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# TARP ACCOUNTABILITY AND OVERSIGHT: ACHIEVING TRANSPARENCY

## HEARING

BEFORE THE

## JOINT ECONOMIC COMMITTEE
## CONGRESS OF THE UNITED STATES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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# TARP ACCOUNTABILITY AND OVERSIGHT: ACHIEVING TRANSPARENCY

**WEDNESDAY, MARCH 11, 2009**

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
*Washington, DC.*

The committee met at 10:34 a.m. in Room 106 of the Dirksen Senate Office Building, The Honorable Carolyn B. Maloney (Chair) presiding.

**Senators present:** Klobuchar, Casey, Brownback, and Risch.

**Representatives present:** Maloney, Hinchey, Snyder, Brady, Burgess, and Campbell.

**Staff present:** Eleni Constantine, Nan Gibson, Colleen Healy, Justin Ungson, Andrew Wilson, Chris Frenze, Bob Keleher, Lydia Mashburn, Robert O'Quinn, Jeff Schlagenhauf, and Jeff Wrase.

## OPENING STATEMENT OF THE HONORABLE CAROLYN B. MALONEY, CHAIR, A REPRESENTATIVE FROM NEW YORK

**Chair Maloney.** The meeting will come to order. Thank you all for coming today. I really would like to read my opening statement.

I would like to welcome the witnesses, Superintendent Richard Neiman, head of New York's Banking Department, Damon Silvers, Associate General Counsel of the AFL–CIO; Nicole Tichon, Tax and Budget Advocate for USPIRG; and Alex Pollock, Resident Fellow at the American Enterprise Institute, to this hearing on the Trouble Asset Relief Fund, or TARP.

Mr. Silvers is Deputy Chair of the TARP Congressional Oversight Panel, and Superintendent Neiman is a member of that five-member panel. We are very fortunate that they could both be with us today. Thank you so much for coming.

Ms. Tichon is the author of a newly-released independent report on the TARP: Failing the Bailout, Lessons for President Obama From Bush's Failure on TARP.

Mr. Pollock, an experienced banker, has written frequently on TARP issues. Thank you all for coming.

The focus of this hearing is on the need for better information on the use and beneficiaries of TARP funds. As has become alarmingly clear, we have very little idea where the money has gone or what good it has done, and not knowing, is not acceptable.

The efforts of the panel and of the independent advocates such as PIRG, to get this information, are critically important to the ability of this Congress to ensure that taxpayer money is used as intended to restore financial stability, so that our economy can recover.

Last week, I wrote to Federal Reserve Chairman Bernanke, reiterating a request I had made in a November 2008 Financial Services Committee Hearing, for a full accounting of the Fed's purchase of assets on which AIG had written credit default swaps, insuring the performance of those assets as part of the bailout of AIG.

I requested this information on who the Fed purchased the assets from, how much each of them received, and how the prices for the assets, collateralized debt securities, credit default swaps, and residential mortgage-based securities, were determined in a frozen market.

I attached a letter I had just received from Nobel laureate and noted economist, Joseph Stiglitz, also requesting release of this information. As he said, the provision of this information is absolutely essential to the informed discussion of how the TARP is doing in achieving its goals of restoring stability to our financial system, getting credit flowing, and reducing foreclosure rates.

So far, I have not received an answer. However, the Wall Street Journal seems to have gotten some of the information I asked for, from a confidential source. On Saturday, they published a list of some of the banks that have reportedly received the money, and some information about how much they have received.

Now we have a situation where elected representatives of the taxpayers are denied this information, even when it's leaked by confidential insiders to major publications.

This raises serious questions about how decisions on the use of TARP funds are being made, and who, exactly, is accountable to the American people.

The reports done by the Congressional Oversight Panel, to date, including the most recent on foreclosure mitigation, and the report on valuation of Treasury's purchases of preferred stock, show that, due to poor design and execution of the Bush Administration, we have almost no information about where the TARP funds have gone and whether they are making any difference.

The two GAO reports likewise note that the TARP lacks adequate systems of tracking and accounting for expenses. We are in desperate need of information and data in order to make informed decisions.

Last week, I introduced a bill that will take one step in the direction of getting more data. H.R. 1242 would create a central government database for the use of TARP review bodies, with real-time financial information on TARP recipients, from municipal government entities to which these financial institutions presently report, putting all of the information the government has now, in one place, so it can be effectively analyzed and studied.

My bill will require this data to be translated into a standard format that would enable a comparison of information, so that trends or totals can easily be seen.

The fact that this data would be available in real time, would enable the oversight bodies to spot misdirection of the program, before it's irreversible, so that preventive action could be taken.

We would not be here months after the fact, asking how much the government paid who for what; we would have known right away and been able to decide whether to let other similar purchases go forward or not.

There are other legislative proposals, as well, that call for greater accountability and transparency, such as the bill that passed the House in January, H.R. 384. These bills lay down in no uncertain terms, the marker that this Congress expects better use of the second tranche of TARP funds than was made of the first.

We have to find a better balance between how the TARP is being administered and the public's right to know how this money is being spent. Transparency and accountability must be transformed from slogans into achievable actions.

I look forward to the testimony.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 36.]

[Letters from Representative Maloney to Ben Bernanke and from Joseph E. Stiglitz to Representative Maloney appear in the Submissions for the Record on pages 37 and 39, respectively.]

**Chair Maloney.** I recognize my colleague and good friend, Ranking Member Senator Brownback.

## OPENING STATEMENT OF THE HONORABLE SAM BROWNBACK, RANKING MINORITY, A U.S. SENATOR FROM KANSAS

**Senator Brownback.** Thank you very much, Chairwoman Maloney. I appreciate your statement, I appreciate your holding this hearing. I think it's really important that we look at these issues on transparency and accountability of the TARP.

It was created as a $700 billion program under the Emergency Economic Stabilization Act of 2008. My understanding of the Oversight Panel's report, thus far, is that Treasury has been less than forthcoming in its explanations of what it has accomplished with an allocation of up to $700 billion of taxpayer money.

This is certainly unfortunate. Ordinary taxpayers would like to know what the taxes are doing, that are financing Treasury's efforts, are being used effectively.

Taxpayers and financial markets worldwide would also like to know that there's a definitive plan to address our ongoing financial crisis. When we look at that, I think there's a real question of whether there is.

A constituent of mine is President and CEO of the Federal Reserve Bank of Kansas City, Mr. Thomas Hoenig, and he did a speech recently that I think should be read by everybody interested in this particular problem that we have today.

It was done over this past weekend. The title of the speech is "Too Big Has Failed." It's about the financial system and efforts to deal with the financial crisis.

He delivered this on March 6th, and he said—he identified that, quote, "We have been quick to provide liquidity and public capital, but we have not defined a consistent plan."

