, because I think they stepped in at the request of, first, the Bush Administration, and now the Obama Administration to fill some gaps.

Going forward with the support of Chairman Bernanke and others, we will be filling some of those gaps so that the role that the Federal Reserve has played over the past year will change—not that this is a criticism of what they did, although people don't have to agree with every aspect of how they did it—but it is a recognition that there are better structural ways to do it. It is the not the Federal Reserve's fault that it was the only institution that could do certain things. That means we will be putting some limitations, as the Chairman has agreed should be done, not, as you know, that is necessary for us to go forward, but it is helpful when we can be working in a cooperative way on the powers under section 13(3). We will make explicit that auditing will be fairly complete, with a couple of exceptions that protect market integrity.

We have had debate and will have further debate about exactly what the role of the Federal Reserve will be in systemic risk regulation. There were some, myself included, who earlier this year thought the Federal Reserve would have a larger role than it looks like it will have, that it will be part of a conciliar structure.

But there was one area which I am puzzled by. Because many of those who have been the most vociferous in their criticism of the Federal Reserve are resisting the bigger shift of power away from the Federal Reserve currently on the table, and that is in the consumer area. Those who object to the creation of a Consumer Protection Agency and insist on leaving consumer protection exactly where it now is statutorily, perhaps putting those who now have the power, the Federal bank regulators, into some kind of conciliar structure, but essentially leaving that distribution of power in place, are the great defenders of the Federal Reserve's power. Because the largest loser of authority when we take consumer affairs away from the existing bank regulators and put it in the consumer agency is the Federal Reserve.

We don't do that out of criticism of them, although I must say, prior to Mr. Bernanke, the record of the Federal Reserve on consumer protection was dismal. There has been an improvement, although I do know that in every case, actions taken by the Federal Reserve in the consumer area followed actions that were initiated in Congress, and in particular this committee, once we became the Majority in 2007. That is true with credit cards, it is true with subprime mortgages, it is true with overdrafts, and it is true with formulating a code of unfair and deceptive practices.

But the fact is that if you look at the current arrangement of power involving consumer protection in terms of mortgages under HOEPA, in terms of credit cards, in terms of overdrafts, the largest single agency in the bank regulator field doing consumer protection is the Federal Reserve. And those who resist taking consumer protection powers and putting them into a separate agency are de facto the greatest defenders of the Federal Reserve power now around. Because we have a consensus on auditing, I believe. Some details might be debated. We have a consensus on limiting the powers under 13(3). I think we will have a consensus on the role or a very large degree of agreement on its role in systemic risk.

So the one issue that now appears to be debated between us is, do we leave the Federal Reserve with the single largest chunk of consumer protection powers or do we move it, as I think is appropriate, to a better agency?

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

First of all, Mr. Chairman, let me respond to say that we do not object to consumer protection being removed from the Federal Reserve. What we do object to and what we strenuously think would be a mistake is what you do with consumer protection, and that is you vest it in a new government agency and you give it tremendous power not only to protect the consumer, but you also give it power to design financial products. You give it power to dictate terms on financial agreements. You give it power to limit choice. You give it power to restrict competition. And by giving it the power to approve new products, you completely stifle innovation.

America didn't get to be the largest economy in the world, 3 times bigger than the next biggest economy, by taking away individual choice, by stifling innovation, and by putting government in the business of managing financial services and making choices for both institutions and individuals.

So I am sorry that we have had a miscommunication, but our objection is that you have a tremendous shift of responsibility from individuals and institutions to the government.

We also object and, Chairman Bernanke, we have strenuously objected to something else, and that is vesting in the Federal Reserve the right to bail out individual non-bank financial institutions. We believe that the FDIC has the power to resolve banks through their statutory authority, but we think that is to protect depositors and not to protect the bank, its shareholders, or to protect it from risky investors.

Now in the remaining time I have left, let me tell you something else that we have a great unease about.

I believe it was in March of last year, not September, that I had conversations with you and Secretary Paulson; and at that time, you actually expressed tremendous concern about the overextension of debt and of leverage. And I think there was a real concern on the part of a lot of people, whether this deleveraging and constriction of debt could be done in an orderly way. So there was some forewarning of what we saw in September, I think, starting with Bear Stearns.

But, I am not sure that even until this very day we have identified exactly what caused the events of last year and how to address it. Instead, we have had, almost with light speed, the Obama Administration propose a sweeping change in financial regulation, which includes and continues to include as late as this month the possibility that the Treasury would spend a trillion dollars to bail out another non-bank financial institution.

Chairman Volcker—former Chairman Volcker—said he had extreme concern over that. He felt like it was a mistake; and we, as Republicans, do, too. We simply do not believe the government ought to be in the bailout business of nonfinancial—non-bank financial institutions.

The CHAIRMAN. The gentleman's time—

Mr. BACHUS. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from North Carolina is recognized for 4 minutes.

Mr. WATT. Thank you, Mr. Chairman, and welcome back, Chairman Bernanke.

I want to first express delight at the change of just some basic things related to the Federal Reserve under your chairmanship. I quite often tell the story that after being on this committee ever since I came to Congress and seeing it have jurisdiction over the Federal Reserve, not only did I not understand anything the former Chairman said in his testimony, but I couldn't tell my constituents where the Federal Reserve was located until you became the Chairman of the Federal Reserve and invited a number of us over to a discussion with you. That, in and of itself, was an indication to me that it was a new day at the Federal Reserve, and I would have to say that since that time, there has been an ongoing willingness to open the Federal Reserve from the mystique that both the language and the appearance the Federal Reserve had under the prior Chair and the actual operations of the Federal Reserve.

And in that connection, I want to compliment the witness, Mr. Alvarez, who is sitting behind you, whom you sent to the last hearing about the proposed bill that Mr. Paul has authored regarding the audit of the Federal Reserve. I think we made substantial progress toward putting information in a public record based on that hearing that will both educate the public about what the Federal Reserve does and the changes that have been made in transparency and accountability at the Federal Reserve and what needs to be done legislatively as part of regulatory reform to memorialize that in legislation. And I think we will come to a resolution that I am honored to say that the Chair has given me the primary authority for in my subcommittee. So I think we are going to work through a resolution of that.

I hope we can also work through a resolution in regulatory reform of this whole consumer protection issue. Because I think there are some things in your testimony this morning that when I get back to question you about will help us really put that issue in perspective in a much more public and transparent way. And so I welcome you back to this hearing and I look forward to working with you on both the audit issue and on the consumer protection issue, as well as the systemic risk and other issues that we are trying to resolve during this regulatory reform debate.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas is recognized for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Over the past couple of weeks, the media has been replete with 1-year anniversary stories of historic bailouts or economy recovery actions by our Federal Government. Before deciding on how we best proceed with financial markets reform, we would do well to learn the lessons of the good, the bad, and the ugly.

First, the good: Within months of intervention, there is no doubt that credit spreads returned to more normal levels. Equity markets have clearly risen appreciably, and the panic we felt last September has subsided.

Then, the bad: Our economy continues to contract in the face of massive government intervention. Too much private capital remains on the sidelines. After the passage of the Administration's $1.2 trillion stimulus bill, 3 million of our fellow countrymen lost their jobs, and our Nation suffers from the highest unemployment rate in a quarter of a century. And I remind all there is no such thing as a jobless recovery. No jobs, no recovery.

And finally, the ugly: This orgy of spending has brought our Nation its first trillion dollar deficit, and our national debt will triple in the next 10 years. According to the Special Inspector General for the TARP program, the taxpayer is now on the hook for up to $23.7 trillion or $202,940 per household.

The government's continued bailouts of Fannie Mae, Freddie Mac, AIG, Chrysler, GM—the list goes on—now hamper our economic recovery and threaten to institutionalize us as a "bailout nation" with no visible exit strategy in sight.

There remains a huge difference between adding emergency liquidity to a panicked financial system and bailing out individual non-bank firms fortunate enough to be designated "too-big-to-fail." Under the latter policy, the big get bigger, the small get smaller, the taxpayer gets poorer, and our children get saddled with the mother of all debts.

Clearly, there is a better way. Reforms are needed. But the best way to end taxpayer bailouts is to end taxpayer bailouts.

The CHAIRMAN. The gentleman from New Jersey is recognized for 2 minutes.

Mr. GARRETT. I thank the chairman for holding this hearing, and I welcome Chairman Bernanke back again to the committee.

I note in the Chairman's testimony you continue to advocate that the Federal Reserve should be given authority for consolidated oversight for all "systemically important financial institutions." And, quite candidly, I do have a number of concerns about this pro-

posal, many that I have expressed before. Among them, first of all, specifically designating institutions as systemically critical leads to unfair competitive agendas, disadvantages, increased moral hazard, and makes it more likely such institutions will be considered "too-big-to-fail."

Secondly, the Federal Reserve already has consolidated supervision over many of the large bank holding companies, including Citi and Bank of America, which the Federal Government has pumped billions of dollars into due to the fact that such consolidated supervision apparently failed in the past.

Furthermore, Fed policy itself—that is, keeping interest rates too low for too long, primarily before you were here—was one of the major factors leading to this crisis.

I am not alone in my concerns about the Fed as a systemic regulator. There seems to be a universal distaste for the Fed in such a role on the Senate Banking Committee. Such a political reality would seem to make it less likely that the House would confer such new powers on the Fed either. And as has been stated previously, rather than give the Fed additional powers, Republicans on the committee have proposed as part of a reform plan that the powers of the Fed be focused primarily on monetary policy and others be reduced.

So preventing future taxpayer-funded bailouts is a primary aim of the GOP plan and is also the primary aim of a piece of legislation I plan to introduce later today that will call for raising the minimum downpayment for the FHA loans as well as a study to examine what is an appropriate leverage ratio for the FHA. There have been increasing reports of a likely necessity of a taxpayer-funded bailout for the FHA, and this legislation aims to implement—

The CHAIRMAN. The gentleman's time has expired.

Mr. GARRETT. I appreciate your comments on that.

The CHAIRMAN. I want to begin, Mr. Bernanke, with some of the issues of history that were raised.

It was—the gentleman from Texas listed the bailouts he has found damaging: Fannie Mae; Freddie Mac; AIG; the automobile companies; and the banks, all of which were, of course, initiated by the Bush Administration. And I do think it is appropriate to note that the Obama Administration inherited all of these. It has carried some out more or less in a number of cases. But every single one of those was initiated by the Bush Administration, suggesting that it was not part of some ideological agenda but a reaction to reality. And, indeed, much of what we are talking about today was first articulated by Secretary Paulson in April of 2008.

So that doesn't make them right or wrong. It ought to make them nonpartisan.

Secondly—

Mr. BACHUS. Mr. Chairman, your time has expired. Now if you want to give additional time—

The CHAIRMAN. Excuse me. I am in my 5 minutes.

Mr. BACHUS. You have an opening statement of Chairman Bernanke.

The CHAIRMAN. Oh, I forgot about that. I apologize. You are quite right.

So I will take whatever time I used in that opening statement, and it will be deducted from my 5 minutes, and the Chairman is recognized.

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 the opportunity to discuss ways of improving the financial regulatory framework to better protect against systemic risk.

In my view, a-broad based agenda for reform should include at least five key elements:

First, legislative change is needed to ensure that systemically important financial firms are subject to effective consolidated supervision, whether or not the firm owns the bank.

Second, an oversight council made up of the agencies involved in financial supervision and regulation should be established, with a mandate to monitor and identify emerging risk to financial stability across the entire financial system, to identify regulatory gaps, and to coordinate the agencies' responses to potential systemic risks. To further encourage a more comprehensive and holistic approach to financial oversight, all Federal financial supervisors and regulators—not just the Federal Reserve—should be directed and empowered to take account of risks to the broader financial system as part of their normal oversight responsibilities.

Third, a new special resolution process should be created that would allow the government to wind down a failing systemically important financial institution whose disorderly collapse would pose substantial risks to the financial system and the broader economy. Importantly, this regime should allow the government to impose losses on shareholders and creditors of the firm.

Fourth, all systemically important payment, clearing, and settlement arrangements should be subject to consistent and robust oversight and prudential standards.

And fifth, policymakers should ensure that consumers are protected from unfair and deceptive practices in their financial dealings.

Taken together, these changes should significantly improve both the regulatory system's ability to constrain the buildup of systemic risks as well as the financial system's resiliency when serious adverse shocks occur.

The current financial crisis has clearly demonstrated that risk to the financial system can rise not only in the banking sector but also from the activities of other financial firms—such as investment banks or insurance companies—that traditionally have not been subject to the type of regulation and consolidated supervision applicable to bank holding companies. To close this important gap in our regulatory structure, legislative action is needed that would subject all systemically important financial institutions to the same framework for consolidated prudential supervision that currently applies to bank holding companies. Such action would prevent financial firms that do not own a bank but that nonetheless pose

risk to the overall financial system because of the size, risks, or interconnectedness of their financial activities from avoiding comprehensive supervisory oversight.

Besides being supervised on a consolidated basis, systemically important financial institutions should also be subject to enhanced regulation and supervision, including capital, liquidity, and risk-management requirements that reflect those institutions' important roles in the financial sector.

Enhanced requirements are needed not only to protect the stability of individual institutions and the financial system as a whole but also to reduce the incentives for financial firms to become very large in order to be perceived as "too-big-to-fail." This perception materially weakens the incentive of creditors of the firm to retrain the firm's risk-taking, and it creates a playing field that is tilted against smaller firms not perceived as having the same degree of government support.

Creation of a mechanism for the orderly resolution of systemically important non-bank financial firms, which I will discuss later, is an important additional tool for addressing the "too-big-to-fail" problem.

The Federal Reserve is already the consolidated supervisor of some of the largest, most complex institutions in the world. I believe that the expertise we have developed in supervising large, diversified, interconnected banking organizations, together with our broad knowledge of the financial markets in which these organizations operate, makes the Federal Reserve well suited to serve as the consolidated supervisor for those systemically important financial institutions that may not already be subject to the Bank Holding Company Act. In addition, our involvement and supervision is critical for ensuring that we have the necessary expertise, information, and authorities to carry out our essential functions as a central bank of promoting financial stability and making effective monetary policy.

The Federal Reserve has already taken a number of important steps to improve its regulation and supervision of large financial groups, building on lessons from the current crisis. On the regulatory side, we played a key role in developing the recently announced and internationally agreed-upon improvements to the capital requirements for trading activities and securitization exposures; and we continue to work with other regulators to strengthen the capital requirements for other types of on- and off-balance sheet exposures.

In addition, we are working with our fellow regulatory agencies toward the development of capital standards and other supervisory tools that will be calibrated to the systemic importance of the firm. Options under consideration in this area include requiring systemically important institutions to hold aggregate levels of capital above current regulatory norms or to maintain a greater share of capital in the form of common equity or instruments with similar loss-absorbing attributes, such as "contingent" capital that converts to common equity when necessary to mitigate systemic risk.

The financial crisis also highlighted weaknesses in liquidity risk management at major financial institutions, including an overreliance on short-term funding. To address these issues, the Federal

Reserve helped lead the development of revised international principles for sound liquidity risk management, which had been incorporated into new interagency guidance now out for public comment.

In the supervisory arena, the recently completed Supervisory Capital Assessment Program (SCAP), properly known as the stress test, was quite instructive for our efforts to strengthen our prudential oversight of the largest banking organizations. This unprecedented interagency process, which was led by the Federal Reserve, incorporated forward-looking, cross-firm, aggregate analyses of 19 of the largest bank holding companies, which together control a majority of the assets and loans within the U.S. banking system.

Drawing on the SCAP experience, we have increased our emphasis on horizontal examinations, which focus on particular risks or activities across a group of banking organizations; and we have broadened the scope of the resources that we bring to bear on these reviews.

We are also in the process of creating an enhanced quantitative surveillance program for large, complex organizations that will use supervisory information, firm-specific data analysis, and market-based indicators to identify emerging risk to specific firms as well as to the industry as a whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operation specialists, and other experts within the Federal Reserve System. Periodic scenario analysis will be used to enhance our understanding of the consequences of the changes in the economic environment for both individual firms and for the broader system.

Finally, to support and complement these initiatives, we are working with the other Federal banking agencies to develop more comprehensive information-reporting requirements for the largest firms.

For purposes of both effectiveness and accountability, the consolidated supervision of an individual firm, whether or not it is systemically important, is best vested with a single agency. However, the broader task of monitoring and addressing systemic risks that might arise from the interaction of different types of financial institutions and markets, both regulated and unregulated, may exceed the capacity of any individual supervisor. Instead, we should seek to marshal the collective expertise and information of all financial supervisors to identify and respond to developments that threaten the stability of the system as a whole. This objective can be accomplished by modifying the regulatory architecture in two important ways.

First, an oversight council—composed of representatives of the agencies and departments involved in the oversight of the financial sector—should be established to monitor and identify emerging systemic risks across the full range of financial institutions and markets. Examples of such potential risks include: rising and correlated risk exposures across firms and markets; significant increases in leverage that could result in systemic fragility; and gaps in regulatory coverage that arise in the course of financial change and innovation, including the development of new practices, products, and institutions.

A council could also play useful roles in coordinating responses by member agencies to mitigate emerging systemic risks, in recommending actions to reduce procyclicality and regulatory and supervisory practices, and in identifying financial firms that may deserve designation as systemically important.

To fulfill its responsibilities, a council would need access to a broad range of information from its member agencies regarding the institutions and markets they supervise; and when the necessary information is not available through that source, they should have the authority to collect such information directly from financial institutions and markets.

Second, the Congress should support a reorientation of individual agency mandates to include not only the responsibility to oversee the individual firms or markets within each agency scope of authority but also the responsibility to try to identify and respond to the risks that those entities may pose, either individually or through their interactions with other firms or markets, to the financial system more broadly. These actions could be taken by financial supervisors on their own initiative or based on a request or recommendation of the oversight council.

Importantly, each supervisor's participation in the oversight council would greatly strengthen that supervisor's ability to see and understand emerging risk to financial stability. At the same time, this type of approach would vest the agency that has responsibility and accountability for the relevant firms or markets with the authority for developing and implementing effective and tailored responses to systemic threats arising within their purview. To maximize effectiveness, the oversight council could help coordinate responses when risks cross regulatory boundaries, as will often be the case.

The Federal Reserve already has begun to incorporate a systemically focused approach into our supervision of large, interconnected firms. Doing so requires that we go beyond considering each institution in isolation and pay careful attention to interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis. For example, the failure of one firm may lead to runs by wholesale funders of other firms that are seen by investors as similarly situated or that have exposures to the failing firm. These efforts are reflected, for example, in the expansion of horizontal reviews and the quantitative surveillance program that I discussed earlier.

Another critical element of the systemic risk agenda is the creation of a new regime that would allow the orderly resolution of failing, systemically important financial firms. In most cases, the Federal bankruptcy laws provide an appropriate framework for the resolution of non-bank financial institutions. However, the Bankruptcy Code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a non-bank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after the Lehman Brothers and AIG experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for those firms.

A new resolution regime for non-banks, analogous to the regime currently used by the FDIC for banks, would provide the govern-

ment the tools to restructure or wind down a failing systemically important firm in a way that mitigates the risks to financial stability and the economy and that protects the public interest. It also would provide the government a mechanism for imposing losses on the shareholders and the creditors of the firm. Establishing credible processes for imposing such losses is essential to restoring a meaningful degree of market discipline and addressing the "too-big-to-fail" problem.