I agree with President Hoenig, and I believe that there is a large amount of uncertainty about how we will deal with the pressing problems in our financial system.

This uncertainty is preventing us from moving forward. Until there is resolution of uncertainty about how we are going to shore up our financial system, there is little reason to expect private capital to flow into our financial system.

Private money is simply waiting on the sidelines until there is a resolute signal about who will absorb losses and how the banking system will be structured, moving forward.

President Hoenig identifies that while we prefer not to use the term, "nationalize our major financial institutions," we are nevertheless drifting into a situation where institutions are being nationalized piecemeal, with no resolution of the crisis.

The term, "nationalization," is not well defined. We have, by some definitions, already effectively nationalized some major financial institutions such as AIG. It seems to me that it would be prudent to avoid fascination with the term, "nationalization," and move to definitive steps to address the difficulties of our nation's financial institutions and resulting credit crunch, which involves severely interrupted credit flows and the negative consequences such as businesses' inability to finance payrolls and expansion, and households' inability to weather our current severe economic downturn, thus the term, "zombie banks," that is floating around so much.

Rather than arriving at definitive steps to address our financial problems, it seems that the Treasury, under past and current Administrations, has chosen to adopt half-measures and incomplete plans.

Financial markets are certainly not buying it. Judging by stock prices, generally, and stock prices of potentially troubled financial institutions, in particular, there is little to no confidence in the plans of Treasury and the Administration to move us out of our financial malaise.

Today's hearing is useful in helping to identify both what has been done with massive amounts of taxpayer money to address our challenges in financial markets, and what is planned by Treasury and the Administration, as we move forward.

My hope is that the Treasury and the Administration will come forward with a resolute plan to face up to the difficulties in our financial markets.

We need a plan that offers hope to markets, and not a plan that raises more questions and more uncertainty. We also, as the Kansas City Fed Chairman pointed out—or Fed President has pointed out, has clearly articulated, we need to move definitively away from a system of finance subject to the threat of "too big to fail."

In his insightful words, he said, "Too big has failed." I ask that his speech be placed in the record at the end of my comments, and I look forward to the panel's presentation. Thank you for the hearing.

[The prepared statement of Senator Brownback along with the report "Too Big Has Failed" appear in the Submissions for the Record on page 41.]

**Chair Maloney.** Thank you for your thoughtful statement. Congressman Hinchey, for three minutes, to be followed by Congressman Brady for three minutes.

## OPENING STATEMENT OF THE HONORABLE MAURICE HINCHEY, A U.S. REPRESENTATIVE FROM NEW YORK

**Mr. Hinchey.** Well, thank you very much. I'm anxious to hear the testimony of all four people here today, because they have a very good insight into what is going on here.

I'm sure that they are going to be focused on the most important aspects of it, and I thank you all very much for being here with us. We're looking forward to hearing from you.

The issues that we're concerned about, are how the so-called TARP bill is being handled, how that money is being spent. What is the accountability and the context of that spending?

Who has gotten the money? What have they done with it after they received it? Why was it given to them in the first place?

And with what they did, what were the results? Have they achieved anything significantly, as a result of that spending?

We know that under the Bush Administration, about $380 billion were provided to the banking institutions, and that was done very, very quickly.

We also know that there are some serious issues with regard to the accountability of those funds. All of these things are very critical.

There is an interesting, sort of ironic amount of attention being focused on the two percent of the so-called "earmarks" in the $410 billion budget bill that was passed by the Senate yesterday, and a lot of attention being given to that little two percent, while very little attention is being given to the $700 billion in the TARP bill, the $380 billion that has already been spent and given to banks, and the lack of accountability with regard to how that $380 billion already has been spent. Actually, the number now is higher than $380 billion.

So all of these things are very critical issues for the economy and the deep and dire economic circumstances with which we are dealing and which we are supposed to be solving.

So, again, I thank you all very much for being here, and I'm very interested and very anxious to hear what you can tell us about the way in which this situation is being dealt with. Thank you very much.

**Chair Maloney.** Congressman?

## OPENING STATEMENT OF THE HONORABLE KEVIN BRADY, A U.S. REPRESENTATIVE FROM TEXAS

**Mr. Brady.** Thank you, Madam Chairman, for holding this meeting. I am pleased to also welcome the panel of witnesses before us.

But today, I think there is a great level of frustration about the TARP program. When President Bush first proposed it and the Democrat Congress led the effort to approve it, it was believed that the Congressional Oversight Panel would be the eyes and ears of this nation and of this Congress.

Yet, here it is three months after the panel was formed, and, to my knowledge, you have no approved budget, no approved oversight plan, have yet to hold any public meetings with Treasury officials. The basic question of how is our money being spent and what are the results, is still unresolved.

I'm hopeful that you'll address that today, and if there are road blocks, if you have a lack of resources, or if there is some problem with doing your job, I think it needs to be raised. I appreciate having private meetings with Treasury, but the truth of the matter is, there's too much secrecy in this TARP as it is, and we need transparency and accountability and results from the Congressional Oversight Panel on this important issue.

TARP certainly raises a number of very troubling issues, but the central one, is why we still do not have a credible, effective, and transparent financial rescue plan in place.

Economists and financial experts agree that nothing else we do will matter much, until the issue of how to dispose of toxic bank assets is resolved.

The Treasury proposal unveiled last February 10th, has not been well received, because it did not clearly address this issue. The Economist Magazine, for example, characterized it as "timid, incomplete, short on detail."

Over the last several weeks, the financial press had daily noted how the lack of specifics, undermines confidence and is contributing to more uncertainty and more financial market instability.

As observed by Business Week, following the announcement of the Treasury plan, the stock market was down on sketchy details, and, last week, the Financial Times noted that since the Treasury plan was unveiled, the S&P has declined 20 percent.

So the lack of details is hurting, not helping our recovery. Despite the fact that a timely economic recovery is entirely dependent on an effective and credible plan for dealing with the toxic assets, the Administration, so far, has failed to provide one.

The lack of a clear policy framework, raises fears about undue political influence and meddling, and is deterring new private investment in banks.

Financial decisions regarding bank lending, investment, and capital structure, shouldn't be politicized. Policymakers do have an important role to play in setting appropriate ground rules, but this should not include micromanaging the banks.

There's much to criticize in the TARP, as well as other financial bailouts, but the key question facing the country, is, is the government policy regarding these toxic assets.

The Administration so far has been focused on other priorities, whether it be tax increases or climate change, instead of the critical and pressing need for a clear resolution to the banking crisis.

And while the Administration devotes its attention to pushing its budget with huge increases in deficit spending and federal debt, financial markets and the economy seem daily in greater distress.

However, a financial recovery plan may cost Treasury up to a trillion dollars more, this means that Congress should not enact costly new deficit spending measures that the country cannot afford.

I am afraid that we have misplaced priorities in the budget that is based on rosy economic forecasts that simply cannot come true. In fact, in recent days, the new blue chip consensus forecasts a 2009 GDP decline of 2.6 percent. That's twice the rate that is included in the President's budget. The unemployment rate has already hit their estimate for the entire year.

I think we need to focus on the resolution of the banking crisis as the best way to establish a reasonable prospect for economic growth. That's the key issue before us. Thank you, Madam Chairman.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 46.]

**Chair Maloney.** Thank you so much. Senator Klobuchar, for three minutes?

**OPENING STATEMENT OF THE HONORABLE AMY KLOBUCHAR, A U.S. SENATOR FROM MINNESOTA**

**Senator Klobuchar.** Thank you very much, Madam Chair. Thank you and thank you to our witnesses for being here. Thank you for holding this hearing today to talk about the oversight and the transparency of the federal programs that use American taxpayer money to stabilize our financial system.

Since this financial crisis erupted in the Fall of 2008, our Government has distributed hundreds of billions of dollars to a variety of programs and initiatives that are intended to stabilize the banking system, intended to stimulate the credit markets to resume lending.

They are intended to help homeowners prevent foreclosures, and they are intended to create jobs in our communities.

I, for one, believe that we need to do this, so that we can't just put our heads in sand and pretend that this is isn't happening. But with this decision and with these bold moves, comes a responsibility, and that responsibility is to make sure that we protect the American taxpayers' money and that we get back as much as we can every step of the way.

And my concern from the very beginning, when we first—when this first came up in the Fall, is that there has been too little accounting for how this money has been distributed and how the taxpayer assistance is being spent.

I likened it the other day to the Wall Street—driving down Wall Street in their Ferraris and the Government sort of following behind in a Model T Ford.

I think we can improve that, and I believe that this Administration is devoted to improving that, so that we can show exactly—I like the President's idea to put on the Internet, where these funds are being spent, the TARP funds.

I like the idea of showing a timeline to the taxpayers, of when and how some of this money is going to be paid back. We have one bank in Minnesota, Twin City Federal, that got hundreds of millions of dollars, that is now wanting to pay that back now.

There are small banks in our state that I have pointed out many times, and credit unions, that either didn't take money, but are being really tainted by the brush of some of the other banks. I think it's very important for the accountability and for the trust of the taxpayers, as we go forward, that we show how this money is spent, show if there have been failures—and we know there have—and show how we're going to do this going forward.

Because if we do that and we're able to better regulate the financial markets and we're able to better show what's going on, so the people of this country understand it, then I think some of this

broad brush that has been struck on so many of our banks that really didn't do anything wrong, can be lifted, and we're going to be able to get this country on track.

So I really see this not as much as posturing, but as much as accountability for the money, but also getting this straight, so that we can move on and allow the economy to start working again. Thank you very much. I look forward to hearing from you.

**Chair Maloney.** Thank you. Senator Casey, for three minutes.

**OPENING STATEMENT OF THE HONORABLE ROBERT P. CASEY, Jr., A U.S. SENATOR FROM PENNSYLVANIA**

**Senator Casey.** Madam Chair, thank you very much for calling this hearing. We appreciate the witnesses. Your testimony is going to be very important today, for a number of reasons:

Principally because there are an awful lot of Americans who don't have confidence with what we did in the Emergency Economic Stabilization Act, what we've done since then on a whole series of oversight initiatives, and the oversight votes that were taken in the Congress on the recovery bill. It all goes back to concern about what the Treasury was doing in the prior Administration, which has led to concerns about where we're headed in this Administration. For all those reasons, we have to give the American people a clearer sense of where this is oversight headed.

Unless we do that, we will not be able to sustain support for any initiative, whether it's what we do with regard to banks, or broader efforts to jump-start the economy.

It is not that we don't have enough legislation or enough programs or enough oversight or transparency, it's that we have 11 different entities required to prepare and submit a total of 18 different types of reports to six different entities, and the complexity causes confusion and concern.

If we continue along the path that we're on right now, we're going to erode confidence that the American people have a right to expect in our—not just our financial system,—but in our government. We need to display that we can get it right, that we can streamline the oversight, that we can have clear and identifiable transparency, which is, and that there's one place that people can go to for information about how their government is spending their money.

Until we get this right, we're not going to have the confidence of the American people; and those of us in government need their confidence to sustain these policies over time.

So we have a long way to go, in terms of exploring how the Economic Stabilization Act has been implemented, what was right or wrong with the law in the original drafting and the implementation of the policy.

Today's hearing will help us, but will not solve all of our problems. Until we give the American people a better sense of where we're headed, there's still going to be real concern, and, frankly, a lack of confidence in what their government is doing. Thank you.

**Chair Maloney.** Thank you. Congressman Burgess, for three minutes.

## OPENING STATEMENT OF THE HONORABLE MICHAEL C. BURGESS, M.D., A U.S. REPRESENTATIVE FROM TEXAS

**Mr. Burgess.** Thank you, Madam Chairman. I won't take the whole time, but I will submit an opening statement for the record. I would just like to point out that Bill Clinton, when he took office—and I was no great fan—he talked about focusing like a laser beam on the economy.

I truly believe that we need that type of activity right now, and constantly going from one social program to another, right now, the economy is the main issue that the American people want us to concentrate on.

I'm grateful to have the members of the Oversight panel here today, and I'm anxious to hear what has been happening with the funding that was provided last October, and if we are asked to provide yet additional funding, what we can look forward to.

Thank you, Madam Chairman. I will submit my statement for the record.

[The prepared statement of Representative Burgess appears in the Submissions for the Record on page 47.]

**Chair Maloney.** Thank you so much. The Chair recognizes Mr. Silvers for five minutes, to be followed by Superintendent Neiman, then Ms. Tichon and then Mr. Pollock. Please proceed.

## STATEMENT OF MR. DAMON SILVERS, ASSOCIATE GENERAL COUNSEL, AFL–CIO; AND DEPUTY CHAIR, CONGRESSIONAL OVERSIGHT PANEL FOR THE EMERGENCY ECONOMIC STABILIZATION ACT, WASHINGTON, DC

**Mr. Silvers.** Thank you. Good morning.

**Chair Maloney.** Good morning.

**Mr. Silvers.** I would like first to express my thanks to you, Representative Maloney, for inviting me and my colleague, Richard Neiman, to appear today before the Committee.

I should note at the outset, that my testimony today is mine alone, and does not necessarily reflect the views of the Congressional Oversight Panel, as a whole, or its staff.

I'm going to speak briefly about the general role of the Panel, and then address the Panel's work in valuing the preferred stock purchased by the Treasury under the TARP program, which is the vast majority of the expenditures made, literally, of taxpayer dollars.