The availability of a workable resolution regime also will replace the need for the Federal Reserve to use its emergency lending authority under 13(3) of the Federal Reserve Act to prevent the failure of specific institutions.

Payment, clearing, and settlement arrangements are the foundation of the Nation's financial infrastructure. These arrangements include centralized market utilities for clearing and settling payments, securities, and derivative transactions, as well as the decentralized activities through which financial institutions clear and settle transactions bilaterally. While these arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks and, absent strong risk controls, may themselves be a source of contagion in times of stress.

Unfortunately, the current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, creating the potential for inconsistent standards to be adopted or applied. Under the current system, no single regulators is able to develop a comprehensive understanding of the interdependencies, risks, and risk-management approaches across the full range of arrangements serving the financial markets today.

In light of the increasing integration of global financial markets, it is important that systemically critical payment, clearing, and settlement arrangements be viewed from a systemwide perspective and that they be subject to strong and consistent prudential standards and supervisory oversight. We believe that additional authorities are needed to achieve these goals.

As the Congress considers financial reform, it is vitally important that consumers be protected from unfair and deceptive practices in their financial dealings. Strong consumer protection helps preserve household savings, promotes confidence in financial institutions and markets, and adds materially to the strength of the financial system. We have seen in this crisis that flawed or inappropriate financial instruments can lead to bad results for families and for the stability of the financial sector. In addition, the playing field is uneven regarding examination and enforcement of consumer protection laws among banks and non-bank affiliates of bank holding companies on the one hand and firms not affiliated with banks on the other. Addressing this discrepancy is critical both for protecting consumers and for ensuring fair competition in the market for consumer financial products.

Mr. Chairman, Ranking Member Bachus, thank you again for the opportunity to testify in these important matters. The Federal Reserve looks forward to working with the Congress and the Administration to enact meaningful regulatory reform that will

strengthen the financial system and reduce both the probability and the severity of future crises.

Thank you.

[The prepared statement of Chairman Bernanke can be found on page 58 of the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

I apologize again for my outburst, and I begin with 4 minutes and 30 seconds. I used up 30 seconds before the gentleman from Alabama correctly interrupted me. So make that 4 minutes and 30 seconds, please.

Just to recap, the need to intervene in the economy was regrettable. I think it was caused by past failures. But we do want to note that every item that the gentleman from Texas mentioned as a regrettable bailout was initiated by President Bush and his advisors, carried on by President Obama. Our job is to try and prevent this, we think, from happening again.

One other historical reference I want to make to the Chairman, and I think it is fair to note again, we are trying to get bipartisanship. The Chairman has been a high economic official appointed first by President Bush to a couple of positions and now by President Obama. There has been reference to the economic recovery plan. It was noted in what would seem to me to be fairly simplistic economics, the plan was passed, but even after the plan passed, unemployment went up. The assumption that a plan being passed could instantly undo things that had been built into the economy seems to me questionable. But I would—like you said before, what is your estimate of the employment impact of the economic recovery plan that was passed earlier this year, Mr. Chairman?

Mr. BERNANKE. Mr. Chairman, I don't have an immediate number for you.

Part of the issue here I think is only about 20 percent of the monies that were appropriated have been put into the system, and I think it still remains to be seen what the net effect will be. The estimated employment impact is very difficult because you have to compare it to what would have been the case in the absence. Of course, that is very difficult.

I do believe that fiscal policy can have positive effects on growth and employment based on a large literature looking at previous episodes, the effects on consumer spending on State and local spending and the like. But I would have to concede that at this point, again because it is early in the process and because it is difficult to assess the counter factors.

The CHAIRMAN. But the report did mention a number of areas where you thought it had some positive impact.

Mr. BERNANKE. Yes, based on our analysis, which largely reflects studies of previous episodes, there is a presumption that we saw, for example, in the last—in the early 2000's that consumers did respond to income transfers by increasing spending over a period of time.

The CHAIRMAN. Let me move on. I appreciate that, and we do have more to be spent.

I want to respond to the ranking member's denial of my assertion that the Republicans want to leave full consumer power to the Federal Reserve; yes, they do. The proposal to create a consumer agen-

cy takes more powers from the Federal Reserve than from the other agencies. And the counter has been to leave the powers where they are and to perhaps enhance their enforcement. So the largest defense of existing Federal power, Federal Reserve power that we now have, is coming from those who oppose a consumer protection agency.

Now the gentleman from Alabama said he objected to some other things which are not in the bill that we circulated last week. We are not talking about doing some of those things. I think they were interpretations of the Administration's bill. We have already substantially rewritten it to talk about what we are talking about.

But, again, let's be very clear. The position that the Republicans have talked about, as I understand it, is to leave consumer protection with the bank regulatory agencies, not to separate, as they say, safety and soundness and consumer protection. Of the bank regulatory agencies—the FDIC, the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve—more consumer protection statutes are lodged in the Federal Reserve than anywhere else; and if you preserve that status quo, you preserve the powers of the Federal Reserve.

I have seen no proposal from my Republican colleagues that would in any way diminish the consumer protection powers of the Federal Reserve. They say we want the Federal Reserve to concentrate only on monetary policy, but under their approach, the Federal Reserve would continue to be the major consumer protector of all of the other Federal agencies.

I think that is a mistake, and that is why we have proposed a change. If there is a proposal to diminish the very large repository of Federal Reserve consumer powers, I haven't seen it yet, and I would look forward to it. The notion even of a council, which was proposed by the witness the Republicans asked us to have the other day, it would be a council of the existing Federal regulators; and he said they would retain their power. So that is where we are.

The gentleman from Alabama.

Mr. BACHUS. Thank you.

Chairman Bernanke, I guess you didn't know you were being invited to a debate between the chairman and me. I would like to get back to your testimony.

I think, as you know, what the Republicans have proposed is consolidating financial regulation within a single agency and not bifurcating safety and soundness from consumer protection. You have actually, in a letter to me on July 29th, agreed that bifurcation had tremendous risk. Am I correct in that regard?

Mr. BERNANKE. I think there are some costs to separating enforcement and rule-writing.

Mr. BACHUS. Thank you.

And the chairman, also, although I am not sure he has read our plan—what we have proposed is very similar to what Senator Dodd and Senator Warner in the Senate have proposed, and that is consolidation of some of the bank supervision.

Now, Chairman Bernanke, as you have heard from Mr. Hensarling and others, we are deeply concerned over the Obama Administration's failure to abandon an option to use taxpayer money to bail out "too-big-to-fail" non-bank financial institutions. I am

sure you are aware or are you aware that former Chairman Volcker expressed his strong concern for that, also? Do you share our concern that you do create, as I think Mr. Garrett said, moral hazard and also the question of fairness—

And I will end with this. There are too many questions.

But, as you know, you probably heard Secretary Geithner say he wouldn't take a trillion dollar intervention off the table. I would ask you to maybe start with that and work back. Would you endorse his statement?

Mr. BERNANKE. Let me address the key issue which was raised by Mr. Hensarling. I do not in any way support "too-big-to-fail." I think it is a huge problem. I think whatever we do must address that problem. Big companies must be allowed to fail, but they must be allowed to fail safely so they don't bring down the system.

So I see the resolution regime, for example, as having three objectives.

Objective number one is to avoid damage—collateral damage to the broad financial system, and for that reason some flexibility is needed for the Treasury or whomever is running that to bridge to a new company or take whatever actions are needed to intervene at that point.

I think there are two other objectives. The second one is to get rid of "too-big-to-fail." And for that purpose, I think the ability to wind down the firm should be there; and I think we ought to make it a very, very strong presumption that whenever there is an intervention that not only shareholders but also creditors lose money. And that will create the market discipline that will take away the biggest advantage of being "too-big-to-fail".

And then the third objective is to protect taxpayers. I want to stress very strongly that I do not support government or taxpayer investments such as TARP as a means of preventing these failures. What I propose is something similar to what we have now for the FDIC, which is that, even if there are short-term extensions of credit from the government, that ultimately the full cost will be borne either by the creditors of the company or by the rest of the industry.

So, I do very much want to address your concerns. At the same time, I do think that we need to have a system for avoiding chaos. The Lehman Brothers failure is still not resolved. There is still an enormous amount of monies tied up and confusion and uncertainty about claims, and that is just because the bankruptcy process can't deal with this in an orderly way.

Mr. BACHUS. Let me close by asking this. The Consumer Protection Agency, the chairman said today that we were talking about pure vanilla products. He said he has taken that off the board.

The New York Times, in an editorial on September 30th, says the agency still has the ability to create incentives that would encourage the provisions of plain vanilla products, including charging reduced oversight fees to firms that offer simpler loans. Do you agree with the provision where the Federal Government would actually tax or charge fees if banks did not offer plain vanilla services or plain vanilla products?

Mr. BERNANKE. Congressman, I addressed this in an earlier testimony; and the point I made was that there is some case for va-

nilla products which relates to what behavioral economics says about the ability of consumers to deal with very complicated processes or products. But I did also say I thought the basic design ought to come from the firms. The agency should not be designing the products.

I think I would add also that simplicity is sometimes in the eye of the beholder. One-size-fits-all doesn't always work. There may be some products that are simple and appropriate for some but not necessarily for all consumers.

The CHAIRMAN. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman. Welcome back, Chairman Bernanke.

And, first, may I take the opportunity to congratulate you. From what I have heard, you have now determined that you are not supportive of greater powers for the Federal Reserve but would prefer the council in systemic risk regulation. Is that a reasonable conclusion from what you have said?

Mr. BERNANKE. Well, only that there is not really a change. We have supported—I think there has been some misunderstanding. We have never supported, and the Administration has never supported, a situation in which the Fed would be some kind of untrammeled superregulator over the entire system. That was never contemplated.

The original Administration proposal proposes a council, and we support the council. We think it has a very valuable role to play. And we think that underneath the council, each of the agencies, including the Fed but also the SEC and others, should be looking at the systemic implication of their actions and working together through the council to look at the whole system. So we have never objected.

Mr. KANJORSKI. Well, whether I interpreted it correctly or not, anyway, congratulations. I think we are on a course to now perhaps put together something that can be accomplished here.

The only thing that I did not hear you talk about is a factor that came to our attention when we held the hearings on General Motors, Ford, and Chrysler. The testimony was quite clear there, and including the foreign manufacturers, that they all concluded that if we allowed Chrysler to fail it would cause systemic risk and bring down all of the other automobile industry because of the intertwined nature of their dealers and their suppliers; and that was a major consideration in what the Congress did in supporting the bailout of General Motors.

Now my question is, I heard you only talk about financial institutions in relationship to systemic risk. Does that mean you see no other systemic risk in our system beyond the financial institutions? Or is it because that happens to be the flavor of the day and we should wait until there is a failure or systemic risk in other industries?

Mr. BERNANKE. Well, no doubt the failure of the auto companies would have been disruptive, particularly in the areas where employment is concentrated in that area; and it was particularly troublesome given the state of the general economy when these decisions were made. But I would draw a strong distinction I think between financial institutions, particularly large, complex, inter-

national, interdependent financial institutions and any other kind of firm. I think only those large financial institutions have the ability to bring down the entire global system. So the failure of Lehman Brothers affected not only the United States economy but every economy in the world.

Now, clearly, damage would have been done by other kinds of firms, but I would personally—my focus is on financial firms.

Mr. KANJORSKI. I understand that is your specialty and that is your focus, but are you having someone do analysis and study to find out whether we should worry, for instance, about the world energy problem or transportation, particularly aircraft, where we have very limited manufacturers? What would happen to the world if there were a failure in one of those industries? Is that something we should think about or worry about?

Mr. BERNANKE. Well, we should certainly think about it. But if you look at the airline industry, for example, every major airline has been through bankruptcy at one point or another. And it has been a process—

Mr. KANJORSKI. I am probably a little bit more worried about the manufacturers than the operators. I realize there are just really a few left in the world; and if there were failure there, it could be, I would think, systemic.

Mr. BERNANKE. There are tough questions there. I guess I would—it is not just a question of specialization. Unfortunately, financial crises, booms and busts are a long-standing problem of capitalism; and they have, I think, a special role in the broader—

Mr. KANJORSKI. I agree. And that being the case, are you planning to come forth with a proposal to the Congress of how not only we can have a systemic regulator that can identify "too-big-to-fail" but how we start winding them down and preventing them from getting that large? Are we going to go into an industrial plan or financial plan in America where we—once identified, we establish a way of taking these institutions down to a controllable size where their failure would not cause systemic risk?

Mr. BERNANKE. I don't think it's possible to reduce all financial institutions to a size so small that there would not be any systemic consequences without losing some very substantial benefits of international financial flows, for example.

I think the best way to do this is by making it costly, removing the advantages of being "too-big-to-fail." So, on the one hand, by increasing the oversight regulation capital requirement, making it less profitable, "too-big-to-fail," and making it much more constrained; and, on the other hand, by having the resolution authority which would tell the creditors that they will lose money if this company fails and, therefore, they will not benefit the company by providing resources or funds at below-market rates.

So I think those two things will remove a lot of the incentives that the firms have to become too large and that they will naturally tend to shrink.

The CHAIRMAN. The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

Chairman Bernanke, yesterday, we had a hearing in our committee on the CFPA that many of us view as a financial services product approval agency. The language that we have seen from our

chairman still would allow this agency to have sweeping draconian powers to outlaw financial products that it subjectively believes to be "unfair or abusive." Again, fairly subjective terms.

As part of that hearing, we heard testimony from the U.S. Chamber of Commerce. They submitted a study they did, and let me quote from that: "The CFPA credit squeeze would likely result in business closures, fewer startups, and slower growth. Overall, this would cost a significant number of jobs that would either be lost or not created."

As you have viewed the CFPA, even through the Administration's White Paper or to the extent you have knowledge of the chairman's bill, could the CFPA indeed lead to further job losses or did the Chamber of Commerce just get it wrong?

Mr. BERNANKE. Well, I think would depend on the execution.

I will make two comments. The first is that the Federal Reserve, in our consumer regulation, works within a statutory context, a set of laws, TILA, TISA, others that define the parameters of what we are supposed to do, and we do things in the context of what Congress has told us is the appropriate set of objectives and constraints. So that is how we operate. I think there should be a statutory context for whatever agency is making those decisions.

It is always the case, though, in making specific decisions about trying to balance the benefits of protecting consumers versus the cost of restraining credit availability—and I will just speak for the Federal Reserve—which is that in our efforts we have brought together not only lawyers and experts on the minutia of consumer law but economists and financial people and so on to try to look at the full implications for the credit markets of the decisions we have taken. I would say it would be important for the agency to take that view as well. One mechanism I think is that the board of this agency should include some other agencies, which I believe is the plan. But it is important to balance those two—

Mr. HENSARLING. Is the summary of that answer "maybe?"

Mr. BERNANKE. It depends. It depends on how—

Mr. HENSARLING. We will turn it into a two-word answer.

Clearly, you are familiar with the incredible financial commitment of the taxpayer to the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac. I believe that the Fed has purchased roughly $130 billion of their debt; another roughly $700 billion of their MBS; and I think FHFA and the Treasury is up to about $100 billion. So we are looking at almost $1 trillion of taxpayer commitment here.

The legislation that the Administration and the Democratic Majority has brought before us is almost silent on the issue of any reforms for the GSEs. And the legislation before us will apparently regulate pawn shops and payday lenders. To the best of my knowledge, they had no role in our economic turmoil.

Many economists believe that Fannie and Freddie were central to our economic turmoil. I don't believe pawn shops and payday lenders have taken any taxpayer funds, and now we are looking at an almost $1 trillion commitment.

In your testimony, you said that your reform, any reform agenda, should include at least five key elements. If our reform agenda is silent on reforming Fannie and Freddie, did we meet your test?

Mr. BERNANKE. I think, in the near future, we need to have a plan for Fannie and Freddie. I didn't include it because I was focused essentially on the Treasury's proposal and on the systemic risk aspects. But you are absolutely right; I think the GSEs need to be discussed in the near term. Not just for systemic risk reasons, but because we have a lot of uncertainty about housing and what is going to happen to the housing structure, housing finance system. So I hope that in the very near future, and I believe that is the intention, I hope in the very near future, we will have some proposals on that.

Mr. HENSARLING. In the small time I have remaining, could you discuss the pros and the cons? What might the Federal Reserve look like if it was strictly engaged in monetary policies? We did achieve some version of the resolution authority that you seek, and the Federal Reserve retains its 13(3) powers, otherwise shedding its responsibilities for bank supervision, consumer protection, payment systems and the like. Might that be good or bad public policy and why?

Mr. BERNANKE. That would make us look very much like the Bank of England and some other central banks that have been brought back to monetary policy-making. I think the experience of the recent crisis is that, and this is the case in the U.K., that the fact that the bank did not have the information it needed about the crisis, about what was happening in the banking system and so on, was a real drawback in terms of the ability of the Central Bank to help stabilize the system. So, of course, you could have a central bank that was focused only on monetary policy, absolutely. But I think that it is very important for the Central Bank to have the information, the expertise, the insight about the banking system in order to both make better monetary policy and to be able to play an appropriate role whenever there is a crisis.

Mr. HENSARLING. Thank you.

Mr. KANJORSKI. [presiding] The gentleman's time has expired.

The gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you very much.

Mr. Bernanke, I am very pleased that you are here with us once again. And I would like to thank you very much for your responsiveness to the requests that we have made to you several times and the discussion that we had at the recent ALC that was sponsored by the Congressional Black Caucus. I really do appreciate that.

Let me just say that I believe that the presentation that you have made here this morning, where you discussed your agenda for reform and pointed out the five key elements, makes a lot of sense. I just want to ask about the oversight council. You talk about the oversight council being able to monitor and identify emerging risk to financial stability across the entire financial system. And I wondered if this would include taking a close look at credit default swaps, naked credit default swaps in particular, because I consider them a risk to the stability across the entire financial system.

And I am focused somewhat on the fact that the taxpayers, in bailing out AIG, had to pay for that gamble to Goldman Sachs and, I don't know, maybe some others. How would you deal with that?

With this council, how would you see the potential for risk to the system that is presented by these transactions.

Mr. BERNANKE. I think that credit default swaps are an almost perfect example of the kind of thing that the council would be focused on. The CDS market cut across so many different jurisdictions. AIG was under the AG of the Office of Thrift Supervision. Some of the clearing mechanisms were not regulated at all. The New York Fed was trying informally to get them working better since they were regulated. You had the SEC and the CFTC involved in that process to some extent. Partly it was an issue of bank regulation, because banks were also involved in these transactions, and they were not adequately capitalized to do that. So it is a classic example of something that went across a whole bunch of different areas in which no one regulator had a holistic view of what was going on.

And I think this would be a really good example of how by sitting today in a serious way and having a staff and reviewing developments, issues, new instruments, new markets and so on, that this is the kind of thing where maybe working together, it might have been—you know, of course we are human beings and we won't be infallible, but there would have been a much better chance of identifying it earlier in this kind of council context than the way the system we currently have.

Ms. WATERS. As you know, I do not share the opinion of many who work in this whole financial services industry about regulation of any product that comes on the market. I believe that there are some products that are just too risky and should be eliminated. They just should not be there. Have you ever thought about how, perhaps, we could identify such risk and say, this just can't work, we just can't do this?