Superintendent Neiman will address our latest report on the mortgage crisis.

The Congressional Oversight Panel was created as part of last year's Emergency Economic Stabilization Act, or EESA.

The Panel began our work in our first report issued in December, by asking ten basic questions about TARP, starting with the question, what is Treasury's strategy, and including the question, is the public receiving a fair deal in TARP transactions?

This first report had only one substantive recommendation; that the public has a right to know how financial institutions that have received public money, are using that money, and, quote, "that the Treasury should be responsible for holding individual institutions accountable for how the use the public's money."

While the Treasury Department, under both the current and prior Administrations, has committed to the concept of tracking the use of TARP money by financial institutions, in principle; the specific plans for doing so, have not been released, to date.

The Panel thought that it was not possible to begin to answer questions like, "did the public get a fair deal," without understanding first, exactly what deal the public did get in the transactions completed under TARP last year.

The Panel retained Duff and Phelps, the world's largest independent valuation firm, to assist us in this inquiry overseen by Professors William Goetzelman of the Yale School of Management, and Deborah Lucas of Northwestern's Kellogg School of Management. Professor Lucas is the former Chief Economist of the Congressional Budget Office.

They were joined by Adam Blumenthal, the former Deputy Comptroller of New York City.

In parallel, the Panel engaged a legal team with experience in both bank rescues and preferred stock transactions, to review the legal terms of the TARP transactions.

This valuation and legal analysis, had a limited purpose: To understand and place before the public, the extent to which the TARP transactions had been investments that obtained fair value for the taxpayer and the extent to which they were subsidies to the recipient banks and their shareholders.

We did not attempt to answer the question of whether subsidies were a good idea or a bad idea; whether the TARP transactions created public benefit that made them worthwhile, or whether that same public benefit could have been created without the subsidy.

In their 700-page report, Duff and Phelps found that the 2008 TARP transactions ranged from preferred stock purchases that delivered close to full value to the government, in the case of the strongest banks at the time, where the discounts were five and seven percent in the case of USBanCorp and Wells Fargo, to purchases that at the time they were made, delivered 50 percent or less of their face value to the government in the case of the purchase of AIG preferred stock and the second purchase of Citigroup preferred stock in November 2008.

The Panel found that the key structural reason for the failure to obtain securities that were worth their purchase price on a market-value basis, was the decision to offer the same price to all the banks in the initial purchase and the apparent decision to only vary the terms of the second Citi investment to a small degree, from the terms of the investments in, quote, "healthy banks," made under the Capital Purchase Program.

Once the decision was made to offer all banks the same terms, in order to attract the participation of relatively healthy banks, those terms had to be ones that would be attractive to healthy banks, and, thus, would offer a subsidy to weaker banks.

The Duff and Phelps study led to the conclusion that through the end of December, the TARP program had involved a $78 billion subsidy to all 311 Capital Purchase Program recipient banks at the time of the report.

However, Duff and Phelps found that more than half of the subsidy in the program, as a whole, went to two institutions—AIG and Citigroup.

This analysis has clear implications for future TARP transactions with weak financial institutions. Because we are not trying to drain cash from banks, there is no way to protect value for taxpayers by charging interest in the form of preferred dividends adequate to compensate the taxpayers for the very real risk of further losses in the preferred.

The only way to do so, is to take a large percentage of the upside in the form of common stock, warrants for common stock, or other equity-linked instruments. In the case of the weakest banks, it appears to me that even if the government took 100 percent of the future upside, we would still not be able to receive securities worth the value of the funds we would infuse into such weak banks.

It may still be in the public interest to do such transactions, but we should not fool ourselves or the public, that we are receiving, in the form of securities, full value for the public's money, and the less we ask in terms of common equity, the greater the subsidy will be.

Our valuation report relied entirely on publicly-available data. The Panel did make a broad request of the Treasury Department, pursuant to our authority under Section 125 of the EESA, on December 17th.

In a letter dated December 24th, the Department declined to provide the material we requested, and raised concerns about our newly-formed panel's internal controls over confidential documents.

Despite extensive discussions between our staff and the Treasury Department, Treasury has only produced a small number of the documents the Panel requested.

To Congressman Brady's question, we have sought, from the beginning of our existence as a Panel, to have the Secretary, the prior Secretary and the current Secretary, appear before us in a public hearing.

We made a formal request of the prior Secretary, which was never responded to formally. We have made a request of the current Secretary and that request is being discussed with the Department.

It is of significant and prime importance to us that the Secretary appear before us in a public hearing.

Finally, this matter relates to a matter of concern to this Committee. Although it was not the primary purpose of our document requests, I had expected that our December request, would result in the Panel being informed as to the identities of the counterparties to derivative transactions who were made whole as a result of the funds provided, both by the Federal Reserve Bank of New York and the TARP, to AIG.

The Panel currently does not know for certain, the identity of those counterparties or the amounts they received, although, like the Committee, we are aware of press accounts on this matter.

The Congressional Oversight Panel is seeking to expand the scope of its analysis of the larger impact of TARP and related programs. The Panel is particularly interested in looking at transactions under the Term Asset–Backed Securities Loan Facility, the

TALF, and potential transactions involving public/private partnerships.

The Panel is also working to define its role in relation to activities undertaken by the Board of Governors of the Federal Reserve, and the Federal Reserve Bank of New York, that are linked to actions undertaken by the Treasury Department, pursuant to EESA.

We are honored to have been asked to appear before you and to assist the Congress in this matter. I apologize for running over, and I thank you for your indulgence.

[The prepared statement of Damon Silvers appears in the Submissions for the Record on page 48.]

**Chair Maloney.** Superintendent Neiman?

**STATEMENT OF MR. RICHARD NEIMAN, SUPERINTENDENT OF BANKS, NEW YORK STATE BANKING DEPARTMENT, NEW YORK, NY; AND MEMBER, CONGRESSIONAL OVERSIGHT PANEL FOR THE EMERGENCY ECONOMIC STABILIZATION ACT, WASHINGTON, DC**

**Mr. Neiman.** Thank you, Chairwoman Maloney and distinguished members. I'm Richard Neiman, Superintendent of Banks in New York, and a member of the Congressional Oversight Panel.

I very much appreciate the opportunity to comment on Treasury's implementation of the EESA. I think this is a very important hearing. I appreciate you including members of our Panel.

As you know, the Panel is charged by statute to provide monthly reports to Congress, assessing the effectiveness of the Treasury's implementation.

Damon discussed the five prior reports that we issued, and I'll be happy to answer any questions on those. But given my limited time this morning, I will focus on the Panel's most recent report that was issued last Friday, on foreclosure mitigation, which I took a lead role in preparing.

As the only bank regulatory on the Panel and as one who has led his state's foreclosure prevention efforts, I believe I bring a unique perspective to this critical issue. I look forward, however, to the questions from the Committee on the full range of our Panel's responsibilities.

The Panel's March report highlights the symptoms that gave rise to the housing crisis, as well as the major impediments to finding a solution.

The report provides a road map for successful foreclosure prevention going forward, so let me just summarize some of the major impediments that we highlighted in the report.

Affordability: The key to any sustainable modification program is whether the borrower can afford the monthly payments.

A problem that began with exploding mortgage products that may have been inappropriate at inception has now expanded to borrowers who are falling behind for many reasons, such as illness, divorce, or job loss in the economic downturn.

Existing modification efforts have not adequately addressed the critical impediment of affordability, leading to high rates of re-default.

The voluntary modification efforts often leave the borrower with the same or even higher monthly payments, through repayment plans or capitalization of amounts past due.

The Panel is concerned that the commonly-used housing payment ratio of 38 percent of the borrower's gross income remains too high to be affordable, and is encouraged by President Obama's foreclosure plan that targets a 31 percent housing ratio.

Negative equity is another impediment that can occur when property values decline or if appraisals are overstated. Borrowers in this situation, are unable to refinance and cannot sell the home, unless the lender agrees to reduced payoff in a short sale.

Panel data shows a strong correlation between high negative equity and default, however, this is not necessarily evidence of a causal relationship.

Further, I should note that the survey data that we relied on, received from the federal banking agencies, was limited by the lack of current borrower income information, which may have underestimated the importance of affordability in this result.

Securitization: Mortgages that have been securitized are subject to the terms of pooling and service agreements that may present obstacles to loan modifications. These PSAs often contain restrictions on the number of loans within the pool that may be modified and the circumstances under which modification is permissible.

As modification and other loss mitigation outcomes may impact various tranches of investors, litigation risk does exist and is a disincentive for investors to engage in modification.

A safe harbor from litigation for servicers that modify loans, as contained in the House bill, would help to overcome this impediment.

Service incentives: The fee arrangements for servicers can also create misaligned incentives. In particular, servicers need incentives to engage in intervention while borrowers are still current, but when default is imminent.

The Obama plan does address this issue by providing incentive payments to services for early outreach, as well as pay-for-success incentives to both servicers and borrowers, based on performance of the modified loans.

Other impediments that I have highlighted in my testimony go to borrower outreach, capacity of the servicer, the resources used by the servicer to handle the millions of mortgages that we're dealing with, as well as issues around junior mortgages.

The President's plan addresses many of these critical elements, particularly those focused on affordability and servicer incentives, and it estimated to help seven to nine million homeowners at risk.

Now, while these projections are encouraging, the Panel has additional areas of concern that are not fully addressed. In particular, the plan does not include a safe harbor for servicers operating under pooling and service agreements, to address the potential litigation risk.

And while the modification aspects of the plan will be mandatory for banks receiving TARP funds going forward, the level of broader industry acceptance remains unclear.

We will continue to monitor implementation of the plan and advise Congress and the American people accordingly.

Now, there is one more important recommendation that I would like to highlight to this panel that we included in our report, and that goes to the adequacy of mortgage loan performance data.

Access to complete information on foreclosures and loans in default is currently unavailable, and the reason is simple: There is no mortgage loan performance data requirement for the industry.

Congress and the regulators need to have much better data available, so they can ensure the smooth and efficient functioning of the national housing finance market, and to prevent future crises.

This is why the Panel believes that Congress should create a national mortgage loan performance reporting requirement applicable to banking institutions and others who service mortgage loans, to provide a source of comprehensive intelligence about loan performance, loss mitigation efforts, and foreclosures.

This is something that you did when you adopted HMDA with respect to new mortgage originations.

Federal banking or housing regulators should be mandated to analyze such data and share the results with the public. We cannot solve this financial crisis without dealing with the root of the problem the millions of American families who at risk of losing their homes to foreclosure.

I appreciate the opportunity to share my views, and hope the dialogue between the panel and this Committee becomes a regular occurrence. Events are developing rapidly, and many of the tools needed to respond are best accomplished with the support of progressive legislation.

I'd be pleased to provide more details on the Panel's work to date, or answer any questions. Thank you.

[The prepared statement of Richard H. Neiman appears in the Submissions for the Record on page 51.]

**Chair Maloney.** Thank you so much. Ms. Tichon?

**STATEMENT OF MS. NICOLE TICHON, TAX AND BUDGET REFORM ADVOCATE, U.S. PUBLIC INTEREST RESEARCH GROUP, WASHINGTON, DC**

**Ms. Tichon.** Thank you, Madam Chair Maloney, Committee members, and distinguished panelists. Good morning.

We, too, are very pleased to be part of this critical conversation. My name is Nicole Tichon and I am the Tax and Budget Reform Advocate for the U.S. Public Interest Research Group.

We serve as a federation of state PIRGs, which are nonprofit, nonpartisan, public interest advocacy groups that take on powerful interests on behalf of our members.

Taxpayers have lost a lot of their own investments, their pensions, retirement savings, and education savings, and in their first mass investment into the banks that failed them, they were undersold by $78 billion, according to the Congressional Oversight Panel, and, so far, we get approximately 67 cents on each dollar they have invested so far.

That gap is likely to get larger, as we learn more and more about the truth of the financial health of these companies. This hardly inspires confidence that taxpayers will be seeing much of a return on their investment, and prompts more questions than answers.

A number of bills and amendments have surfaced in the House and Senate, with respect to what was known as the Troubled Asset Relief Program, TARP, to get to these answers, but few have made it to law.

This tell us quite a bit about the outstanding concerns over these programs. USPIRG's position is very straightforward: Congress should take specific action to make transparency and accountability requirements law.

This would give the Treasury Secretary and the Administration, a comprehensive tool set to help them manage these programs, and also to make sure that the oversight of these activities, ensures that they are applied completely and consistently across all institutions.

Transparency and accountability requirements, should not be viewed as punitive. This not a "gotcha" game. This is the future of our economy, and, quite frankly, if CEOs insist that they are gaining strength and momentum, then we want to know what's working.

And, on the flip side, if the situation does not improve, then Congress and the Administration, should demand to know what's not.

Making these requirements, law, is the most fair way to approach this, for both the government and the participants. Everyone starts with the same information and the same expectations.

That way, if an institution is not complying, the law can require them to return the funds.

Government leaders and financial institutions should see this as an opportunity, if anything else, to restore some of the confidence back to the American taxpayers.

In February of this year, PIRG issued our first quarterly report card to track progress on transparency and accountability. Since then, there have been varying degrees of progress on several line items.

Some of the key reforms where progress has been made, include Treasury's use of online resources to provide information and reports, as well as eligibility assessments for the public, however, taxpayers and consumers would prefer something more dynamic and searchable for contract agreements.