Mr. BERNANKE. The Federal Reserve has taken this position. For a very long time, the Fed was focused on transparency and disclosures on the theory that if people could read the information, that they would make good decisions. But, for example, in our recent credit card work, which became the basis for a lot of the legislation here, we identified through consumer testing and other kinds of means that there were a number of practices and products and so on that did not benefit the consumer and which could not reasonably be understood by a typically educated consumer to understand the full implications of what that practice was. And based on that, we said that in some cases transparency is not enough, and we employed the Unfair or Deceptive Acts or Practices provisions simply to ban those practices.

So I think, in situations where there is no benefit to the consumer and where disclosures are not adequate, there are grounds for banning a product or a practice. And the consumer agency or whomever is in charge would look at that, and the council could look at those thinks as well.

Ms. WATERS. I am very pleased to hear that. And I thank you very much.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from California.

Mr. ROYCE. Thank you.

Chairman Bernanke, I have a question for you. Last month, the Federal Housing Administration acknowledged that a new audit that HUD did there found that the FHA's cash reserve fund is rapidly depleting. It might drop below the congressionally mandated 2 percent by the end of the year. And so the leverage there, the ratio was 50 to 1 for FHA. And it will soon have a smaller capital cushion than Bear Stearns had on the eve of its crash. At 50 to 1, it is about halfway to where Fannie Mae and Freddie Mac were at 100 to 1 leverage ratio. And the delinquency rate for the FHA is now above 14 percent, so that is about 3 times higher than unconventional mortgages.

In many respects, the reason for this financial deterioration is that the FHA is underwriting record numbers of high-risk mortgages. Between 2006 and the end of next year, the FHA's insurance portfolio will have expanded to $1 trillion from about $410 billion. The FHA's very low, I would say absurdly low, 3.5 percent downpayment policy in combination with other policies to reduce upfront costs for new home buyers means that the home buyers can move into their government-insured home with an equity stake of about 2.5 percent. So, in essence, the private market for loans with little or no money down has shifted onto the books of the Federal Government.

Are you concerned with the long-term consequences of this trend and the rapidly deteriorating capital cushion of the FHA? And are you confident this will not turn into another Fannie-Freddie situation, which could have been easily prevented had we listened to the Fed in 2004 and 2005, but ends up costing taxpayers billions of dollars? I remember when the Fed came to us in 2004 and said, we need to be able to regulate for systemic risk, the leverage is 100 to 1. Basically, what you are doing in government is that the Congress has forced us into a position where half of the portfolio has to be subprime and Alt-A; this represents a systemic risk. We need the ability for the regulators to slowly bring down this overleveraging and bring down the portfolio size by giving us the ability to regulate for systemic risk. Are you worried that we are going through that kind of a cycle again here?

Mr. BERNANKE. Well, I should say first that we don't directly evaluate the FHA's position, and I think they disagree somewhat with this outside view, and so I won't try to adjudicate between that. But it is true that the FHA de facto has replaced the riskier part of the mortgage market. It has a very high share now of new mortgages because it is the only source of mortgages where downpayments can be less than basically 20 percent. And so it is providing mortgage access to a large number of people who could not otherwise buy homes.

So I guess you have two conflicting public policy goals here. On the one hand, it is providing support to the housing market and housing homeownership. On the other hand, clearing, I think it is fair to say, that given the low downpayments, there is certainly greater risk of loss there, which would be ultimately borne by the taxpayer, than under a policy of higher downpayments and higher FICO scores and so on. So I think that is a tradeoff that Congress has to look at.

Mr. ROYCE. Let me ask you another question. Some economists are arguing that the Fed not only lost control, but its policy actions have unintentionally become procyclical—encouraging financial excesses instead of countering the extremes. And this gets to the point that has been argued by many economists. In fact, Friedrich Hayek won the Nobel Prize in 1974 for arguing that artificially low interest rates lead to the misallocation of capital and the bubbles which then lead to bursts. Looking back, do you agree that the negative real interest rate set by central banks from 2002 to 2006 had a dramatic impact on the boom and the subsequent bust, especially when you take into consideration what was already an inflating housing bubble with the drastic steps taken by the Federal Government to encourage less creditworthy borrowers to get into loans they could not afford? Do you think those combinations could have had an impact on that boom-bust?

Mr. BERNANKE. We are actually looking very carefully at this question because it is very important for policy going forward, and I think we need to keep an open mind. Having said that, I think that the very strong way you stated it is probably an overstatement. I think there are a lot of reasons to think that there were other factors involved in the housing boom and bust besides monetary policy. And I would say secondly that a strong, well-regulated financial system should not have been crashed by an increase and decrease in house prices. I think the failures of regulation, supervision and oversight allowed this to become as big a deal as it was. So I think that is a very high priority right now.

The CHAIRMAN. The gentlewoman from New York.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Chairman, what are some considerations that a systemic regulator should look for to determine what activities and what institutions should be subject to its oversight?

Mr. BERNANKE. So, again, we may be talking about a coordinated effort of the systemic risk council, the Fed and so on, so it is not clear exactly how that process would work. But there are a number of considerations, not just size. For example, what is called interconnectedness, the number of counterparties the firm has around the world, the complexity of its operations, whether it provides critical services like providing market making or other utilities to the financial system. So there are a lot of considerations you would take into account.

Ms. VELAZQUEZ. Is it conceivable that private equity funds, firms or venture capital funds could fall under a systemic risk regulator?

Mr. BERNANKE. Well, my view at this point is that I would not think that any hedge fund or private equity fund would become a systemically critical firm individually. However, it would be important for the systemic risk council to pay attention to the industry as a whole and make sure that it understood what was going on so there wouldn't be kind of a broad-based problem that might cut across a lot of firms.

Ms. VELAZQUEZ. As we continue to see fallout from this recession, one result has been even greater consolidation in the banking and financial sector. Our largest banks are now bigger than ever, and events from the past year have demonstrated that some financial institutions are indeed "too-big-to-fail." What steps could a sys-

temic regulator take to mitigate the continued concentration of risk in a few very large institutions?

Mr. BERNANKE. Well, this was a very undesirable side effect of the steps we had to take to protect the system in the short run. And as I was discussing earlier, I think it is extremely important to address this "too-big-to-fail" problem, and I see several ways to do that. One would be, again, to—in the recognition that these firms if they fail threaten not only their own stability and their own creditors, but the whole system—I think they should be subject to extraordinary oversight, including higher capital and liquidity requirements, tougher risk-management rules, and basically stronger supervision.

Secondly, one of the big concerns about these large firms is that as "too-big-to-fail" firms, they are not subject to the discipline of the market because lenders do not believe that the firm would be allowed to fail. I think that has to be eliminated and fixed. I would not be satisfied with any resolution authority that did not have a strong presumption and a strong mechanism for allowing these firms when being taken over by the government to impose significant losses on not only shareholders but also creditors.

I guess a final comment is that the Federal Reserve, in approving mergers and the like, looks at the monopoly issues and the concentration issues. And our view is that at least in retail services, those are most important at the local level rather than at the national level. So we always examine whenever there is a merger or expansion of a company, we always look at each of the market areas, SMSAs and try to make sure that there is not a domination of that region by one or two companies.

Ms. VELAZQUEZ. Mr. Chairman, I would like to go again back to my first question about institutions and activities where you said that, depending on size, but that is kind of vague. What do you have in mind in terms of size? Or when you talk about risks how much risk? And when you talk about interconnectedness, if that means to 5, 100, 1,000; I am not clear on that.

Mr. BERNANKE. Well, there has been some research in the Fed system and elsewhere trying to lay out criteria. But to some extent, there would have to be a set of principles that the Congress would enumerate in terms of what we would be looking at. One of the issues is that which firms are systemically critical may depend to some extent on the state of the broad economy. So, for example, it might have been possible to let certain firms fail if the rest of the economy had been in a healthy condition and the financial system in a healthy condition. But in a situation where we are in a panic and a recession and so on, that may lower the bar in some sense. So I can't give you precise numbers. I do think we would owe the Congress some careful studies of what the considerations would be, recognizing that they might change over time depending on the state of the economy and the state of the financial system.

Ms. VELAZQUEZ. Thank you.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

And thank you, Chairman Bernanke, for being here. During the previous hearings I have asked you about the status of the Fed's work with HUD on harmonizing RESPA and TILA efforts. So I

think it is particularly important to ensure that the consumers have simplified information disclosures. How are things going with that task?

Mr. BERNANKE. We agree with you 100 percent on that, and we have been trying to work this out for some time. We have recently, as you may know, released some new rules on mortgage disclosures, yield spread premiums and some of these related issues which bear on the documents that consumers sign when they take out a mortgage. And we are in conversations now with HUD, and I think there is a lot of good will on both sides, to try to come to some agreement that will allow us to eliminate duplication and to create a more consistent set of rules between the two institutions. So we are trying, we are in conversations. It has taken a long time because the commitment has waxed and waned, but we are working very hard to do that and we hope to have some results.

Mrs. BIGGERT. Do you think that you will finalize the regulations before RESPA takes effect?

Mr. BERNANKE. We will try to do so. I can't promise.

Mrs. BIGGERT. Under the proposed legislation, the CFPA is given authority to write RESPA and TILA rules. If you finalize the rules, if this new agency were to come into effect, I worry then that the new agency would probably start all over again and look at those rules.

Mr. BERNANKE. Well, that would be up to the new agency. If they thought that the rules that were in existence were not adequate for some reason, they would obviously have the right to do that. If I were running this new agency, I would try to address what I perceived as the biggest gaps and not revisit a lot of old rulemakings, but that would be up to that person.

Mrs. BIGGERT. Thank you.

If Congress overreacts to this crisis and overregulates, for example, with derivatives regulation, requiring all customized and standardized transactions to be conducted on an exchange, could U.S. businesses and jobs move overseas?

Mr. BERNANKE. I think in general, it is very important not to overreact but to create, maybe not more regulations, but smarter regulations, is the way I have put it before. On the case you are talking about, I think there is a case from both market efficiency and from systemic safety to use clearinghouses of central counterparties for standardized contracts. But at the same time, I think there is also scope for leaving a part of the industry in a more bilateral or noncustomized basis. I think there is a good economic reason for that. And so an appropriate balance between those two things would be welcome.

Mrs. BIGGERT. I hope we don't overreact as we have in some other cases.

there is one other issue that I have heard some concerns about, and that is with the CFPA, that there is fear that every company really will be included under that. And I know you talked about the statutory authority that you have for dealing with the issue. But every company that has any financial transaction at all, even a plumber or a baker or whatever, would be under this regulation. Do you believe that could happen or would there have to be legislation to make sure what is actually defined?

Mr. BERNANKE. I think the legislation would define that. I understand the chairman has dropped that from his current version of the bill. But certainly the Federal Reserve does not have that kind of authority, so it would have to be specifically granted to the new agency.

Mrs. BIGGERT. Thank you.

I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Chairman Bernanke, let me just make this opening comment because sometimes we send subtle messages that obviously are unintended, and I have two this morning that kind of reinforce the concern that I have been expressing throughout this process.

You talked about five different areas that you wanted to comment on. You gave us five sentences on consumer protection, and then you referred, in response to a question, to the minutia of consumer laws. We keep sending this message to the public that this whole issue of consumer protection is secondary to everything else that we are here involved with. And we need to be very careful about that.

I am not looking for a response from you, but five sentences on consumer protection when everything else that we talked about this morning gets substantially more space is just not a good message to send. Referring to consumer laws as the minutia of consumer protection laws is just not a good message to send.

Now, let me get to the real question. On page 9, you make this comment on consumer protection: "The playing field is uneven regarding examination and enforcement of consumer protection laws among banks and non-bank affiliates of bank holding companies on the one hand and firms not affiliated with banks on the other hand. Addressing this discrepancy is critical both for protecting consumers and for the other parts of the system." Now, my question is, Mr. Hensarling was asking about these non-banks. What are the non-bank parts of this that we are referring to? Let's get some of those on the record.

Mr. BERNANKE. Sure. But first I just have to say that—

Mr. WATT. No, no. That was not intended to draw a response from you, Mr. Bernanke, and I have a limited amount of time.

Mr. BERNANKE. I disagree with your implication on that.

On non-bank firms, there are many firms that are not—

Mr. WATT. Such as?

Mr. BERNANKE. Mortgage companies, consumer finance companies, brokers.

Mr. WATT. Check writing, check cashing?

Mr. BERNANKE. Yes.

Mr. WATT. Payday loans?

Mr. BERNANKE. For example.

Mr. WATT. Okay. And if we give the regulation on the consumer side to a Consumer Protection Agency of those and we retain the regulation of consumer issues in other regulators with the regulated banks, tell me how that doesn't do exactly what you just described here as a problem. I don't understand that. Tell me that.

Mr. BERNANKE. There is a big problem that currently exists, and it would be hard to fix, which is that many types of companies are State-chartered and are supervised by the States.

Mr. WATT. All right. So it is okay to create, to have a consumer protection agency that deals with the States, but it is not okay to have a consumer protection agency whose sole primary—they come to work every day looking at consumer issues, and it is not okay when some other Federal agency is involved, is that what you are saying?

Mr. BERNANKE. No, not at all. I am just saying that—

Mr. WATT. Now, let me just go back and ask this question. You coordinate with other agencies on safety and soundness. Other agencies do safety and soundness on various institutions. But they don't come back and answer to the Federal Reserve, right?

Mr. BERNANKE. We coordinate very closely.

Mr. WATT. You coordinate very closely. And we presume that this consumer protection agency would coordinate very closely, too. They would be on this council that you keep referring to, wouldn't they, if we created this agency?

Mr. BERNANKE. Yes, and we certainly would coordinate with them.

Mr. WATT. Okay. So how is that any different than the coordination that would take place on safety and soundness? Why is it terrible to put this responsibility on the consumer protection agency and allow it to coordinate when there is a conflict?

Mr. BERNANKE. Because there are different issues here. Currently, the OCC does both consumer compliance and safety and soundness—

Mr. WATT. They aren't doing much consumer compliance, I can tell you that.

Mr. BERNANKE. Well, in theory at least, they are supposed to do consumer compliance and safety and soundness for a bank, but they do both, and this would break it up. That is all.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman.

Just a couple of questions on areas I know are outside of your regulatory area, but goes to the macroeconomic. One Mr. Royce brought up before; he gave you all the stats and what have you, the dire prediction with regard to the FHA. And I just want to delve into that just a little bit more. I heard your answers on that.

I mean, what some of us are suggesting, the legislation I threw out at the very beginning, is to say that maybe we should treat them with some of the same requirements that we are asking the rest of Wall Street and the rest of the financial markets to have some skin in the game and to have proper capital level rate aspects and also leverage ratios.

I think from your answer, you are saying, well, there are two issues here. What does Congress want to do with regard to housing and getting that going on the one hand, but what do you want also to do to protect, which is your job in part, to protect the taxpayer? How should we or how can we come down on the one side without harming the other side?

Mr. BERNANKE. Well, first, the difference between the FHA and the GSEs is the GSEs had private debt and private shareholders,

and that made it more complex in terms of the overall financial system.

I think it is undeniable that the FHA loans, because of the low downpayments and so on, are riskier than other mortgages being made and therefore have greater chance of loss, which would be made up by the taxpayer. And that tradeoff is your tradeoff in terms of what you think is worth—you know, what risk you think the government should be willing to take in order to support the housing market and homeownership. You made the same decision on things like in first-time home buyers tax credit. You know, it is a cost to the government, but it supports the housing market. I don't know how to tell you that.

Mr. GARRETT. Can we do it in a way, do you think, by just raising it up just a smidge—our bill would say 5 percent down—without having a dramatic impact?

Mr. BERNANKE. I don't know how much effect it would have. That would require more study. I think it is the same tradeoff, though. You can make the conditions tougher and tougher, and that reduces the risk to the taxpayer, absolutely, but it also reduces the number of people who can get mortgages.

Mr. GARRETT. Another area outside of yours but on the macro issue is the FDIC and the other issues. I don't have to tell you what they are facing right now, and one of their proposals I am reading about is going to the banks and saying, help us out here. The same sort of dilemma there, isn't it, is that the banks are going to push back and say, well, if you are asking us to do that, we just are not going to be able to make as many—our capital level is going to go down; we are going to have a harder time of it, and we are not going to be able to make the loans. So where is the tradeoff in that situation?

Mr. BERNANKE. Well, the FDIC has some tough choices because they are trying to replenish the fund without creating a "procyclical effect," that is, without hurting the banking system in a way at a bad time when we want the banking system to be lending. The solution they have, as I understand it, is that even though there would be prepayments by the banks, that those prepayments would be treated as assets on the bank balance sheets, and therefore capital would not, at least in the a regulatory sense, be affected. And that is the solution they have chosen.

Mr. GARRETT. I thought I was reading it that way, but I wasn't really sure, quite honestly, that they were going to treat it that way. And if you treat it that way, then really what you are doing, aren't you, is just like getting a loan from the bank, because you are really not taking the assets off the balance sheet of the bank?

Mr. BERNANKE. It is like making a loan.

Mr. GARRETT. It is like making a loan. And so, really, instead, the way I think of it is, instead of the FDIC coming back to Congress or using that line of credit that they have taking a loan from the American public; instead, they are saying, we are going to sort of kick the can down the road and just borrow it from the banks instead and spread it over to them. Is that the right way to interpret it?

Mr. BERNANKE. It is a loan from the banks, but it is not a loan that requires capital to back it up. And therefore, in that sense, it

doesn't crowd out other lending. But there are no good solutions there, and I know the FDIC has really struggled with the right approach.

Mr. GARRETT. But my understanding, is that a correct analysis of it? It is just a loan from them, and it is really just—and one way of looking at it is they are really sort of creating money at the same time because you are able to count that dollar twice: once when the FDIC is able to take it and hand it over to this bank over here, I am bailing you out with that one, which is what they want to do with it; and the second time, they are going to count that dollar when it is still sitting in the original bank that loaned the money because they are still going to be treating it as capital in that bank so they can loan it out to somebody else. So you are really counting that dollar twice, aren't you?

Mr. BERNANKE. Well, I don't think it is creating money technically, but it is basically a loan from the banking system to the FDIC which will have to be replaced eventually by actual assessments on the rest of the banking system.

Mr. GARRETT. And I can't see the clock. Speaking on the actual assessment, really quick on the aspect of the resolution authority and who actually pays, I still haven't gotten a clear picture on who actually would pay if, heaven forbid, you have this next scenario, and then you assess it out to everybody. Can you tell us who that would be? How broad is the group of banks that you would be going after or financial institutions that you would actually assess, and is there potential that they would just not be large enough to pay because it is small?

Mr. BERNANKE. I think, to answer quickly, there are a lot of unresolved issues that we need to talk about. I think it should be fairly broad. It should be the financial industry. But it should exclude insured deposits, which are already assessing the size of liabilities that you are going to tax in some sense, you should exclude those which are already paying deposit insurance premiums.

The CHAIRMAN. The gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Mr. Chairman, let me ask, I think what we have to get right is this resolution, a resolution authority, and it is absolutely key. And just listening to some of the testimony yesterday, some of the rating agencies, for example, it became abundantly clear to me that they would rate everybody triple-A because they just felt the government would bail everybody out. But if we get this resolution authority correct, then everyone will know that the government will not bail these folks out. And I think that is absolutely one of the most critical pieces that we have to work on to make sure that we get right.

That being said, you know, what I have been also focused on and concerned about when we deal with resolution authority, for example, the Lehman Brothers situation with all of the money that is caught up in the U.K. So how and what do we do when we come up with a resolution authority to deal on capital firms like Lehman who have operations headquartered in various places of the world so that if they go into bankruptcy, the process can be quick, transparent and efficient? I am not hearing how we are really going to do that in this regard.

Mr. BERNANKE. That is an excellent, very important question. And you are absolutely right; it is much tougher than a lot of these bank resolutions because of the global nature. There are companies who are in the 120 countries around the world. There are some working groups in international bodies which are looking at the cross border issues. And I think what we need to do is have some international agreements or at least some working frameworks that explain how we are going to work together to address this. If we don't do that, then what will happen is that every country will ring-fence the assets of the bank or the failing institution within their country, and ultimately, we may have a situation where every country will demand its own capital requirements for the subsidy within its own country, and that would be a very inefficient way, no doubt, to run the system and no doubt will reduce the global financial flows in an important way.

So you have your finger on a very important issue, and we need to keep working on that. But it is something that has to be done in collaboration with our major partners, particularly those like the U.K. and Europe.

Mr. MEEKS. Do you know of any dialogue that has begun, anything where people are talking? I know that we just finished G–20. Is that part of that conversation?

Mr. BERNANKE. Yes. This is being discussed in a lot of contexts, including, as I said, some working groups within the bank regulator groups that meet internationally.

Mr. MEEKS. And also, I know that President Obama and other leaders are calling for a more stable and sustainable global trade system, where countries like China and Germany are less dependent on export-driven growth, and the United States is less dependent on cheap international capital to finance their deficit-driven consumption.

Now, there is talk of the IMF playing a more crucial role in monitoring global trade balances in global financial institutions. But given the strong incentives to sustain the system as it is, however unsustainable and volatile it is in the long run, how do we get there from here? How do we—you know, I don't understand; how do we get there?

Mr. BERNANKE. It is a difficult problem, and we haven't made much progress in 15 years, basically. The IMF was given the authority to counsel, you know, to look at the situation in different countries and make recommendations, but with no binding power. And that didn't really have much effect on getting a more balanced growth across different countries.

It has also been an issue for bilateral discussions. In the strategic economic dialogue with China, for example, it has been a central issue that we have discussed. I wasn't part of the G–20 meetings in Pittsburgh last week, but my understanding is there was discussion of sort of a peer review system whereby countries would agree to let other countries evaluate whether or not they were making progress. If that is the case, that would perhaps strengthen the mechanism, but it is a very important issue.

Mr. MEEKS. Let me just get this question in really quick because of the big issue that is starting to happen in New York, and that is dealing with commercial real estate. Could you give us a quick

update on the state of the commercial real estate market and whether it would be a drag on the recovery going forward, or is it another potential systemic risk crisis brewing? And which parts of the market do you expect would be the most affected by any pending crises in the commercial real estate area?

Mr. BERNANKE. Commercial real estate remains a very serious problem. It depends, to some extent, as you point out, by category. Construction loans, for example, are particularly weak. Within other categories, you know, hotels and office buildings and apartment buildings, there are differences in the situation. But we are concerned both because the fundamental is weakening and because the financing situation is bad.

For example, the commercial mortgage-backed securities market is still not really open. It could provide a source of a lot of stress, particularly for small and regional banks that have a very heavy concentration in commercial real estate. So we are working hard to work with the banks. And we have, as you know, our TALF program which is going to try to restart the commercial mortgage-backed securities.

Mr. MEEKS. A crisis brewing?

Mr. BERNANKE. I hesitate to answer. I don't think so, but we will have to watch it carefully.

Mr. WATT. [presiding] The gentleman from Georgia, Mr. Price.

Mr. PRICE. Thank you, Mr. Chairman.

Welcome once again, Chairman Bernanke. I appreciate you joining us today.

I want to follow up on the old issue of tier-one financial institutions. I think the American people are sick and tired of governmental bailouts. I think that we need to respond to that concern and fear and anger on the part of the American people and assure them that there won't be any more. Secretary Geithner said that there will be no fixed list for companies that will be bailed out. Are you in agreement with that?

Mr. BERNANKE. Well, there is nobody more sick and tired of bailouts than me. I think the way the system has to be set up is that, when there is a resolution, as we have been discussing, that people lose money and that the company can be wound down, but done so in a safe way.

As far as tier-one is concerned, the idea there would be to—if you do that, if you designate firms, and there may be other ways to do it—that those would be the firms that would be subject to particularly tough capital liquidity and other requirements to make their failure and bailout much less likely. But we don't want any bailouts. We want to have a system that puts the cost on the industry and allows creditors—

Mr. PRICE. The question is, do you agree or disagree with the Secretary of the Treasury that there should be no fixed lists of companies that would be "too-big-to-fail?"

Mr. BERNANKE. That is a change, I think, from the Administration's earlier position. I have no problem with sort of a sliding scale in the sense that the largest firms have—

Mr. PRICE. Should there be a fixed list of companies that are identified?

Mr. BERNANKE. I am willing to say "no," except I have one concern, which is that outside of bank holding companies, if there are firms which are systemically critical and they are not designated as systemically critical, how do we know that they received special attention, that is my question.

Mr. PRICE. The concern that I have is that if we are going to identify tier-one financial holding companies as being somehow special, and we are going to say that we are not going to identify companies that are "too-big-to-fail" so that they have an unfair advantage in the market, aren't those two statements contradictory?

Mr. BERNANKE. No, because what I am saying is that no company—you can have a tier-one company, which means they get tougher oversight, but it is still not "too-big-to-fail" because we will have methods to make sure that the problem of "too-big-to-fail" is no longer with us because we will have ways of winding those firms down, and they will fail.

Mr. PRICE. Let me just urge you to carry your disgust for bailouts to having no more bailouts, and we would support you on that.

I want to follow up on the comments about the FDIC and the comments made by Mr. Garrett. It does seem to me as well that they are counting a dollar twice; the prepayment that the FDIC is now requiring, and then continuing to use that dollar on their books for assets. Is that not some kind of accounting gimmick?

Mr. BERNANKE. Well, the banks would have to make this payment at some point in the future anyway, so they are agreeing to make the payment earlier. So, essentially, from now until the time where they would actually have to make the assessment, they are essentially making a loan to the FDIC.

Mr. PRICE. But they can still use that dollar for other aspects of their own private business, correct?

Mr. BERNANKE. Yes.

Mr. PRICE. So they are counting it twice. Now, my concern about all of that is, and I think that is probably not the wisest thing to do, but you have said that you would like to use the model of the FDIC for your own resolution authority. Isn't that a flawed model to begin with?

Mr. BERNANKE. No, I don't think so. You know, an alternative, the FDIC made a decision about how they wanted to fund this. Of course, an alternative would have been to borrow from the Treasury and pay the Treasury back with interest.

Mr. PRICE. Wouldn't that have been more honest, more open?

Mr. BERNANKE. They made the decision based on what they thought would be the least negative effect on the banking system, and I don't want to second guess that.

Mr. PRICE. Any time I can count a dollar twice on my books, if I were allowed to do that by law, that would be a wonderful, wonderful thing, but it certainly wouldn't be more healthy for the economy.

There was discussion about the banning of products. There are products out there that—in fact, a statement was made there are some products that are just too risky. You talked a lot about process in that, the transparency that Americans ought to be able to receive when they are evaluating a product, but you never talked about a product that was too risky. Are you willing to say that

there are—well, are you willing to identify a product that is too risky?

Mr. BERNANKE. No-doc loans.

Mr. PRICE. And so how long does that list get?

Mr. BERNANKE. Well, it depends on what the industry is proposing. But the criteria would be that here is a product that is not in the consumers' interest and that—

Mr. PRICE. Is it the government's role to determine what is in the consumer's interest?

Mr. BERNANKE. In some cases, I think that we have—for a long time, the Federal Reserve believed that transparency and disclosure was all that was needed, and we have been very much proponents of that point of view. But I do think there are some circumstances where the benefits to the consumer are overwhelmed by the complexity and other aspects that just are not worth whatever benefits.

Mr. PRICE. Mr. Chairman, I would just suggest that there continues to be a process question as opposed to a product question.

The CHAIRMAN. If people ask you a question, it has to get answered later. They can't come back again. We have a lot of members who deserve consideration in having the time observed.

The gentleman from Illinois.

Mr. GUTIERREZ. Mr. Bernanke, it is good to see you here again this morning.

Mr. Chairman, this week, the FDIC passed another special assessment on our Nation's banks to help shore-up the Deposit Insurance Fund. It is true that most of the losses to this Fund have been the result of failures of small lending institutions. These community banks have also suffered from severe decreases in the values of housing and commercial real estate markets caused by loans financed by some of the largest banks in our system.

I have legislation in front of the committee, H.R. 2897, and I would appreciate if you could take a look at it and kind of write us a note back on your more expansive opinion on it. I would appreciate that. And it would require the riskiest banks in our financial system to pay more, not only into the Deposit Insurance Fund, but also into the systemic risk fund. My goal is to create a more efficient pricing regime that would disincentivize banks from becoming or remaining "too-big-to-fail." What are your recommendations for creating a system that would prevent or discourage banks from becoming "too-big-to-fail" and what relationship do you think they should have to paying into a fund? Do you think there should be differences?

Mr. BERNANKE. Well, I discussed a number of methods to avoid "too-big-to-fail," and not to repeat, but to include tougher supervision and regulation and being subject to this resolution regime. But you point out another dimension, which is the assessments that would go into the fund either for deposit insurance or for paying for any intervention that does occur. The FDIC currently risk-adjusts the premiums that they charge to banks for deposit insurance. Perhaps it is time to revisit that. Maybe they are not sufficiently differentiated, I don't know. It certainly is always worth considering that. And I think the same principle would apply to assessments for addressing the special resolution regime, those type

of interventions, of firms that are larger, more risky, more interconnected, presumably would pay disproportionately relative to small banks, for example. So I think that would be a sensible approach.

Mr. GUTIERREZ. Thank you. Then I would appreciate it if you and your staff could review it, because it is one of the ways I am looking at making sure—it is kind of like if you—I just kind of thought when I get my insurance, if I was speeding or drinking and I had risky behavior in terms of driving my car, I am going to pay more in insurance. And it seems to me that we have seen different kinds of behaviors on different components of our financial system. And maybe everybody should not pay the same. So I would like to see how we can do that.

Just one other question. So, you know, I have—you know the Federal Reserve, you are the Chairman. You have these huge responsibilities. You come with this wealth of knowledge to the job that we appreciate as a public servant. And although you have all of these wonderful responsibilities, right, and this wonderful talent that you bring to the job, I would just like to ask you, what do you think about what we should be looking at in terms of compensation and executive compensation of people. Do you think this Congress should do anything about it? How do you look at it? Because there is a lot of anger out there as they look at large financial institutions and executive compensation. Can you give me your sense? I went through Europe. And as I went from city to city, it was in late August with Mr. Kanjorski, and we were talking to the EU members. And it was the most important thing that they were bringing up. Can you give us your view?

Mr. BERNANKE. Well, as you may know, the Federal Reserve is about to issue guidance for comment on executive compensation, which will apply not only to the top, you know, 5 or 10 executives, but way down into the organization to traders or anybody whose activities can affect the risk profile of the company. We view this as a safety and soundness issue. And that is what we have heard, in fact, even from the institutions themselves. They believe that the incentive structures affect safety and soundness.

So I think there are two principles: first, that the structure of executive compensation should not be such as to incentivize excessive short-termism or risk-taking; and second, that there be a reasonable connection between actual performance and pay. The American people don't care if a star baseball player gets paid a lot of money as long as he earns the money. The same applies, I think, in the financial sector. But they are upset if somebody earns a lot of money and their company fails. So, from a safety and soundness perspective, it is important that there be those appropriate links between performance and pay.

The Federal Reserve is following some international standards that have been set forth by the Financial Stability Board, which is a group of more than 20 countries that looks at these issues. And again, we are looking at the structure of pay, not so much absolute amounts, but how pay is structured and how pay and performance are related. So that is our approach.

And also there are issues related to transparency which we are working on with the SEC. I don't know whether Congress wants to do additional things, but we are addressing that question.

The CHAIRMAN. The gentlewoman from Minnesota.

Mrs. BACHMANN. Mr. Chairman, thank you.

I just wanted to note for the record that at the beginning of this hearing, the chairman had said not once, but twice, that President Obama had inherited the current financial mess that we are dealing with now. And while that is true, that is true also of every other President who has ever been here. But also, it is true that in the case of Senator Obama, he supported all of the spending initiatives, all of the bailouts, and all of the stimulus plans while he was Senator as well.

So this is an ongoing effort that this committee can again look at and try and turn around for the better of our country in the future.

And so on with my question to Mr. Bernanke. On Monday, the president of the World Bank, Robert Zoellick, said, "The United States would be mistaken to take for granted the dollar's place as the world's predominant reserve currency. Looking forward there will increasingly be other options to the dollar."

I found this statement astounding when I heard him make it on Monday. A statement of this magnitude should concern everyone, I think, because replacing the dollar's favored role in the global marketplace with another country's currency or with a new international currency of some sort would be devastating to the soundness of our dollar and to our Nation's currency and our economy.

Mr. Zoellick also claimed that the value of the dollar will depend heavily on U.S. choices. He asked, "Will the United States resolve its debt problems without a resort to inflation? Can America establish long-term discipline over spending and its budget deficit?"

And I would note that, Mr. Bernanke, I heard you say before that you are very concerned about inflation; you are not willing to invite inflation. I derive great comfort from your statement saying that.

But I do think that Mr. Zoellick's comments are very serious questions that he is asking. And I think that Congress just needs to act to address our Nation's long-term budget deficit.

That is why I joined with my colleague Paul Hodes, a Democrat, I was one of 7 joining with 21 Democrats in a letter that stressed our concern about the lack of TARP transparency and the billions of tax dollars that will remain at risk under the program because we believe that no more funds should be used for the bank bailouts.

I would like to get your comments on Mr. Zoellick's comments. Also, the fact that this isn't just the first time. I think, last week, the UN came out and called for a new international currency to replace the dollar. China has. Russia has. Brazil has. South America has. It is a new refrain. It is almost like every day there is another article.

And I think, at this point now, in light of the comments that were made on Monday, we should take this very seriously. So I would like you to respond to that.

Also another question I have for you, Mr. Bernanke, under the chairman's proposal, the consumer protection authority will be

transferred from other regulatory agencies to the CFPA, including authority from the CTF. Section 4 and 5 of the Act provides the commission with jurisdiction only over persons, partnerships, or corporations organized to carry on business for their profit or that of their members, which means that the FTC can't currently regulate nonprofits for unfair and deceptive practices.

So here is my question: Would the CFPA have broad authority to regulate all entities that provide a financial service or product regardless of their tax status, meaning if they are nonprofit? And here is my specific concern in light of what we have seen in the last couple of weeks. For example, it is my understanding that ACORN provides education service and financial advice to consumers. So would ACORN then be regulated under the CFPA? Because this is on ACORN's Web site. They are a national nonprofit housing organization that opened HUD-certified Fannie Mae-approved housing counseling offices across the United States. And here is a quote from their Web site: "ACORN housing provides one-on-one mortgage loan counseling, first-time home buyer classes and helps clients obtain affordable mortgages through our unique lending partnerships. We look at your savings and credit history to see if you qualify for a mortgage. We can help you with credit problems and to create a downpayment savings plan. When you qualify, we can help arrange a mortgage with lower interest rates, lower downpayments, and lower settlement costs than what banks usually offer."

It seems to me, Mr. Bernanke, from what ACORN claims, that they would come under this CFPA. And I am wondering if you would comment on that.

So if you would first comment for me on Mr. Zoellick's comments, what your feelings are about replacing the dollar's international currency of potentially a new currency. And then if you would comment also on whether or not, in your opinion, ACORN would be covered by the new CFPA.

The CHAIRMAN. Well, I would just point out, there are only 3 seconds remaining.

Mrs. BACHMANN. If I could have my time reclaimed, so that my time—will this come from my time, Mr. Chairman?

The CHAIRMAN. No, your time has—there were only 3 seconds left in your time when you got to him. I can let him go on for a little while, but I don't think he can give full answers to both questions. This practice of going right up to the end and then taking another minute or two is unfair to other members. I will give Mr. Bernanke 30 seconds to answer as much as he can and then answer the rest in writing. There were only 3 seconds left to answer two big questions when the gentlewoman yielded to him.

Mr. Bernanke, for 30 seconds.

Mr. BERNANKE. I agree with two things Mr. Zoellick said. The first is, I believe he said that there is no immediate risk to the dollar; it is a relatively long-term issue. I also agree with him, though, that if we don't get our macro house in order, that will put the dollar in danger, and that the most critical element there is long-term fiscal stability, which you referred to.

I can't answer your second question. I don't know what the legal status of that is. I just don't know.

The CHAIRMAN. The gentleman from Kansas is recognized.

Mr. MOORE OF KANSAS. Mr. Chairman, "too-big-to-fail," I don't know if you had a chance to review the recent proposal offered by President Tom Hoenig and his colleagues at the Kansas City Fed. But I would like your views on it, either now or in writing, if you would as soon as possible, sir, after the hearing. Their proposal on resolution authority lays out more explicit rules than the Administration's proposal of how a large financial institution like Lehman Brothers or AIG could be resolved so the debt holders, shareholders, and management would be held accountable before taxpayers step in. As we think of ending "too-big-to-fail," would providing more clarity on resolution authority to all stakeholders create the right mix of incentives to put pressure on these firms to behave responsibly and not get overleveraged and keep to a manageable size? And what about the question of making public the tier-one list? I know some people argue that making it public will create competitive disadvantages. But doesn't the marketplace really already know more or less who these large firms are?

Mr. BERNANKE. There are two elements of the Hoenig proposal. I can reply in writing in more detail, but there are two with which I fully agree. One is, and I have said before, one is that there should be a very strong presumption that a failing firm, that the creditors of a failing firm will lose money; that should be known in advance. There should be a strong commitment to doing that. And that will be a very important way of reducing the "too-big-to-fail" problem.

The other is that the taxpayer should not bear this cost, that it should be borne by the industry. So if you do those two things, then I think that dangers of naming a firm as a tier-one firm, which would not be acceptable if you didn't do those things because you would be memorializing "too-big-to-fail," but if you do those things, then I think that the tier-one designation is not nearly so worrisome.

Mr. MOORE OF KANSAS. And Mr. Chairman, what steps could be taken to ensure Federal bank regulators do their job on consumer protection? FDIC Chairman Sheila Bair proposed that the CFPA could be given back-up authority where they could intervene case-by-case if they saw lack of enforcement by bank regulators. Another idea I might suggest is a stronger use-it-or-lose-it authority requiring bank regulators to either enforce consumer protection laws or lose that authority. After being graded by the CFPA or the GAO, if a bank regulator fails to fully enforce consumer protection laws, should they lose that authority to CFPA, would this use-it-or-lose-it approach ensure regulators do a better job?