Treasury has also begun the process of sending monthly surveys to the 20 largest fund recipients. USPIRG agrees with the general—we agree with GAO that this request for information, should be program-wide and not limited to the largest recipients only.

A request by the Special Inspector General for reports on the initial disbursement of funds, was made to all of the recipients in the first tranche. Taxpayers are very anxious to know these results.

In addition, consumers and taxpayers would like to know that the following requirements be included in any new accountability and transparency efforts: With respect to reporting, we'd like any reporting and oversight activities to be consistently applied; to relate—to make sure that they relate to the goals and objectives and to the original program and that they are posted online.

Finally, we would like these reports to make every effort to equate outcomes to things that help taxpayers and are meaningful to them.

From a strategy and operations perspective, taxpayers would like to see the following items addressed: The public is still unclear as to the reasons for the initial, seemingly ad hoc programs created for the first $350 billion disbursement, and would like the public provided with a more detailed explanation for the most recent shifts described in the Financial Stability Plan.

The restructuring agreements with Citigroup and AIG, demonstrate another change in strategy, and one that may put taxpayers at additional risk.

Finally, we would like to see additional governance guidance around internal operations, accountability, leadership, strategic planning, and items such as that, which would make the banks more accountable for achieving success and help us feel more confident that they are not going to repeat the mistakes of the past.

Taxpayers and consumers deserve an open and fair government that will not take them nor their investment, lightly. Thank you, and I look forward to your questions.

[The prepared statement of Nicole Tichon appears in the Submissions for the Record on page 53.]

**Chair Maloney.** Thank you. Mr. Pollock?

**STATEMENT OF MR. ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, WASHINGTON, DC**

**Mr. Pollock.** Thank you, Madam Chairman, Ranking Member Brownback, Congressman Brady, Members of the Committee.

The United States and many other countries once again now demonstrate the dilemmas of the recurring historical experience of using public money to offset the losses of banks in the name of economic stability. As I noted in my written testimony, debates about this go back at least to 1802.

In my view, it's imperative to have a clear accounting for the financial results of all such bailout operations. As we know, government bailouts make the 60 percent of households who actually pay federal income taxes, into involuntary investors, either investors in bank equity, in distressed assets, or both.

How can these involuntary investors and their Congressional representatives figure out what's happening to the money? Senator Casey rightly pointed out the overlapping complex reporting we've got, so, first and foremost, I believe we need something really simple and powerful.

This is that all the activities of the TARP program, should be isolated in a separate accounting entity, preferably a government corporation, one that would be Treasury-guaranteed. This entity, in my view, should have to borrow on its own balance sheet to finance the investment it makes.

All investments and other assets, all related borrowings, other liabilities, all expenses, and all income, should be clearly measured as if TARP were a corporation. This would be most straightforward if it were, in fact, a corporation like the Reconstruction Finance Corporation of the 1930s was.

An audited balance sheet and income statement should be regularly produced. The bailout operation's retained earnings or accumulated losses, will show its results life to date. In my view, Con-

gress should require such a regular and disciplined accounting by TARP.

Looking forward, as well as measuring backwards, should also be businesslike. Congressman Hinchey mentioned the large TARP outlays. It seems clear to me that Congress should certainly demand a clear forecast of next year's TARP activity and results, before it approves any federal budget.

The investments the taxpayers are involuntarily making might, in the end, have an overall positive return, as asset prices recover, as they inevitably will.

It's my view that if there is a profit in the end, 100 percent of any such profit should be earmarked as explicit dividends to the taxpayer investors. These could be in the form of cash or specific tax credits.

It seems to me that this would be a well deserved recompense for the majority of the citizens who bought houses they could afford, paid their mortgage loans on time, didn't engage in leveraged speculations, paid their taxes, and then paid for and took all the risk of the bailout efforts.

That would represent real accountability to the real investors.

Looking back a good way, it seems to me that a fruitful historical comparison can be made between TARP and the Reconstruction Finance Corporation, the bank bailout operation of the 1930s, which made investments in more than 6,000 banks in its day.

Set up under President Hoover, then expanded by President Roosevelt, the Reconstruction Finance Corporation, or RFC, was run for most of the time by a forceful and very experienced character named Jesse Jones (a successful entrepreneur from Texas, and, of course, a Democrat, by definition, in those days), whose formal schooling had ended in the eighth grade.

So, since he never started high school, Madam Chairman, he didn't get the chance to be a high school dropout.

As described in my written testimony, the RFC had a logical crisis model. This model is also discussed in Fed President Hoenig's speech, Senator Brownback, which you cited. At one point, the RFC held capital in about 40 percent of all the banks there were, but, in the end, it had no net cost to the taxpayers.

A key lesson of this experience, in my view, is that organizations are important, but more important for accountability, is **who** [emphasis added] is running them. In addition to making sure TARP has disciplined accounting, I think we need to find a modern day Jesse Jones to run our bailout operation.

Thank you very much again for the opportunity to share these views.

[The prepared statement of Alex Pollock appears in the Submissions for the Record on page 75.]

**Chair Maloney.** Thank you, thanks to all of the panelists for your testimony.

I'd like to ask this to Mr. Silvers and Superintendent Neiman. There has been substantial controversy, because $60 billion federal funds was reportedly used by the Fed to buy collateralized debt obligations, or CDOs, that were insured by AIG credit default swaps.

Do you know whether TARP funds were used for these purchases, and do you think the government should be covering the bets of the CDO buyers this way?

**Mr. Silvers.** Madam Chair, I do not know for certain that no TARP funds were used. I believe that those purchases occurred, using Fed Funds, using Federal Reserve Bank of New York Funds, but I am not certain.

The structure that is being contemplated today for TALF, involves a slice of TARP funds supporting a large Fed funding structure, and there would be an issue—and it's also an issue of kind of the fungibility of money here. The TARP fund were provided to the Federal Reserve Bank of New York on behalf of AIG and were disbursed from there.

Again, I believe those were largely used to—based on press reports, I believe those were largely used to cover counterparty obligations in credit default swaps and other derivatives transactions, and not to purchase CDOs, which—the purchase of CDOs has a similar effect. That's the extent of my knowledge.

In respect to your question of whether that's a good idea or not, here is the—I think there are several issues in play here.

One of them is the question of systemic risk related to AIG's inability to meet its obligations broadly in the derivatives markets. Based on the size and the scale of their derivatives obligation, it seems to me there is a significant systemic risk issue embedded in that problem.

The second question is: What is the best way to deal with that? Those expenditures raise a question as to whether—to the extent the operations with AIG with counterparties are having the effect of propping—of really significantly focusing federal funds toward specific counterparties, whether it was wiser to do that indirectly through AIG or whether perhaps we ought to have looked directly at those counterparties.