Mr. BERNANKE. I am not sure that the use-it-or-lose-it approach makes sense in the sense that the agency—what check would there be on the agency making that determination? One direction would be back-up authority, I guess, where if the agency was unsatisfied with a specific resolution, that it could do that. But that would require them to have the resources and the information to do that.

Mr. MOORE OF KANSAS. Thank you, sir.

I yield back my time, Mr. Chairman.

The CHAIRMAN. Would the gentleman yield to me then his remaining time? I just want to make a couple of points.

First, Mr. Bernanke, you correctly, I think, talked about banning some products, but I think we ought to expand on the rationale. For instance, you talk about no-doc loans. My own view is we do not ban things totally, primarily for consumer protection. I am in favor of letting people be stupid in a number of other areas. The problem is that, in some of these areas, there is a spill-over to the system, that the problem with no-doc loans was not simply an individual within that position, but those accumulate into a systemic position. So I think, as we talk about whether or not you prohibit certain practices, the argument for doing that gets stronger when there is a systemic overlap. Is that an accurate assessment?

Mr. BERNANKE. Yes, and that is why you would want to have this as part of the systemic risk council.

The CHAIRMAN. Second, I do want to address a couple of the fears of the gentlewoman from Illinois because I don't like it when things are put out there and people get nervous. The gentlewoman from Illinois said she hoped there would be no banning of OTCs. I know of no proposal to do that. There is zero chance of it happening. No one is talking about it. The legislation that we are raising doesn't do that. The chairman was correct that you try to get it as much sanitized as possible. No one is talking about banning the over-the-counter efforts.

And finally, I did want to respond to the gentleman from California, who is not here, Mr. Royce, who said that Congress led to Fannie and Freddie being 50 percent in Alt-A and subprime. Actually, it was the Bush Administration that did that in 2004. The Bush Administration promulgated that. As was noted in an amendment offered by the gentleman from Texas, Mr. Hensarling, and adopted by the House, the Bush Administration in 2004 ordered Fannie and Freddie to go from the 40s into 54 percent, I think from 42 percent to 54 percent, and specifically to give some loans to people below the median, and I, for one, objected.

The gentleman from Florida, Mr. Posey.

Mr. POSEY. Thank you, Mr. Chairman.

Mr. Bernanke, I will just follow up a little bit on the line that the Congresswoman from Minnesota was discussing. I had read the same comment by the IMF president. And I hope that you and I can both agree that the ultimate consumer protection would be for us to have a strong dollar, and then Americans would have faith in their currency, and their purchasing power would not be eroded by the stealth tax known as inflation. Do you agree with that?

Mr. BERNANKE. Absolutely.

Mr. POSEY. Question number one would be what you think the impact on Americans, and I mean the average guy on the street, the average family, the retiree, the investor, what the impact would be on the dollar if it were to lose its currency of choice as some of these other world leaders are calling for now? You know, the Russian president is calling for a super currency. If China and South America and everybody went along with that, what do you think the impact would be on our country?

Mr. BERNANKE. Well, it would weaken the dollar, clearly, and we would have to watch for any inflationary consequences from that. But, again, I want to reiterate that I don't see this as a near-term

risk so long as we as a country take the appropriate steps to manage our fiscal position and keep inflation low.

Mr. POSEY. I hope we will. We know that Secretary Geithner will to go to China to give them some reassurance. And I think they are also calling for this alternative currency. It is not just Russia, and it is not just South America, but China is also very interested. And of course, you know the role they play in buying our paper, and that can be pretty devastating.

What do you think the United States should do in response to the concerns that they have? How are we going to give them assurances that we are not going to start going to an inflationary level that would spur them forward?

Mr. BERNANKE. Well, there are two key issues, I think. One is inflation, and the Federal Reserve is responsible for inflation. We are confident that we can manage our policies to support the economy without inducing inflation in the medium term. So we will—we are committed to low inflation, and we believe—we fully believe that we have the tools and the political will necessary to achieve that.

The second issue is about foreign borrowing, which is the current account and trade deficit. As someone mentioned earlier, we need to have a better balance whereby the United States saves more, imports less, and other countries, including China, rely more on their domestic demand rather than exports for their growth. And so that is a mutual process where both sides have to accommodate that.

But from our perspective, the best way we have to raise our national saving rate over the medium term is to manage our fiscal position, because the government deficit is a net subtraction from our national saving. By reducing the deficit, we increase our national saving.

So that, again, I think that this year and next year, given the state of the economy and all the things that have happened, I don't think that a budget balance is just at all feasible. But certainly, over the medium term, we need to have a credible plan for returning to budget discipline.

Mr. POSEY. And the next question was going to be, what is the plan?

Mr. BERNANKE. Well, obviously, that is Congress' responsibility, fortunately for me. Certainly I would say that, as you look at these very important issues relating to health care, which are incredibly important and affect people's lives in many ways, that as part of that, you take a close look at health care costs, which are a very big part of the expected expansion of the deficit, particularly a decade from now.

Mr. POSEY. Very good, thank you very much.

The CHAIRMAN. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

There is a thinking on Wall Street that $700 billion was necessary and may be needed in some future emergency as well that we put $700 billion or some much larger amount at significant risk. And there is a thinking on Wall Street that Congress cannot be trusted to grant extraordinary powers in some future crisis, and so we need to modify the statutes now, so that the Executive Branch

can deploy $700 billion or $1.7 trillion or whatever it is at significant risk.

Section 13(3) has been discussed here. In your testimony, you indicate that if there was proper resolution authority, that could replace section 13(3). Do I understand it correctly that if we get resolution authority right, you don't need 13(3) or should there be two separate avenues by which the Executive Branch can deploy hundreds of billions of dollars?

Mr. BERNANKE. If the resolution authority is passed and is a workable plan, then I don't think the Fed would need to have 13(3) authority for the purpose of rescuing failed firms. I think there might be other contexts where it might be useful, but in the context of bailing out firms, no.

Mr. SHERMAN. What statutory restriction would you want on section 13(3) since you are saying it shouldn't be repeale? How would it be restricted?

Mr. BERNANKE. The Federal Reserve should not be empowered to use the 13(3) authority to prevent the failure of a financial firm.

Mr. SHERMAN. But to perhaps prevent a systemic problem for the economy, it might end up also putting hundreds of billions of dollars at risk for some other purpose?

Mr. BERNANKE. Well, we have other programs, for example, when we stepped in to stabilize the commercial paper market, which wasn't directed at any individual firm but which was very helpful to the economy as a whole.

Mr. SHERMAN. Looking at 13(3), we have discussed the idea of limiting the dollar amount that you could spend; perhaps facetiously, we discussed $12 trillion. As you know, section 13(3) basically allows you to loan money to anyone as long as there are unusual and exigent circumstances. And the key phrase in 13(3) is that you be secured to the satisfaction of the Federal Reserve Bank.

To your credit, you have testified that secured to the satisfaction of the Federal Reserve Bank is not some illusory requirement, but instead is the equivalent of Triple-A rated investment. Your General Counsel testified last week to a somewhat lesser standard, and who knows who will be holding your position or his in the years to come.

From your General Counsel's testimony, I would gather that some future Administration might well extend hundreds of billions of dollars of credit under 13(3) and feel that they were adequately secured as long as they are more likely than not to be repaid. That is a junk bond standard.

And since we don't know who is going to hold your position in the future and I can't question them, would you oppose legislation that would define what "secured to the satisfaction of the Federal Reserve Bank" meant to say that those voting would have to believe that there was a 99 percent chance that the Federal Government was going to be fully repaid?

Mr. BERNANKE. We are certainly open to discussing that. I would just like to point out that the only case where it has been in any way risky has been in these individual bailouts, and I would like to get rid of those. I think that is a step in the right direction.

Mr. SHERMAN. I would point out we have been blessed to have you at the Federal Reserve. If someone with the attitude towards statutory construction that we have seen in other parts of the Executive Branch were in charge of the existing 13(3), they never would have had to have brought TARP to the Floor of the House; 13(3) could have fully financed the full $700 billion, but not on your watch. It would have to be on the watch of someone with an aggressive approach to statutory construction. We have seen that aggressive approach at the Treasury Department, and we better modify the statutes, unless we can assure that all of your successors will be as conservative in their statutory interpretation as you have been.

You talk about section 1204 not costing the taxpayer money. The provision for that involves an assessment on institutions as low as $10 billion to repay the cost of bailing out a systemically significant firm. I would think that would mean that the medium-sized banks are hit two ways. First, their bigger competitors get some sort of implicit Federal guarantee of some help to competitors, and if it ever comes to pass, they are the ones who pay for it.

The CHAIRMAN. The gentleman's time has expired.

Mr. SHERMAN. I ask you to respond for the record.

The CHAIRMAN. We have a vote.

We can go to Mr. Paulsen. I intend, on the Democratic side, we will come back, and those members who are here will be recognized for a while until we finish up, but no new members will be recognized. So on the Democratic side, we will begin with Mr. Hinojosa. Those members who were here will get to ask questions as long as you can stay. I will yield to my Republican colleague as to who he wants us to recognize on his side.

And the gentleman from Minnesota is now recognized.

Mr. PAULSEN. Thank you, Mr. Chairman.

Chairman Bernanke, yesterday, we heard from bankers and the members of the financial services industry in general. They still have indicated now the current problems with consumer financial protection was due primarily to a lack of focus by regulators like the Federal Reserve.

Apart from the recent credit card regulations that had been released, 800-and-some pages, what is the Federal Reserve doing right now to sort of refocus, if you will, its efforts and duties on consumer protection efforts more specifically?

Mr. BERNANKE. Well, first of all, we have had, in the last 3 or 4 years, we just had a huge number of rulemakings that we have put out in the mortgage area, in the credit card area. We have one coming out on overdraft protection. We have just done something on student loans. So we have been extremely active, and so we have really elevated our focus on this area. And we have strengthened the leadership of the division to make this a very effective part of our activities.

I have made some suggestions in the past; if the Congress wanted to strengthen the focus of the Federal Reserve further on these matters, there would be various ways to do that. For example, the chairman should be required to testify on consumer matters the same way I testify on monetary matters.

Another thing that would be useful, we currently have a Consumer Advisory Council which by law consists of both the industry folks and the consumer advocates. The consumer advocates feel this is unfair because the bankers have several other councils and several other forums for meeting with the Federal Reserve, and we can't change that because of the legislation. One possibility would be to create a stronger Consumer Advisory Council to meet with us periodically and evaluate what we are doing.

There are other ways to do it, such as a regular program of hearings and so on. And we are interested and willing to make institutional changes that would strengthen our commitment if that is the direction the Congress wants to go.

Mr. PAULSEN. So just to follow up then, if the Federal Reserve is refocusing its efforts in this manner and you are looking at the council potentially, from your perspective then, is the CFPA really necessary as being proposed by the Administration, to have that specific CFPA organization?

Mr. BERNANKE. Well, you know, I think the issue which Congress has to make a judgement about is the reason that—I think the motivation behind the CFPA is the concern that the Federal Reserve has not been sufficiently focused on this issue. And I certainly concede that, until recently, we have not done what we should have done in this area. So that is the concern.

I think that is Congress' judgment about whether the Federal Reserve could be sufficiently focused, and I think we are very competent. We have the skills and the mix of talents and experience to do a good job here. And I think the issue is essentially the confidence that Congress has in our focus going forward.

I personally think we can do that, and we would be willing to strengthen the institutional factors that affect our focus, but I understand the concerns, and I think Congress will have to make that judgment.

Mr. PAULSEN. And Mr. Chairman, earlier you had mentioned, and I believe, Congress often does not look at things until they are brought to our attention. But you said you would be okay, it would be valuable if the Federal Reserve or someone from the Fed came to testify to Congress or to us periodically on consumer protection as opposed to just monetary policy.

Mr. BERNANKE. Yes, by statute, as is the case with monetary policy.

Mr. PAULSEN. And if I could just switch gears then.

Let me ask another question, the Federal Reserve's approach to managing monetary policy in advance of the last two recessions, if you go back in time, seems to be a little bit unstable. In other words, by waiting for an asset bubble to build up and then rescuing the economy after the bubble bursts, you know, it appears that you can create other problems.

And just maybe give some comments on, why can't the Federal Reserve show a little bit more restraint in the monetary policy in advance when we are faced with what looks like a risky asset bubble coming down the pike? Would it ultimately be better to protect job loss or inflation down the road if we are able to—it is not often popular, for instance, to do it, but is that going to make more sense

than—given the recent experience we have had recently, does that make more sense to look more in advance on that?

Mr. BERNANKE. In principle, it would be great. But there are two practical problems that we have to try to confront. One is actually identifying the bubble. And when the policies in question were taking place in 2003, 2004, there really was substantial disagreement among experts about whether this was a bubble and how big it was.

The other problem is that by using monetary policy, which is a very blunt tool, to try to pop bubbles, you may have a side effect of having bad effects on the rest of the economy, because you can't just target one sector.

That is why, even though, as I say, I am open-minded about the role of monetary policy in bubbles, in affecting bubbles, I do think that the first line of defense needs to be a stronger regulatory system that would, on the one hand, prevent excessive build-ups of risk in the first place; and if they do pop and if there is a problem like that, would make the system strong enough that it wouldn't create such an enormous crisis as we have seen recently.

The CHAIRMAN. Last question, the gentleman from Texas, Mr. Hinojosa, and then we will return and start right away. The gentleman from North Carolina will be the Chair.

The gentleman from Texas.

Mr. HINOJOSA. Thank you, Mr. Chairman.

And I thank you also, Chairman Bernanke, for coming to speak with members of our committee.

At a recent congressional hearing at which Secretary of the Treasury Timothy Geithner testified, I noted that I met with Treasury Assistant Secretary for Financial Institutions Michael Barr, and we discussed some of the concerns that I have with the proposed Consumer Financial Protection Agency we have been debating for quite some time.

During that conversation, I expressed some concern about the negative impact the CFPA as proposed would have on the local economies across the country, and the negative impact it would have on community banks, regional banks, and credit unions. Community banks and regional banks and credit unions played no significant role in the current economy crisis, both domestic and global.

And Secretary Barr stated that Treasury wants a level playing field. Therefore, he stated, that Treasury wants to put all financial institutions in the same box and wants all those institutions to be examined and enforced by the CFPA. I think that the community banks, the regional banks, and the credit unions should be exempted from the CFPA umbrella. Thus, tell me, what are your conclusions on exempting those groups that I mentioned from the CFPA umbrella?

Mr. BERNANKE. Well, I don't think I would want to exempt fully any lender, including non-bank lenders, from appropriate consumer protection laws. That would invite those practices to migrate out of the big banks to other institutions.

But on the enforcement side, the Federal Reserve takes what we call a risk-focused approach, jargon for saying that we put more resources where there are greater dangers. So we would spend a lot

more time in a national credit card company, for example, than we would in a local community bank that makes standard consumer loans or mortgages, for example.

So I do think it would be appropriate to have some differences in the level of intensity of enforcement, depending on the nature of the business and the kinds of risks that are inherent in the products that the company is involved with.

Mr. HINOJOSA. Thank you for sharing your thoughts with me.

My time has expired, and I yield back.

The CHAIRMAN. The hearing will recess. And I appreciate the indulgence of the Chairman.

We will return on our side with questions from Mr. Clay, Mr. Scott, Mr. Green, Mr. Cleaver, Ms. Speier, Mr. Minnick and Ms. Kosmas if they wish to do so, and I will be guided by my colleagues on the other side. The hearing is recessed.

[recess]

Mr. WATT. [presiding] The hearing will come back to order.

The chairman has asked me to preside in his absence, and I think the next person to be recognized is the gentleman from California, Mr. Miller.

Mr. MILLER OF CALIFORNIA. Thank you.

Mr. Chairman, it is good to have you back.

I am glad you decided to stay and were reappointed. I think you are doing a very difficult job, but I think you are doing the best anybody could do in this country.

I would be interested in your comments, and we talked about, you said you are trying to increase the national savings rate on the part of individuals and such, which is a goal. I believe you said that earlier. Yet I am looking at what is happening with the banks. The interest rates are so low that people are saying, I have to find some better investment for my money rather than putting it in a savings account. And then, on the other hand, banks aren't lending money still. It is an unusual anomaly we have. It is not as bad as it was last September when they stopped lending to each other. But for individuals with good credit, they are having trouble even going out and getting a loan to keep a business operating. How do you see those in conflict with each other?

Mr. BERNANKE. Well, it is first certainly true that we are better off than we were with the system in crisis. It is also true that the banks have not returned to normal lending by any means. I think the low interest rates do have positive effects on the economy, for example, operating through other markets, like the mortgage market or the corporate bond market.

But getting the banking system back into a lending mode is very important. We continue to work with the banks to encourage them to raise equity so they have sufficient capital to support their lending. We have provided them with an enormous amount of liquidity so they are able to have the funds to lend. We are encouraging them to lend, in that going back to November, the bank regulators had a joint statement encouraging banks to lend to creditworthy borrowers as being in the interest both of the banks and of the economy. And we continue to try to follow up on all those things.

In addition, as you may know, we have some programs, including the Term Asset-Backed Securities Loan Facility, which is trying to

open up sources of funding from the capital markets, for example, for consumer loans and small business loans. I would add, I guess, that there are also some efforts taking place from the Treasury to support small-business lending. It is a difficult problem, but we are trying it attack it in a number of fronts. Just to conclude, I would say that it is true that as long as the banks are as reluctant to lend as they are, to some extent, it weakens the effect of our stimulative policies.

Mr. MILLER OF CALIFORNIA. You recall last September, we were having a very lengthy debate, and you and I had some conversations requiring the $700 billion to going to buy mortgage-backed securities, which we approved the first $350 billion. But it seems like we went through a tremendous amount of debate to make that decision; yet the Federal Reserve last week decided to buy a trillion and quarter dollars of mortgage-backed securities. And your previous comments, we have talked about the Fed's role in injecting liquidity in the marketplace and being able to fight inflation as needed, but you can't do that with assets you are buying. They are not liquid. Unless you are going to have a barn sale and just get rid of them for liquidity, how can you justify those two? They seem to be—

Mr. BERNANKE. Well, the purchases of the asset-backed securities?

Mr. MILLER OF CALIFORNIA. How do you justify the ability to do that when we were requested to authorize the Treasury to do that originally?

Mr. BERNANKE. Well, under open-market operations, we normally transact in these markets. We buy and sell both treasuries and agencies; we are authorized to do that. And given the situation we are in with interest rates close to zero, it is now becoming a recognized approach of monetary policy to expand assets and a balance sheet as an additional way of providing support to the economy. And I think it is justified, not only narrowly by the authorizations for open-market operations but by the mandate that Congress gave us to try to maximize employment and achieve price stability. These are the only tools we have to try to achieve those objectives. I want to assure you that we have every means of exiting from the situation and avoiding inflation, even if we do not sell any of these assets.

Mr. MILLER OF CALIFORNIA. You can do it in other ways, then.

Mr. BERNANKE. I am sorry?

Mr. MILLER OF CALIFORNIA. You can do it in other ways.

Mr. BERNANKE. Yes.