There is no way to answer that question without knowing exactly how much money was disbursed on behalf of AIG to counterparties, information we don't have despite those press reports many of which are inconsistent with each other.

**Chair Maloney.** I think you're pointing out the need to get this information so we can make informed decisions.

Superintendent Neiman, would you like to comment on this?

**Mr. Neiman.** I would just like to clarify and distinguish the program under which those Fed funds were provided to AIG, and to distinguish the fact that that was done under the systemically significant failing institution program which has different and broader objectives than the capital purchase plan.

In a program to assist AIG, we can't lose sight of the fact that it was to prevent a disorderly failure of systemic institutions as well as the tag-along effect it would have on counterparties and other institutions.

So I think when we come back and look at these programs, we do have to keep in mind the objectives of the program.

Having said that, I think the transparency issues that you raise are a separate issue. And I did listen to Mr. Kohn's testimony, Vice Chairman Kohn's, and that was something they said they would take back to the Federal Reserve.

As a regulator, I certainly understand the issues around confidentiality of individual information, but I think in this day and age that is something that all regulators should be revisiting.

I am not going to opine on how they should come out at this stage, but it is certainly an issue that regulators are revisiting.

**Chair Maloney.** Mr. Silvers?

**Mr. Silvers.** Yes. My colleague's comments raise an additional point that I would like to expand on for a moment, if you will indulge me.

I think it is important for the Committee to be fully aware of the, currently the three programs under which the funds have been disbursed to financial institutions under TARP, and their differences.

The Capital Purchase Program was the initial TARP Program. It was the program under which all of the initial October disbursements were made, in the form of purchases of preferred stock. And all of the purchases of preferred stock from smaller banks have been made under this program. It has only one criteria, which may seem a little odd. The criteria is that you have to be healthy. You have to not need the money in order to get it. Because the purpose of—the stated purpose of the program is to provide liquidity to banks who are in a position to then pass that liquidity on to the larger economy.

It is somewhat—it raises questions that money was provided under this program in October to banks which very quickly became not so healthy. The ones that are obvious are Citigroup and Bank of America.

The second program, as Superintendent Neiman mentioned, is the Systemically Significant Failing Institutions Program. Only one institution has received money under that Program, and that institution is AIG.

The Panel raised questions in its second report as to why other institutions that appeared to fit the definition of a "systemically significant failing institution" were not funded under that program when they came back to Treasury seeking additional funds.

Those institutions are Citigroup and Bank of America.

Citigroup and Bank of America got funding in November of 2008, and then Bank of America got funding in January of 2009, additional funding and guarantees of assets in their portfolios.

In the case of the Citigroup funding in November, it was not done under either existing program. It had no programmatic home when it was done. At the end of December, the Treasury Department created a new program, the Targeted Asset Program, whose criteria are, shall we say, more general than either the Capital Purchase Program or the Systemically Significant Failing Institutions Program.

The Citigroup transaction was placed in that program after the fact, and then the Bank of America transaction in January was put in that program.

I should note that one striking content—one striking distinction of the Systemically Significant Failing Institutions Program is that, as the Committee has noted in this hearing, that the government took 80 percent of the upside of AIG as part of that program through obtaining warrants in AIG stock.

The upside that was taken under the CPP Program in Bank of America and in Citigroup when they were deeply troubled was no greater than the upside taken in healthy institutions under the Capital Purchase Program as a percentage of the preferred stock purchased in those programs.

**Chair Maloney.** Thank you. My time is expired.

Senator Brownback?

**Senator Brownback.** Thank you, Madam Chairwoman.

I am old enough to remember the pieces of old acts like even on The Ed Sullivan Show, and there is one that comes to my mind of what we've been doing lately, the one where the guy has a stick and he puts a plate on top of it and starts twirling the plate, and then he starts another one, starts another one, starts another one, and he starts about ten of these, and by the time he starts the tenth one the first one is getting ready to fall off, so he runs back and he twirls that one again, and then the third one, and he's bouncing back and forth, and that is what really reminds me of what we've been doing, it seems like, since this thing first started falling apart last year.

It is like we're going from one crisis, lurching to the next one, and we've got to do this, got to do that. We rush bills through. We don't do proper oversight on it. And at the end of the day all the plates come crashing down. And that it's—that we're not—we haven't developed something that is a sustainable, or set, or consistent, or predictable model for the marketplace to look at.

And at the end of the day it seems like we have driven private capital out of the system by this ad hoc system and its unpredictability.

We have got more—if I remember my numbers correctly—we have got more private funds sitting on the sideline right now than at any time we have had in the past 20 years, and it is sitting there. The market is plummeting, and the financial institutions are as well, and this was all supposed to be stopped by us jumping in and fixing it and doing it, and doing it now.

I really think it is time for us to sit back and get to a predictable type of system. And that is what Chairman—the Fed Chairman in Kansas City, or president in Kansas City was writing about, was he looked at the prior models of what we have done when we have had financial institution problems, and we've had a fair number of these happen in the history of the country and in the history of the world.

This is not a new type of crisis. It's a big one, and it is a bigger one than we have seen in the past, but it is not a new type of crisis. And he points to the number of times that we have gone in in a pretty aggressive but predictable and clear way removed management, put in our management to run a place over a period of time, keep the institution running, and then deal with the institution at that point in time at a later phase, or at a time when it can be sold.

And he also points out the Japanese model that he believes was a failed model, which is kind of what it seems like to me we've been following, "too big to fail," we can't let it fail, don't let it fail, don't let it fail, but without any predictable institutional setting.

Mr. Pollock, I presume you have read Mr. Hoenig's paper. I gather from your testimony you agree with that analysis and do you think now is an appropriate time? It's past time in my estimation. But to get to some sort of established, stabilized, predictable system for these institutions that have been heretofore deemed too big to fail?

**Mr. Pollock.** Senator, I think that paper makes a lot of good points. In it is the summary of the approach of the old RFC, which I mentioned in my comments. I would just like to run through the four steps, because I think they are quite consistent with your comments. These are as described by Jesse Jones in his most instructive memoirs: "Fifty Billion Dollars: My Years With The RFC."

First, you go into the bank and write the assets to economic value. Congressman Campbell, that is not panic market value; that is what you are really going to collect on the assets. Having done that, you may find the institution is insolvent.

The second point, according to Jesse Jones, is make a decision about the management. Now this is happening before you are putting any money in, and you either decide you have the right people there or you decide they have to be changed. Only after those two steps have been taken do you then put in an investment. The point of that investment should not be, as Mr. Silvers said earlier, to drain cash out of the institution, but to bridge the bust.

And then you look to the private market as soon as possible to recapitalize and refloat the organization. I think that is a really logical approach.