Mr. MILLER OF CALIFORNIA. HVCC, as you recall, we passed a new policy, Congress did, that is the ability of appraisers to appraise local units and such. We changed it. And the Federal Reserve, you went through a lengthy process regulating on appraisals recently, and you determined that they could do certain things, and certain requirements were made. Do you support the current policy because it seems to be having a very negative impact on the valuation of homes in a given industry today?

Mr. BERNANKE. Well, we have policies that try to create adequate independence of the appraiser.

Mr. MILLER OF CALIFORNIA. You did that. I think your policies you approached it with were good, but we decided to go a different direction, and that is my problem, the direction we went.

Mr. BERNANKE. Could I answer that in a letter?

Mr. MILLER OF CALIFORNIA. You sure may, sir.

Mr. WATT. The gentleman's time has expired.

Mr. MILLER OF CALIFORNIA. I would appreciate that.

Mr. WATT. The gentleman from Missouri, Mr. Clay, is recognized.

Mr. CLAY. Thank you, Mr. Chairman.

And thank you, Mr. Chairman, for being back here with us. I just want to cover one area, consumer protection, that I would like your insights on. What do you think is best for consumer protection, given the record of the Federal Reserve, given the record of other regulatory agencies that kind of dropped the ball in the last decade on consumer protection? Are you one who advocates expanding the authority of the Federal Reserve to actually, I guess, put some teeth into consumer protection or beef-up consumer protection, or do you think we need a separate Federal agency?

Mr. BERNANKE. Well, Congressman, I continue to think that the debate here has to do with the Congress' view about whether or not a new agency is needed in order to sufficiently prioritize consumer protection. In other words, I think many of those who support a new agency feel that the Federal Reserve does not place sufficient priority or attention on this topic. I have tried to point out that while I certainly agree that the Federal Reserve did not do enough in this area for many years, that in the past 3 years or so, we have been quite active and aggressive in this area. And I think we have been very effective and made use of our particular strengths and economics and finances to compliment our consumer protection authorities.

But I am not going to tell Congress or I wouldn't presume to tell Congress what to do. I think it is Congress' decision whether they think that the Federal Reserve's commitment can be made sufficient, or if not, then presumably you want to have a new agency. I think that is the issue.

Mr. CLAY. Well, going along those lines of thinking, then, how does the Federal Reserve repair the damage that has been done to communities like the one I represent which had a disproportionate number of subprime loans when really the consumer probably should have had a prime loan, but yet now it has caused them to go into foreclosure? It has damaged those communities. Now you have all of these vacant properties sitting there destroying those communities. How can the Federal Reserve at least help repair that damage?

Mr. BERNANKE. Well, in several ways. First, again, I agree that we didn't do enough at an earlier stage, but over the last 3 years or so, we have put some tough rules in place in a variety of areas. We are also trying to address the situation through other mechanisms.

To give one example, we have a partnership with NeighborWorks America where we are trying to work to help stabilize communities where there have been a lot of foreclosures. We recognize foreclosures hurt not only the borrowers; they also hurt the community and the broader housing market for that matter. So we are doing

the best we can in the current situation to try to address the problems.

If Congress decides they want to leave it with the Fed, I think we would have to take steps to reassure Congress that we would in fact, even beyond my tenure and into the future, have sufficient commitment to this area, and I have suggested some ways of doing that, including, as I mentioned, mandatory testimony by the Chairman, various kinds of review processes, strengthening the Consumer Advisory Council, and other things that can be done just to assure Congress that the Fed will not repeat the mistake and let this ball drop, as you put it.

Mr. CLAY. Thank you for your response, Chairman Bernanke.

Mr. Chairman, may I yield the rest of my time to my friend from Georgia, Mr. Scott?

Mr. WATT. Mr. Scott is next, but he can use the rest of your time, too.

Mr. CLAY. Thank you.

Mr. WATT. Thirty seconds.

Mr. SCOTT. So that means I have 5 minutes and 30 seconds when I come. I will come back to that.

Mr. WATT. You just used the 30 seconds.

The gentleman from Delaware, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman.

And Chairman Bernanke, I would like to concentrate on your written testimony, which I have here, in which you indicate an oversight council made up of the agencies involved in financial supervision regulations should be established. And then you say further on, in the same paragraph of the first page of your testimony, all Federal financial supervisors and regulators, not just Federal Reserve, should be directed and empowered to take account of risk to the broader financial systems as part of their council oversight and responsibility.

Then, on page 5, you mention first an oversight council, same thing, composed of representatives of the agencies and departments involved in the oversight of the financial sector should be established to monitor and identify emerging systemic risk across a full range of financial institutions and markets.

I am not sure I understand. I think I understand here what you are saying; I am not totally sure what you said before or where we are on this. I think what you are saying here is we should have a council made up of all regulators who would make decisions with respect to systemic risk. Is that correct?

Mr. BERNANKE. To coordinate the regulators to monitor the system, to look for gaps, a variety of things to try to be the oversight of the whole system, but of course, I think each individual agency would also have a responsibility within their own sphere to look out for potential problems.

Mr. CASTLE. With respect to that council, do you have any ideas about the structure of it? Are you saying the Federal Reserve should be the head of it, and the others should be on it? Or just a general counsel, a separate person being the head of it?

Mr. BERNANKE. The Administration proposed that the Treasury be the permanent Chair, and we are fine with that.

Mr. CASTLE. So the permanent Chair, with the other regulators on it?

Mr. BERNANKE. Yes.

Mr. CASTLE. Is what you are talking about?

Mr. BERNANKE. The Treasury would be the Chair, and the other major regulators would be on the council.

Mr. CASTLE. Yes.

And apart from what the White House said, what is your argument, if there is one, for the Treasury being the head of it versus, say, you or another regulator or somebody independently from the outside? I am not saying it is wrong—

Mr. BERNANKE. Obviously, because the Treasury has the broadest responsibilities for the economy in general, has the broadest responsibilities for any fiscal implications and financial implications, and frankly because the Treasury would probably be better placed to mediate any differences among agencies that might arise for whatever reason.

Mr. CASTLE. Has this been your position consistently from the beginning of the proposal of the systemic risk?

Mr. BERNANKE. It has, yes. My position has not changed at all.

Mr. CASTLE. Okay. Do you disagree with what some of the other regulators, Comptroller Dugan and Chairman Bair, have been saying about this?

Mr. BERNANKE. I think there are two parts here. I think one question is whether, underneath the systemic regulatory council, should the Federal Reserve be the consolidated supervisor of the large financial holding companies? And my impression, based on conversations and also based on the testimony at the end of July, where I was here with the other regulators, is that there is pretty broad support—I know for—well, I think it is very broad support for the Federal Reserve playing that role as the supervisor of these large financial firms.

I think there is a bit of difference about exactly where the authorities of the Systemic Risk Council would end and where the authorities of the individual agencies would begin. And I think they are within the range of negotiation, but our position has been that, for the purposes of both expertise, accountability and responsibility, that the council should not be involved in micromanaging any part of the system; rather it should be a broad, take a broad perspective, which brings together the perspectives of the individual regulators. So I would not at this point recommend the Systemic Risk Council get into the weeds of setting detailed capital requirements, for example.

Mr. CASTLE. I think I agree with you, but I know enough to know I don't really understand it completely. I would hope that you and the Administration and all the regulators could sit down and work out something of which we could have unanimity. I don't think there is any disagreement at all on this committee that we need some sort of a Systemic Risk Council, regardless of what it is and who heads it, the way it is organized.

The details are beginning to confound us a little bit. I would hope that we would get good guidance from you since there seems to be unanimity of opinion about where we should go, but I think it is a very, very important subject as far as the future of the financial

world is concerned. So, hopefully, we can resolve it soon. I appreciate your testimony on that.

I yield back, Mr. Chairman.

Mr. WATT. The gentleman yields back.

The gentleman from Georgia is recognized, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Welcome again, Chairman Bernanke. There are two constitutional statute requirements for the Federal Reserve, one of which is monetary policy controlling inflation. The other one, which we don't touch upon enough, is unemployment and employment, which is a charge. You gave your assessment of how well the economy is doing when you said that you believe the recession is very likely over. Those are your comments. I want you to review your statements in light of the fact that we have ravaging, ravaging, staggering unemployment rates right now.

The major systemic risk to our economy is not within the credit markets right now, not within Wall Street or the banks; it is these individuals who are losing record numbers of jobs every single day. They can't pay their mortgages; 26,000 every week are getting into foreclosures now. Unemployment levels are staggering at the rate of 11.5 percent in my home State of Georgia. And in many other States, it is really at double digits, and across the country now it is hovering right at 10 percent.

So I think it would be very important to examine what I consider the weak link in the Obama Administration's response to this economy. There is no clear-cut jobs policy. There is no direct mission to deal with this problem of rising unemployment. Our only answer to it has been, we throw whatever has been out there for the stimulus; that depends on local and State governments to create. But there is nothing there. There is no manpower training act, as it responded to in the 1960's and 1970's. There is no National Recovery Act that Franklin Delano Roosevelt responded to in the Depression.

What are we going to do to address this issue of rising unemployment, particularly in view of the fact that it is your second or your other charge of responsibility to the Federal Reserve?

Mr. BERNANKE. Well, Congressman, first, I would ask you to read my whole statement. The question that I answered in public was to say that technically the recession may be ending in the sense that the economy is no longer falling and is starting to come back. However, I was very clear that unemployment remains very high and is a continuing problem and that the growth is unlikely to be fast enough to bring it down at the pace we would like to see. And so I completely agree with everything you just said.

In terms of our mandate, which I agree is both price stability and maximum employment, of course, that explains why we are currently not only having our interest rate close to zero, but we are using extraordinary additional tools, as I was talking about before, about the acquisition of mortgage-backed securities and so on to try to stimulate the economy and get people back to work. We think that is very important, consistent with maintaining price stability as well.

Obviously, there are a lot of ways to address unemployment from a fiscal perspective. Unemployment insurance is one of course. I guess one point I would make at least to bring to your consider-

ation, is one of the real concerns that I have is, not only is unemployment high, but the number of people who have been out of work for 6 months or a year is really exceptionally high. And folks who are out of work for that long tend to lose skills. They tend to lose attachment to the labor market. And even when the economy comes back, they may either not be able to find work or they may not ever become a regular part of the labor market again.

So I think there is certainly some scope for trying to ensure that people who do want to come back to work and who have been out of work for a time, that they keep their skills fresh, that they have additional education or training. I can see that as being particularly important in a situation like now when unemployment is both so high and unemployment spells are so lengthy.

Mr. SCOTT. Would you agree that we should approach this serious unemployment and joblessness problem in this country with the same energy, policy directive, and legislative directive to address this issue as we have done in previous downturns in the economy? I mean, unemployment now is 10 percent. It is devastating in many other parts of the country, particularly in the Midwest. It just seems to me that we ought to get packages of tax incentives of tax cuts to businesses that we know will stimulate the economy, direct training acts and job training acts in which we can get money directly into the hands of the unemployed to begin to get retrained for these positions.

I think that the laissez-faire attitude that we have while we throw this up to Wall Street and the big banks to unfreeze the credit and we kind of look at that, I would just hope that, and I have such great respect for you and your knowledge, and moving in this area that you could use your position and your charge in this unemployment area to put greater emphasize to this Administration to do more direct action to address the unemployment problem.

Mr. WATT. The gentleman's time has expired.

I know he was entitled to 30 seconds more, but we just got an e-mail saying that there are going to be 3 more votes shortly. So I want to try to get to the other members who haven't been recognized.

Mr. Manzullo is recognized.

Mr. MANZULLO. Thank you, Mr. Chairman.

Chairman Bernanke, thank you again for coming and spending a good portion of time with us and for your availability outside of the hearings. I have a couple of questions.

First of all, with regard to the oversight council, I think it is on page 2 of your testimony, made up of the agencies involved in financial supervision and regulation, and the mandate is to monitor and identify emerging risks to financial stability across an entire financial system, identify regulator gaps and coordinate agencies' responses to potential systemic risks. I guess another word for systemic risk is moral hazard. To me, a moral hazard is a teetotaler with a beer. But I—even without this group, this is something that is has gone on any way; isn't that correct?

Mr. BERNANKE. Well, for example, we have had the President's Working Group, which is also a group of regulators. But I would have to say that the focus on the system as a whole is lacking.

Mr. MANZULLO. Right.

Mr. BERNANKE. For example, this council, unlike the President's Working Group, would have its own dedicated staff and would have more regular meetings and be very focused, perhaps writing reports and so on, on the gaps in the system leading to systemic risk.

Mr. MANZULLO. At this point, I know from prior testimony and visiting with other groups, you are already doing this as part of your job.

Mr. BERNANKE. We are moving very much in that direction.

Mr. MANZULLO. Right.

Mr. BERNANKE. But the Federal Reserve's authorities don't extend to all the different markets and instruments in the system.

Mr. MANZULLO. Correct. How do you balance, if that is the work that the oversight council would do, with a new consumer financial protection agency, especially if it comes to a dispute over instruments, products? You may think that a particular product may pose a systemic risk, such as the whole rotten subprime market, when people were allowed to get 3/27 and 2/28 mortgages and teaser rates and things like that and were allowed to get loans without written proof of their income. What happens if you have a conflict with the oversight council and a new consumer financial protection agency?

Mr. BERNANKE. Well, first, there are several governance mechanisms which is, of course, on the one hand, the agency part of the council would have to talk to its colleagues; on the other hand, it would be on the board of the agency, as I understand it, some of the regulators would be part of the board. But I think what the most powerful weapon would be if the council believed that actions taken by any of the members of the council were not consistent with a safe financial system, I would think one of their best methods would be to provide a report or recommendation that would be public and that would be a very powerful tool because the agency that ignored that would certainly be going against their peers and taking the risk on themselves that they are making a mistake in being too lax, for example. So I do think that there would be a certain amount of peer pressure that would affect the ability of the council to get cooperation with the members.

Mr. MANZULLO. By the time you came in office 3½ years ago, the die had been cast. It was pretty late for you to do anything to turn around the train, and you tried to.

Looking back with seasoned eyes over the last 10, 12, 14 years, what do you see now that you think should have been seen back then?

Mr. BERNANKE. Well, you know, it is not a single smoking gun, but there are lots of different problems where, again, there were gaps that arose because we didn't take enough of a systemic viewpoint. I talked about consumer protection and the problem of subprime, those things that you talked about. I think that is important. But if you look across the whole range of financial institutions, not just banks but investment banks and others, it seems clear that the strength and consistency of the oversight was not adequate; that there were many individual financial instruments, like the CDS and others, where again the oversight was fragmented and not sufficiently consistent and powerful. So it would

take me some time frankly—I am sure you appreciate how complex the whole crisis has been. It would take me some time to go through all the different elements. But I think what we learned is that the system which seemed to be working fine as long as the economy and financial stresses were not too great; when things got much worse, then the system wasn't able to stand up to it. We learned a great deal from this crisis. I very much hope that this Congress and the agencies together will make use of those lessons.

Mr. MANZULLO. I thank the gentleman.

Mr. WATT. The gentleman's time has expired.

The gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

Thank you, Chairman Bernanke, for appearing again. I trust that all is well with you and your family.

Mr. Chairman, I sense a hint of exasperation with you in terms of your having to continually express that you are opposed to "too-big-to-fail." Trying to get that message out has been quite a challenge for me, too, in that I am opposed to "too-big-to-fail." And the temptation is there to use what I call a pneumonic device, a memory-aiding device. However, pneumonic devices will only help a person have a better sense of memory. It won't force the person to use memory. And I suspect that a lot of the people who continually misunderstand my position are doing so with a certain amount of design as opposed to a lack of memory. But for the record, I, too, am opposed to "too-big-to-fail" for the nth time.

Now, having said this, some of my colleagues on the other side are also talking about jobs and the recovery as though jobs are a leading indicator. I think it is fairly well-documented that jobs are a lagging indicator. But, for the record, Mr. Chairman, have we ever had a recovery from a recession wherein jobs were a leading indicator?

Mr. BERNANKE. I am not aware of any. As you point out, it is normally a lagging indicator, because it takes time for firms to bring people back to work after recovery begins.

Mr. GREEN. Exactly.

The market, stock prices are, generally speaking, procyclical, but unemployment is, generally speaking, countercyclical. So I want to talk for just a quick moment about countercyclicality. When a policy is countercyclical, it will cool down an economy that is in an upswing, and it will stimulate an economy this is in a downturn.

If this is the case, when we require banks to increase that capital ratio in a recession, while it may be a good thing to do, it can also prove to be procyclical in that it can offset some of the lending that might take place. Would you just kindly give a quick comment on this, the capital requirement, because, if you recall, we started out with a TARP fund that became a capital purchase program that dealt with capital requirements, and that may have had some impact on the lending side of banking, if you would, please?

Mr. BERNANKE. No, you are absolutely right. Banks do have various ways to raise capital. They can go to the public markets, for example. But one of the tensions we face now in this and other spheres is that there certainly is a desire, both in the United States and abroad, to raise bank capital levels so that they will be safer in the future, but recognizing though that, in the short run,

raising capital levels may cause banks to reduce their assets and to reduce lending. We need to find a way to phase that in, sufficiently gradually that it doesn't impede the recovery. So we face that problem in a lot of cases. We want people to save more, but not immediately because the economy is in a recession. So it is the timing that is very important.

Mr. GREEN. In fact, this is one of the reasons why Basel II has been criticized, because it advocates this, but moving on.

"Dark liquidity," an interesting term, it has to deal with a term that I call "quiet money" that is placed in the market. Did dark liquidity have an impact on the circumstance that we are dealing with currently?

Mr. BERNANKE. Do you mean "dark pools?" Is that what you are referring to?

Mr. GREEN. Yes, sir.

Mr. BERNANKE. Well, the SEC is looking at that.

I think there are interesting questions about whether the market is served by having more transparency about those pools. I don't really have a firm position on that.

I am not aware that those dark pools were an important factor in the crisis as a whole. I mean, I may be mistaken, but transparency in general is very important, but again, on this particular area, I know the SEC is looking at it and trying to make some determination.

Mr. GREEN. Final comment, with reference to small banks and community banks, I want to thank you for your efforts to avoid having them become—bear the burden, if you will, of a lot of what has happened when they in fact were, in the main, not the cause of this downturn that we are suffering from. I have had an opportunity to meet with many of the community bankers, and one of the things they continually say to me is, look, don't have us punished for the sins of others. We have been here. We are doing a good job, and we are maintaining a lot of loans in our portfolios, so please don't let it happen to us. And I thank you for your efforts in this area.

I yield back, Mr. Chairman.

Mr. WATT. The gentleman from New Jersey, Mr. Lance.

Mr. LANCE. Thank you, Mr. Chairman.

Good afternoon, Mr. Bernanke.

We are all obviously concerned about the levels of unemployment. Traditionally, this is a lagging indicator. My concern is that, given the state of the workforce in this country, post-industrial in many ways, do you believe long term, over the course of the next year perhaps, that the unemployment rate will be lowered significantly?

Mr. BERNANKE. I would be fooling myself and you if I said I knew with any certainty. But most forecasters, including the Fed, are currently looking at growth in 2010, but not growth so rapid as to substantially lower the unemployment rates.

Mr. LANCE. So, at the moment, we are at 9.7 percent. If we may technically get out of the recession the fourth quarter or perhaps the first quarter of next year, could we expect a significant lowering any time next year, Mr. Chairman, of the unemployment rate?

Mr. BERNANKE. Well, if we—just to explain the arithmetic, we have to grow faster than the underlying potential in order to make a dent in the unemployment rate. So it depends entirely on how quickly the economy grows. There are some who think it could grow at a fast clip, but if it only grows at 3 percent, say, which is not much faster than the underlying potential growth rate, then, unfortunately, the unemployment rate would still probably be above 9 percent by the end of the year.

Mr. LANCE. Above 9 percent by the end of 2010?

Mr. BERNANKE. That is right, by the end of 2010, if growth is about 3 percent.

Mr. LANCE. This is as I understand it different from more typical recoveries in the past, perhaps exacerbated by the workforce as it now exists, fewer manufacturing jobs, manufacturing jobs going to other parts of the world.

I can't imagine the American people will consider the country to be in recovery if the unemployment rate is at roughly 9 percent or in the high 8 percent area a year and 3 months from now. Based upon your great expertise and given your extremely expansive knowledge as to what has happened in the past, particularly in the Great Depression, is there anything else we should be doing to make sure that we bring the unemployment rate down more quickly than may now be anticipated is the case.

Mr. BERNANKE. I don't have any magic bullets to offer. If I did, I would have offered them by now.

But I think, as I was saying, and again, these are areas that Congress needs to decide and not the Federal Reserve, but one way to mitigate the long-term damage is to try to make sure that those who are out of work for an extended period don't lose attachment to the labor force and that they do get opportunities to improve their skills and remain employable.

Mr. LANCE. Thank you.

Let me say in conclusion that I think we are all concerned about the unemployment rate, Congress as well as, of course, the Federal Reserve Board. And this is the indicia by which the American people determine whether or not we are out of a recession, even though that might not be the technical definition. And certainly we want to work with you on this issue.

I yield back the balance of my time.

Mr. WATT. I thank the gentleman for yielding some of his balance and recognize Mr. Cleaver as the final questioner.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. Chairman, I want to juxtapose two speeches, one by Governor Duke, and there have been some references to his speech; the other is World Bank President Bob Zoellick.

Let me first deal with Governor Duke. When he testified before this committee, he surprised me a little when he suggested that consumer protection should become one of the Fed's core missions. Are there other central banks in the industrialized world that hold the responsibility of consumer protection as a core mission? Do you know of any?

Mr. BERNANKE. Well, the consumer protection function varies a lot across countries, where it is located and how it is managed, but I can't give you a good example.

Mr. CLEAVER. I am sorry.

Mr. BERNANKE. I don't have a good example to give you, no.

Mr. CLEAVER. So does that mean that you agree with me that consumer protection should be performed by a single agency that has only consumer protection as its core responsibility?

Mr. BERNANKE. I think the main argument for a single agency is the focus core mission aspect that you are talking about. But again, I reiterate that, given the historical accident or whatever that gave this authority to the Federal Reserve, that in the recent years, we have been very aggressive at pursuing it.

Mr. CLEAVER. Secretary Clinton wanted me to correct myself calling Governor Duke a "he."

Let's go back to the World Bank president. In a speech earlier this week, he said that the Fed should not be given the responsibility for regulating systemic risk and he said that the Treasury Department should have that responsibility. And the reason behind his statement was that Treasury is responsible to the President and to Congress. And this doesn't mean that I have joined in with the "eliminate the Fed" movement, but that the Fed does not answer to Congress. And so that the American public should have some participation in this and that the Treasury is the likely spot for this responsibility. Do you agree with Mr. Zoellick?

Mr. BERNANKE. Well, without commenting on his speech in particular, I think I do agree that there should be a systemic risk council and that the head of that should be the Treasury, so in that respect, I agree with that. I think the Federal Reserve is the appropriate body to do the consolidated supervision of large financial companies that may be systemically critical. But that would be underneath the AG of the systemic risk council. And I would dispute the claim that the Fed is less responsive to Congress than the Treasury is, for example. I am here today, and we testify frequently, and of course, we are subject to congressional oversight.

Mr. CLEAVER. Well, yes, but not to the degree that the Treasury—I mean, you would agree that Treasury, that the Secretary of the Treasury can be fired rather easily. I don't think you are going to see a lot of mass firing in the Fed initiated by Congress. And you are probably not mad about it, but you would agree with me, right?

Mr. BERNANKE. Well, it would be the President who would fire the Treasury Secretary, not the Congress.

Mr. CLEAVER. Yes, I understand. That is the whole point, he can be fired easily, I mean, one person.

Mr. BERNANKE. But again, I think—again, I don't know exactly what Mr. Zoellick had in mind. But I do agree the Treasury, I said this just a few minutes ago, I thought the Treasury ought to be a Chair of the council and the council ought to have the overarching responsibility. But underneath the council, you still have agencies to perform specific tasks. You need the SEC to monitor credit-rating agencies and money market mutual funds. You need the CFTC to monitor exchanges. So the Federal Reserve, this is not a new power for the Federal Reserve, the Federal Reserve since the last decade has been the consolidated supervisor of large—all bank holding companies, in fact. And I am just saying that we should retain that, what we already have, and that we should cooperate

with the other agencies to create a more systemic orientation in our oversight.

Mr. CLEAVER. Thank you. You do come and sit through this torturous session with us, so I want to express appreciation.

Mr. WATT. The gentleman's time has expired.

I want to express my appreciation for the gentleman sitting and sitting through the torturous process also. And thank you very much for being here and being as eloquent as you always are. The hearing is adjourned.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

A P P E N D I X

October 1, 2009

EMBARGOED UNTIL DELIVERY
Thursday, October 01, 2009

Contact: Erica Elliott
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Garrett Opening Statement for Federal Reserve Regulatory Reform Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services hearing entitled "Federal Reserve Perspectives on Financial Regulatory Reform Proposals":**

"I thank Chairman Frank for holding this hearing and I welcome Chairman Bernanke back to the Committee.

"I note in Chairman Bernanke's testimony that he continues to advocate that the Federal Reserve should be given authority for consolidated oversight over all "systemically important financial institutions."

"I have a number of concerns about this proposal that I have previously expressed. Among them – 1) specifically designating institutions "systemically significant" leads to unfair competitive advantages, increases moral hazard, and makes it more likely that such institutions will be considered "too big to fail" and 2) the Federal Reserve already has consolidated supervision over many of the large bank holding companies, including Citi and Bank of America, which the federal government has pumped billions of dollars into, due to the fact that such consolidated supervision has apparently failed.

"Furthermore, Fed policy, itself -- keeping interest rates too low for too long -- was one of the major factors leading to the crisis.

"I am not alone with my concerns about the Fed as a systemic regulator. There seems to be universal distaste for the Fed in such a role on the Senate Banking Committee, and such a political reality would seem to make it less likely that the House would confer new powers on the Fed, either.

"As has been stated previously, rather than give the Fed additional powers, Republicans on the Committee have proposed as part of our reform plan to reduce the power of the Fed so that it can properly focus its role on monetary policy.

"Preventing future taxpayer funded bailouts is the primary aim of the GOP plan, and it is also the primary aim of legislation that I plan to introduce later today that will call for raising the minimum downpayment for FHA loans, as well as a study to examine what is an appropriate leverage ratio for the FHA. There have been increasing reports of the likely necessity of a taxpayer-funded bailout for the FHA and this legislation aims to implement reforms to try to prevent such a bailout from occurring.

"I will be interested to hear from Chairman Bernanke his views on the current situation at the FHA and on the proposed reforms to increase borrowers' "skin in the game" to protect taxpayers."

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October 1, 2009

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

October 1, 2009

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate the opportunity to discuss ways of improving the financial regulatory framework to better protect against systemic risks.

In my view, a broad-based agenda for reform should include at least five key elements. First, legislative change is needed to ensure that systemically important financial firms are subject to effective consolidated supervision, whether or not the firm owns a bank.

Second, an oversight council made up of the agencies involved in financial supervision and regulation should be established, with a mandate to monitor and identify emerging risks to financial stability across the entire financial system, to identify regulatory gaps, and to coordinate the agencies' responses to potential systemic risks. To further encourage a more comprehensive and holistic approach to financial oversight, *all* federal financial supervisors and regulators--not just the Federal Reserve--should be directed and empowered to take account of risks to the broader financial system as part of their normal oversight responsibilities.

Third, a new special resolution process should be created that would allow the government to wind down a failing systemically important financial institution whose disorderly collapse would pose substantial risks to the financial system and the broader economy. Importantly, this regime should allow the government to impose losses on shareholders and creditors of the firm.

Fourth, all systemically important payment, clearing, and settlement arrangements should be subject to consistent and robust oversight and prudential standards.

And fifth, policymakers should ensure that consumers are protected from unfair and deceptive practices in their financial dealings.

Taken together, these changes should significantly improve both the regulatory system's ability to constrain the buildup of systemic risks as well as the financial system's resiliency when serious adverse shocks occur.

Consolidated Supervision of Systemically Important Financial Institutions

The current financial crisis has clearly demonstrated that risks to the financial system can arise not only in the banking sector, but also from the activities of other financial firms--such as investment banks or insurance companies--that traditionally have not been subject to the type of regulation and consolidated supervision applicable to bank holding companies. To close this important gap in our regulatory structure, legislative action is needed that would subject *all* systemically important financial institutions to the same framework for consolidated prudential supervision that currently applies to bank holding companies. Such action would prevent financial firms that do not own a bank, but that nonetheless pose risks to the overall financial system because of the size, risks, or interconnectedness of their financial activities, from avoiding comprehensive supervisory oversight.

Besides being supervised on a consolidated basis, systemically important financial institutions should also be subject to enhanced regulation and supervision, including capital, liquidity, and risk-management requirements that reflect those institutions' important roles in the financial sector. Enhanced requirements are needed not only to protect the stability of individual institutions and the financial system as a whole, but also to reduce the incentives for financial firms to become very large in order to be perceived as too big to fail. This perception materially weakens the incentive of creditors of the firm to restrain the firm's risk-taking, and it creates a playing field that is tilted against smaller firms not perceived as having the same degree of government support. Creation of a mechanism for the orderly resolution of systemically

important nonbank financial firms, which I will discuss later, is an important additional tool for addressing the too-big-to-fail problem.

The Federal Reserve is already the consolidated supervisor of some of the largest and most complex institutions in the world. I believe that the expertise we have developed in supervising large, diversified, and interconnected banking organizations, together with our broad knowledge of the financial markets in which these organizations operate, makes the Federal Reserve well suited to serve as the consolidated supervisor for those systemically important financial institutions that may not already be subject to the Bank Holding Company Act. In addition, our involvement in supervision is critical for ensuring that we have the necessary expertise, information, and authorities to carry out our essential functions as a central bank of promoting financial stability and making effective monetary policy.

The Federal Reserve has already taken a number of important steps to improve its regulation and supervision of large financial groups, building on lessons from the current crisis. On the regulatory side, we played a key role in developing the recently announced, internationally-agreed improvements to the capital requirements for trading activities and securitization exposures, and we continue to work with other regulators to strengthen the capital requirements for other types of on- and off-balance-sheet exposures.[1] In addition, we are working with our fellow regulatory agencies toward the development of capital standards and other supervisory tools that would be calibrated to the systemic importance of the firm. Options under consideration in this area include requiring systemically important institutions to hold aggregate levels of capital above current regulatory norms or to maintain a greater share of

[1] See Bank for International Settlements (2009), "Basel II Capital Framework Enhancements Announced by the Basel Committee," press release, July 13, www.bis.org/press/p090713.htm; and Basel Committee on Banking Supervision (2009), *Enhancements to the Basel II Framework* (Basel: Basel Committee, July), available at www.bis.org/publ/bcbs157.htm.

capital in the form of common equity or instruments with similar loss-absorbing attributes, such as "contingent" capital that converts to common equity when necessary to mitigate systemic risk.

The financial crisis also highlighted weaknesses in liquidity risk management at major financial institutions, including an overreliance on short-term funding. To address these issues, the Federal Reserve helped lead the development of revised international principles for sound liquidity risk management, which have been incorporated into new interagency guidance now out for public comment.[2]

In the supervisory arena, the recently completed Supervisory Capital Assessment Program (SCAP), popularly known as the stress test, was quite instructive for our efforts to strengthen our prudential oversight of the largest banking organizations.[3] This unprecedented interagency process, which was led by the Federal Reserve, incorporated forward-looking, cross-firm, aggregate analyses of 19 of the largest bank holding companies, which together control a majority of the assets and loans within the U.S. banking system. Drawing on the SCAP experience, we have increased our emphasis on horizontal examinations, which focus on particular risks or activities across a group of banking organizations, and we have broadened the scope of the resources we bring to bear on these reviews. We also are in the process of creating an enhanced quantitative surveillance program for large, complex organizations that will use supervisory information, firm-specific data analysis, and market-based indicators to identify emerging risks to specific firms as well as to the industry as a whole. This work will be

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[2] See Basel Committee on Banking Supervision (2008), *Principles for Sound Liquidity Risk Management and Supervision* (Basel: Basel Committee, September), www.bis.org/publ/bcbs144.pdf. Information about the proposed guidance is available at Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (2009), "Agencies Seek Comment on Proposed Interagency Guidance on Funding and Liquidity Risk Management," joint press release, June 30, www.federalreserve.gov/newsevents/press/bcreg/20090630a.htm.

[3] For more information about the SCAP, see Ben S. Bernanke (2009), "The Supervisory Capital Assessment Program," speech delivered at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, held in Jekyll Island, Ga., May 11, www.federalreserve.gov/newsevents/speech/bernanke20090511a.htm.

performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and other experts within the Federal Reserve System. Periodic scenario analysis will be used to enhance our understanding of the consequences of changes in the economic environment for both individual firms and for the broader system. Finally, to support and complement these initiatives, we are working with the other federal banking agencies to develop more comprehensive information-reporting requirements for the largest firms.

Systemic Risk Oversight

For purposes of both effectiveness and accountability, the consolidated supervision of an individual firm, whether or not it is systemically important, is best vested with a single agency. However, the broader task of monitoring and addressing systemic risks that might arise from the interaction of different types of financial institutions and markets--both regulated and unregulated--may exceed the capacity of any individual supervisor. Instead, we should seek to marshal the collective expertise and information of all financial supervisors to identify and respond to developments that threaten the stability of the system as a whole. This objective can be accomplished by modifying the regulatory architecture in two important ways.

First, an oversight council--composed of representatives of the agencies and departments involved in the oversight of the financial sector--should be established to monitor and identify emerging systemic risks across the full range of financial institutions and markets. Examples of such potential risks include rising and correlated risk exposures across firms and markets; significant increases in leverage that could result in systemic fragility; and gaps in regulatory coverage that arise in the course of financial change and innovation, including the development of new practices, products, and institutions. A council could also play useful roles in

coordinating responses by member agencies to mitigate emerging systemic risks, in recommending actions to reduce procyclicality in regulatory and supervisory practices, and in identifying financial firms that may deserve designation as systemically important. To fulfill its responsibilities, a council would need access to a broad range of information from its member agencies regarding the institutions and markets they supervise and, when the necessary information is not available through that source, the authority to collect such information directly from financial institutions and markets.

Second, the Congress should support a reorientation of individual agency mandates to include not only the responsibility to oversee the individual firms or markets within each agency's scope of authority, but also the responsibility to try to identify and respond to the risks those entities may pose, either individually or through their interactions with other firms or markets, to the financial system more broadly. These actions could be taken by financial supervisors on their own initiative or based on a request or recommendation of the oversight council. Importantly, each supervisor's participation in the oversight council would greatly strengthen that supervisor's ability to see and understand emerging risks to financial stability. At the same time, this type of approach would vest the agency that has responsibility and accountability for the relevant firms or markets with the authority for developing and implementing effective and tailored responses to systemic threats arising within their purview. To maximize effectiveness, the oversight council could help coordinate responses when risks cross regulatory boundaries, which often will be the case.

The Federal Reserve already has begun to incorporate a systemically focused approach into our supervision of large, interconnected firms. Doing so requires that we go beyond considering each institution in isolation and pay careful attention to interlinkages and

interdependencies among firms and markets that could threaten the financial system in a crisis. For example, the failure of one firm may lead to runs by wholesale funders of other firms that are seen by investors as similarly situated or that have exposures to the failing firm. These efforts are reflected, for example, in the expansion of horizontal reviews and the quantitative surveillance program I discussed earlier.

Improved Resolution Process

Another critical element of the systemic risk agenda is the creation of a new regime that would allow the orderly resolution of failing, systemically important financial firms. In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after the Lehman Brothers and AIG experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.

A new resolution regime for nonbanks, analogous to the regime currently used by the Federal Deposit Insurance Corporation for banks, would provide the government the tools to restructure or wind down a failing systemically important firm in a way that mitigates the risks to financial stability and the economy and thus protects the public interest. It also would provide the government a mechanism for imposing losses on the shareholders and creditors of the firm. Establishing credible processes for imposing such losses is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem. The availability of a workable resolution regime also would replace the need for the Federal Reserve to use its

emergency lending authority under section 13(3) of the Federal Reserve Act to prevent the failure of specific institutions.

Payment, Clearing, and Settlement Arrangements

Payment, clearing, and settlement arrangements are the foundation of the nation's financial infrastructure. These arrangements include centralized market utilities for clearing and settling payments, securities, and derivatives transactions, as well as the decentralized activities through which financial institutions clear and settle such transactions bilaterally. While these arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks, and, absent strong risk controls, may themselves be a source of contagion in times of stress.

Unfortunately, the current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, creating the potential for inconsistent standards to be adopted or applied. Under the current system, no single regulator is able to develop a comprehensive understanding of the interdependencies, risks, and risk-management approaches across the full range of arrangements serving the financial markets today. In light of the increasing integration of global financial markets, it is important that systemically critical payment, clearing, and settlement arrangements be viewed from a systemwide perspective and that they be subject to strong and consistent prudential standards and supervisory oversight. We believe that additional authorities are needed to achieve these goals.

Consumer Protection

As the Congress considers financial reform, it is vitally important that consumers be protected from unfair and deceptive practices in their financial dealings. Strong consumer protection helps preserve households' savings, promotes confidence in financial institutions and

markets, and adds materially to the strength of the financial system. We have seen in this crisis that flawed or inappropriate financial instruments can lead to bad results for families and for the stability of the financial sector. In addition, the playing field is uneven regarding examination and enforcement of consumer protection laws among banks and nonbank affiliates of bank holding companies on the one hand, and firms not affiliated with banks on the other hand. Addressing this discrepancy is critical both for protecting consumers and for ensuring fair competition in the market for consumer financial products.

Conclusion

Thank you again for the opportunity to testify on these important matters. The Federal Reserve looks forward to working with the Congress and the Administration to enact meaningful regulatory reform that will strengthen the financial system and reduce both the probability and severity of future crises.

Questions for The Honorable Chairman Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Bean:

1. The proposal of having the Federal Reserve being the consolidated regulator of tier 1 holding companies calls for the Fed to supersede the regulatory authority of the functional regulator which is different from the relationship between the Fed and the functional regulators for bank holding companies (Fed defers to functional regulator in most cases). If ABC Bank Holding Company is determined to be a Tier 1 holding company, do you envision the Federal Reserve becoming the functional regulator for a national bank within the bank holding company instead of the National Bank Supervisor? What if XYZ holding company that owns an insurance subsidiary is determined to be a Tier 1 holding company, do you envision the Federal Reserve conducting day to day supervision over the current state insurance regulators?

The Federal Reserve would not become the functional regulator of either national banks or insurance companies under any of the pending financial reform proposals. The Office of the Comptroller of the Currency [or its successor] would continue to perform day-to-day supervision of national banks and the appropriate state insurance supervisors would continue to supervise insurance companies. Where the national bank or insurance company is part of a bank holding company structure, the authority of these functional supervisors would continue to be complemented by prudential supervision by the Federal Reserve across the organization as a whole.

To be fully effective, consolidated supervisors must have clear authority to monitor and address safety and soundness concerns and systemic risks in all parts of an organization, working in coordination with other supervisors wherever possible. As the crisis has demonstrated, large firms increasingly operate and manage their businesses on an integrated, firm-wide basis, with little regard for the corporate or national boundaries that define the jurisdictions of individual functional supervisors, and stresses at one subsidiary can rapidly spread within the consolidated organization. A consolidated supervisor thus needs the ability to understand and address risks that may affect the risk profile of the organization as a whole, whether those risks arise from one subsidiary or from the linkages between depository institutions and nondepository affiliates. The financial reform legislation recently passed by the House of Representatives would make useful modifications to the provisions added to the law by the Gramm-Leach-Bliley Act in 1999 that limit the ability of a consolidated supervisor to monitor and address risks within an organization and its subsidiaries on a group-wide basis. The Federal Reserve supports these modifications.

The legislation passed by the House of Representatives would supplement these enhanced authorities for individual supervisors by a broad-based council for the financial system as a whole. Such a council composed of all the financial agencies and departments involved in financial supervision and regulation would be very helpful in monitoring and identifying emerging systemic risks across the full range of financial institutions and markets. In addition, such a council usefully could coordinate the supervisory and regulatory responses of financial supervisors to emerging systemic threats, thereby promoting greater harmony and efficiency in supervisory and regulatory matters of systemic importance.

Questions for The Honorable Chairman Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Foster:

1. On what time scale might we expect that Congress might enumerate guidance on principles for determining which firms are systemically important?

It is expected that the final version of financial services reform legislation enacted by Congress will establish criteria to be used to identify systemically important firms.

Determining precisely which firms are systemically important will require analysis of a number of factors, including the linkages between firms and markets, drawing as much or more on economic and financial analysis as on bank supervisory expertise. The consequences of a firm's failure are also more likely to be severe if the firm is large, taking account of both its on- and off-balance sheet activities. In addition, the impact varies over time: the more fragile the overall financial backdrop and the condition of other financial institutions, the more likely a given firm is to be judged systemically important. If the ability of the financial system to absorb adverse shocks is low, the threshold for systemic importance will more easily be reached.

2. It appears that you are institutionalizing periodic stress tests for Tier I FHCs. What parameters, frequency, and public reporting requirements are contemplated? Would the periodic stress tests be applied to a subset of firms designated to be systemically important?

Drawing on our experience in the successful Supervisory Capital Assessment Program (SCAP), we have increased our emphasis on horizontal examinations, which focus on particular risks or activities across a group of banking organizations, and we have broadened the scope of the resources we bring to bear on these reviews. We also are in the process of creating an enhanced quantitative surveillance program for large, complex organizations that will use supervisory information, firm-specific data analysis, and market-based indicators to identify emerging risks to specific firms as well as to the industry as a whole. We have not yet determined whether or, if so, how frequently to conduct stress tests like SCAP. We are exploring the benefits of each firm incorporating specific parameters into its own stress tests as an alternative.

3. What are the staffing and technical capabilities that should be associated with the systemic risk oversight council? Would it be comparable to the risk management efforts at large firms?

The financial reform legislation passed by the House would establish an oversight council--composed of representatives of the agencies and departments involved in the oversight of the financial sector--that would be responsible for monitoring and identifying emerging systemic risks across the full range of financial institutions and markets. In addition, the council would have the ability to coordinate responses by member agencies to mitigate identified threats to financial stability. And, importantly, the oversight council would have the authority to recommend that its member agencies, either individually or collectively, adopt heightened prudential standards for the firms under the agencies' supervision in order to mitigate potential systemic risks. Examples of such risks could include rising and correlated risk exposures across firms and markets; significant increases in leverage that could result in systemic fragility; and

gaps in regulatory coverage that arise in the course of financial change and innovation, including the development of new practices, products, and institutions. The council also would identify those financial firms that should be subjected to enhanced prudential standards and supervision on a consolidated basis.

While the council would require some dedicated staffing to fulfill its mandate, we envision that the bulk of the staffing and technical expertise required for the council could be drawn from the member agencies. For example, the Federal Reserve would provide resources and information with respect to its role as a consolidated supervisor of financial groups while individual functional regulators would do the same with respect to the institutions under their direct supervision. Enhanced coordination and information sharing among the member agencies of the council will be a critically important component of the process.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

January 5, 2010

BEN S. BERNANKE
CHAIRMAN

The Honorable Gary G. Miller
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you for the opportunity to respond to the questions you posed on the Board's recent rulemaking on appraiser independence during the House Committee on Financial Services' October 1, 2009, hearing entitled, "Federal Reserve Perspectives on Financial Regulatory Reform Proposals."

You raised three questions: Do I think that the Federal Reserve's recent regulation on appraisals achieves a balance between prohibiting improper influence on appraisers and ensuring appraiser independence while not unintentionally increasing the cost of obtaining a mortgage loan for consumers? Is there a need for the Home Valuation Code of Conduct ("HVCC") given the Board's regulation? Is the Federal Reserve aware of any problems that the HVCC is causing consumers and the housing market?

As you indicated in the hearing, the Board has taken a less prescriptive approach to appraiser independence than does the HVCC. The Board recently amended its Regulation Z by adding requirements designed to ensure mortgage appraiser independence and prohibit improper influence on appraisers. The final rule amending Regulation Z prohibits mortgage brokers, mortgage lenders, and their affiliates from coercing, influencing, or otherwise encouraging appraisers to misstate or misrepresent the value of a consumer's principal dwelling. These amendments to Regulation Z are consistent with the Board's longstanding concerns about appraiser independence. The Board and the other banking agencies have long held that depository institutions should order appraisals. In addition, the Board's and the other banking agencies' appraisal rules relating to depository institutions and bank holding companies, adopted in 1990, require that the parties ordering appraisals be administratively separate from the lending function. We believe that this structure strikes an appropriate balance between ensuring appraiser independence and adversely affecting consumers and the housing market.

In response to your second question, the amendments to Regulation Z and the HVCC use similar descriptions of prohibited behavior deemed likely to be coercive of appraisers. Notwithstanding these similarities, during the development of the HVCC, the Board, along with the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the "Agencies"), issued a comment letter identifying concerns about the proposed HVCC and

recommending that it be withdrawn because the HVCC "conflicts in material ways with the rules and guidance established by the Agencies and undermines appropriate risk-management and consumer protection practices at federally regulated lenders." A copy of this comment letter, which details the conflicts that raised our concerns, is enclosed.

In response to your third question, the Board has received letters complaining about the current functioning of the appraisal industry. These concerns include questions about appraiser qualifications, appraising in declining markets, the oversight of appraisal management companies, broker price opinions, and fees paid to appraisers. At this time, it is not clear whether, or to what extent, the HVCC plays a role in the deficiencies discussed in the complaints.

I hope this information is helpful. Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Office of Thrift Supervision
National Credit Union Administration

June 19, 2008

Mr. James B. Lockhart, III
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, D.C. 20552

Dear Director Lockhart:

The Federal Reserve Board ("Board"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration (collectively, the "Agencies") appreciate the opportunity to convey our concerns about the Home Valuation Protection Program and Cooperation Agreements ("Agreements") between your agency, the New York State Attorney General, and the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the "GSEs").[1] The Agreements require mortgage lenders, including federally regulated financial institutions and organizations ("federally regulated lenders"), seeking to sell single-family mortgage loans to the GSEs to adopt the Home Valuation Code of Conduct ("Code") attached to the Agreements and to comply with certain practices imposed by the Code.

We strongly support the goals of protecting appraisers from coercion or other undue influence by lenders, borrowers, brokers, or others involved in the mortgage lending and securitization process. Appraiser independence and reliable valuations of real estate collateral for loans in the primary and secondary residential mortgage markets are a necessary part of the foundation to protect lenders in making safe and sound residential mortgage credit decisions, consumers in their borrowing decisions, and investors in their decisions to purchase mortgage-backed securities.

We are very concerned, however, that the requirements imposed by the Agreements and Code would unnecessarily undermine the safe and sound extension of mortgage credit, reduce the availability of mortgage credit to many consumers, and ultimately lead to less reliability and accuracy in real estate appraisals. Moreover, issues regarding appraiser independence and protection from coercion are already adequately addressed by current and pending rules and guidance of the Agencies. In addition, we believe that insufficient information has been collected and inadequate analysis has been performed to permit confidence that the

[1] The OCC and the OTS have previously submitted separate comment letters concerning the legal and policy issues presented by the Agreements and the Code. See letter dated April 30, 2008, from Timothy T. Ward, Deputy Director, OTS, to Senior Vice President, Credit Risk Oversight, Freddie Mac; and letter dated May 27, 2008, from John C. Dugan, Comptroller of the Currency, to James B. Lockhart, Director, OFHEO.

Code will appropriately address the issue of potential coercion and other undue influence of appraisers without causing other significantly adverse, unintended consequences. We believe, therefore, that the Agreements and Code should be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed.

The Code conflicts in material ways with the rules and guidance established by the Agencies and undermines appropriate risk-management and consumer protection practices at federally regulated lenders. The Code inappropriately attempts to regulate the corporate structure and internal operations of federally regulated lenders in connection with their mortgage lending operations. In addition, the Code contravenes appropriate risk-management practices of federally regulated lenders by banning the use of appraisals prepared by in-house appraisers, appraisers employed by affiliates, or appraisers at entities that also provide loan settlement services. The Code also hinders the ability of federally regulated lenders to perform other types of quality controls necessary to ensure the accuracy and quality of appraisals used in lending decisions and, thereby, protect the safety and soundness of such institutions and organizations. For example, the Code overly restricts lenders from ordering or using a second or subsequent appraisal to ensure the reliability of the collateral valuation. Such appraisals are an important quality control tool for lenders, particularly when markets are turning and public data updates are delayed, as recently demonstrated in various declining markets.

The Agencies have significant concerns that compliance with overly restrictive requirements in the Code will materially disrupt mortgage lending processes and raise costs to consumers without enhancing protections for consumers, lenders, or the mortgage markets. Implementation of the Code will result in higher loan origination costs for federally regulated lenders and other mortgage lenders and thereby increase costs to consumers. For example, the Code's unwarranted restriction on a lender using any appraisal performed by an in-house appraiser or ordered by a broker will likely result in loan application processing delays and require the consumer frequently to pay for multiple appraisals for a loan. Higher costs and disruptions in mortgage lending processes also will result from the Code's restrictions on using appraisals from appraisal management companies that are affiliates of lenders or that provide both appraisal and settlement-related services for institutions. The unwarranted loss of the significant efficiencies these companies can provide to mortgage lenders that provide loans to consumers where the lender has few, if any, loan underwriting offices, and particularly to small financial institutions, is likely to result in loan processing delays, higher costs for consumers, and reductions in the availability of mortgage credit in many areas. We believe that the Code's draconian approach sacrifices quality, efficiency, and cost for a result that would not materially enhance protections against undue influence on appraisers.

The Agencies have issued and proposed appraisal regulations and supervisory guidance, applicable to federally regulated lenders, that promote sound appraisal practices; require lenders to originate, purchase, and sell mortgage loans based on reliable appraisals; and protect appraisers from inappropriate influence by loan production staff, borrowers, or other third

parties.[2] The Agencies require separation of the appraisal function from the loan production, investment, and collection functions to prevent the threat of coercion or other undue influence on appraisers. This measured approach recognizes that staff appraisers can provide the lender with impartial, independent and reliable appraisals. Importantly, staff appraisers can provide effective reviews of appraisals performed by unaffiliated appraisers to verify that such appraisals are accurate, supportable, and comply with the Agencies' appraisal regulations and guidance and the lender's appraisal standards. The Agencies already require that these quality control functions be performed independently and without any influence by the lender's loan production staff. The constraints on the role of staff appraisers imposed by the Code would inhibit these quality control functions and impose increased costs for verifying and ensuring the quality and accuracy of appraisals on mortgage lenders and ultimately on consumers without any demonstrable benefit.

The appraisal regulatory framework established by the rules and guidance of the Agencies is based on balanced requirements to help ensure that federally regulated lenders use reliable appraisals that were prepared independently by competent appraisers who are separated, and protected from coercion or other undue influence, from the lender's loan production, investment, and collection functions or any third party. The Agencies' appraisal regulations and supervisory guidance reflect our belief that the reliability of appraisals is not dependent on a blanket prohibition that requires that lenders use only appraisals prepared by third parties that do not provide settlement services. The key to promoting reliable appraisals is that the appraisal function be separated from the loan production function, whether those functions reside in one organization, affiliated organizations, or unaffiliated third parties. Federally regulated lenders must couple the independence of those functions with robust credit and compliance risk-management systems to ensure appraiser impartiality, appraiser independence, and the reliability of the appraisals used in underwriting residential real estate loans.

The Agencies' appraisal regulatory framework is monitored and enforced through examinations that review the operations of the federally regulated lenders' mortgage lending functions. Such entities are instructed to establish adequate internal controls to ensure appraiser independence through separation of the appraisal ordering, preparation, and quality control processes from the institution's and organization's loan production staff and lending processes, including separation of responsibilities and reporting lines between the appraiser and the lending function. Under the Agencies' appraisal regulations and supervisory guidance, an appraisal ordered or prepared by a third party also must meet these impartiality and independence

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[2] 12 CFR part 208, subpart E (Board); 12 CFR part 34, subpart C (OCC); 12 CFR part 564 (OTS); and 12 CFR part 722 (NCUA). See Interagency Appraisal and Evaluation Guidelines, SR letter 94-55 (Board), Comptroller's Handbook, Commercial Real Estate and Construction Lending (Appendix E) (1998) (OCC), and Thrift Bulletin 55a (OTS). See also Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions (2005), SR Letter 05-5 (Board), OCC Bulletin 2005-6 (OCC), CEO Memorandum No. 213 (OTS), and NCUA Letter to Credit Unions 05-CU-06 (NCUA); and Interagency Statement on Independent Appraisal and Evaluation Functions (2003), SR Letter 03-18 (Board), Advisory Letter 2003-9 (OCC), CEO Memorandum No. 184 (OTS), and NCUA Letter to Credit Unions 03-CU-17 (NCUA).

requirements, and lenders are instructed to review any broker-ordered appraisals thoroughly to ensure that the appraisal complies with the Agencies' regulations and guidance and the institution's appraisal policies.

A federally regulated lender must demonstrate that its appraisal process complies with our requirements to protect appraiser impartiality and independence, and requires quality, independent opinions of collateral market value through appraisals that conform to minimum regulatory appraisal standards, including the Uniform Standards of Professional Appraisal Practice (USPAP). Appraisals also must be prepared by appropriately credentialed and competent appraisers protected from coercion. The real estate appraisal and evaluation policies and procedures of federally regulated entities are reviewed by examiners, and the Agencies require corrective action when deficiencies are discovered.

In addition, the Board is currently considering revisions to its Regulation Z to enhance further the protection of consumers from improperly influenced real estate appraisals.[3] The Regulation Z proposal prohibits all creditors and mortgage brokers from pressuring an appraiser to misrepresent a dwelling's value and prohibits all creditors from extending credit if the creditor knows or has reason to know that an appraiser has been coerced to misstate a dwelling's value. The proposed amendment to Regulation Z would cover all mortgage lenders (both federally and non-federally regulated lenders) and would apply to all consumer credit transactions secured by the consumer's principal dwelling, whether the mortgage is guaranteed by the GSEs or not.

The GSEs recently invited interested persons to submit their concerns regarding the Agreements and the Code. The new requirements to be imposed by OFHEO and the GSEs through the Agreements and the Code, with their far-reaching and burdensome effects on federally regulated lenders and other mortgage lenders across the nation, are the type of federally-imposed requirements that should be subject to the full panoply of laws designed to protect the procedural and other rights of citizens and corporate entities from improper governmental action. The comment process employed, however, does not confer the protections or rigor required by the Administrative Procedures Act and other applicable laws. Use of requirements set by the GSEs to impose obligations on the entire mortgage lending industry and on consumers is tantamount to government agency action and strongly implies that the GSEs are acting as governmental agencies that should be subject to all the procedural and other laws applicable to agency action.

OFHEO requested comment from the Agencies on the implementation timetable for the Agreements and the Code to ensure that no disruption in the marketplace would occur. We believe that the time available for carefully considering the extensive number of comments and obtaining concurrence on changes needed to the Code to address the many serious concerns identified by the Agencies and the commenters will require substantial delay and revision to the content and process for the implementation of the Code, if the Agreements and Code are not

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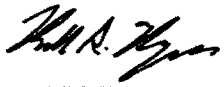
[3] Regulation Z--Truth in Lending, 73 Fed. Reg. 1672, 1726 (proposed January 9, 2008) (to be codified at 12 CFR pt. 226). The proposal was released for comment on January 9, 2008. The proposal's comment period ended on April 2, 2008, and Board staff is analyzing the more than 4,000 comment letters received on the proposal to determine what modifications, if any, to make to the draft regulation.

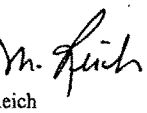
withdrawn. Under the Agreements, the new requirements will apply to all single-family mortgage loans (except government-insured loans) that are originated on or after January 1, 2009, and delivered to a GSE. The actual effective date of the restrictions, however, will of necessity precede that date by a number of months due to the length of time for completion of the origination process, particularly with the new requirements. We expect that the significant number of concerns and adverse consequences identified by the Agencies and commenters will, in fact, result in further disruption of the residential mortgage lending market.

We strongly encourage that the Agreements and the Code be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed. The Agreements' and Code's overly burdensome restrictions and mandates on such a significant segment of the mortgage market would constrain the ability of our regulated institutions and organizations to provide mortgage credit to creditworthy consumers on a safe and sound and timely basis, without increased costs. The Agencies are committed to addressing any weaknesses and deficiencies in mortgage lending practices, including appraisal practices, at any of our regulated lenders through our regulatory and supervisory processes, as necessary. Moreover, the Agencies would be willing to work with OFHEO and the GSEs to identify and address any unresolved issues regarding appraiser coercion.

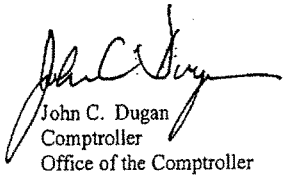
Sincerely,



Randall S. Kroszner
Governor
Board of Governors of the
Federal Reserve System



John M.Reich
Director
Office of Thrift Supervision



John C. Dugan
Comptroller
Office of the Comptroller
of the Currency

JoAnn M. Johnson
Chairman
National Credit Union Administration

cc: Federal National Mortgage Association
Federal Home Loan Mortgage Corporation

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