It takes a hard-minded director of the program, like Jesse Jones was. And it takes, in my judgment, an institutional format of a focused institution, which is why I favor the government corporation with a head and a board of directors. It seems to me the right place for a lot of the discussions about who is getting what and why, what is the rationale, would logically take place between a rightly constituted board of such a bailout corporation and its director.

I think if we did that, a lot of the points that President Hoenig makes could be actually implemented.

**Senator Brownback.** Thank you. Thank you, Madam Chairwoman.

**Chair Maloney.** Mr. Hinchey.

**Mr. Hinchey.** Thank you, Madam Chairman.

And thank you very much, once again, gentlemen, and Ms. Tichon, for the testimony that you have given. We very much appreciate it. It is insightful and I think very, very helpful.

There has been a great deal of skepticism about this situation from the very beginning. A number of us here in the Congress were skeptical about the plan that was put forth by Secretary Paulson originally in the form of this TARP bill, and that skepticism for some of us turned into opposition, including in the two bills that passed both Houses here subsequently.

And I think, looking back on it, that opposition is now very much justified. We still don't know how this money was being spent. And furthermore, we have gotten apparently false information from the Treasury Department saying that, in terms of the money that was given to the banks, that there was a return, a complete return on each of those so-called "investments." But the investments have

turned into subsidies, and those subsidies have been made clear by Professor Warren in statements that she has made, and in the response she has given to questions that she has been asked on this particular subject. And I think she has done it very well and very effectively, and I thank you for being here today and talking about the same kind of thing.

Last month the Congress passed a TARP Reform and Accountability Act of 2009, which is in many ways a misnomer of the bill. In addition to other amendments, I introduced one which was passed in the House, which required that information be given as to how much money was given to the banks, where that money was given, what the money was used for, and how effective that use was.

Unfortunately, that amendment, although it passed the House, was not successful and has not yet come into law. But I think we need to continue to engage in that effort in order to get that done.

We need to know where this money is going. And it is getting closer and closer to $700 billion, and probably will end up even higher than that over the course of time.

With regard to the falsification of information—which I say that because it is apparent falsification of information with regard to the return on the so-called "investments"—it seems to me that the Special Inspector General of the Troubled Asset Relief Program ought to engage in an investigation as to how this money was allocated, what it was used for, and how it is only coming back on an average at about 66 percent. In some cases I understand that 8 percent is being lost. In other cases, more than 50 percent is being lost. It varies from place to place.

So I would wonder what you would think about that, about having that investigation initiated and carried out so we can begin to figure out what is actually going on here? Mr. Silvers?

**Mr. Silvers.** Congressman, well first let me say that I have no intention of telling the Inspector General, Neil Barofsky, what he should or should not investigate. That is his determination to make.

I would like to clarify just for a moment the nature of the Panel's finding which you referred to. I should say that Superintendent Neiman and I are here in Elizabeth Warren's absence. We do not speak for her, but we hope that we have some commonality of views.

The nature of what we found, Congressman, was that the market value of these securities on the day purchased was substantially less than the purchase price paid for them, in some instances. And in some instances only a small degree less.

There is the possibility—in fact perhaps with some of the more secure banks the distinct likelihood that taxpayers will be made whole, that money will come back.

There is also the distinct possibility that, that it will turn out that it will not be possible for the money to be repaid without further infusions of government funding. In fact, if you look at the first set of transactions in October money was provided to Citigroup and to Bank of America, and both of those institutions returned and had to get more money.

It is hard not to look at those circumstances and conclude that the value of the initial infusions into those banks had declined between October, the first transaction, and the second transactions in November and January.

The terms of the transactions—and this is in my written testimony—the terms of the transactions, the legal terms, are what Treasury said they would be. That was what our legal analysis found.

But the issue is that an independent valuation did not find that the economics matched the face value on the date of the transaction. And let me just give you one example of the sort of numbers that drive this sort of thing.

Today the market rate for preferred stock in Citigroup is around 20 percent. If you purchased preferred stock today, the implicit rate of return—or the implicit coupon on that is around 20 percent. The November Citigroup infusion paid a coupon rate of I think it was either 8 or 9—I'm afraid I'm slipping on that—but it was substantially below the market rate. That means that in terms of the cash—in terms of the interest rate we are receiving on that preferred stock, which is really what a preferred stock dividend is, it's interest rate—the interest rate is not comparable to what the markets require for compensate—to compensate for the possibility that we might not receive those interest payments in the future should that particular bank weaken further.

That's the nature of the problem. And like I said, I can't—I can't, I can't offer you an opinion as to whether that's a problem that is deserving of the attention of the Inspector General or not. But we did not find—our report does not find that the terms of the bonds were not what they were represented—the terms of the preferred stock, I'm sorry—our report does not find that the terms of the preferred stock were different from what they were stated to be by the Treasury Department.

We found that the economics appear to have been different than what they said.

**Chair Maloney.** The gentleman's time has expired. Congressman Brady for five minutes.

**Mr. Brady.** All right. Thank you, Madam Chairwoman——

**Chair Maloney.** And we are going to be called for a vote shortly.

**Mr. Brady.** Right, Madam Chairman. Thank you so much. Appreciate all the testimony from the panel. Very helpful.

Mr. Pollock, I should note Jesse Jones comes from Houston, the region that I live. Amazing man. Not so certain there are any Jesse Joneses left in the financial world. Some Jessie James, perhaps, left in the financial world— [Laughter.]

But I'm not sure about the Jones. I appreciate the comment by Mr. Silvers and Superintendent Neiman about the need for direct Treasury oversight. I wish our last Secretary would have met with you. I am hopeful, and would urge the new Treasury Secretary to do the same, in a public forum where you can really be the eyes and ears for this Congress.

Let me ask you this: The public is asking, how is my money being spent and what is the result? The financial markets are basically asking, where's the plan? Where is the clear plan for dealing with toxic assets?

Congressional Oversight Panel began with the first question: What is the strategy? So the question still ought to be: What is the strategy? Can anyone on this panel explain exactly what is the Administration's plan for dealing with toxic assets? Because the whole world wants to know.

**Mr. Neiman.** You know the question comes down to building confidence. I think there are two critical efforts to restoring confidence in our markets. That is, one, having investors believe that the capital numbers that banks report are real numbers.

And as those toxic assets remain on those large banks, that will always be an issue. The President's and Secretary's plan to develop a private and public trust to acquire those assets where the government is alongside the private investors is a sound and reasonable plan which we are all, as you are, awaiting the details of how that will be implemented.

**Mr. Brady.** And I agree with you, but that is the problem. That outline has been around now for a month. The market is getting worse by the day, everyone—each hour and day we wait for those details, because as you said it is so critical. Shouldn't coming up with a clear plan be the top priority of the Administration? Does anyone disagree with that?

Yes, sir.

**Mr. Silvers.** Congressman, I think that (a) I think it would be inappropriate—the panel has not received, in our view, an answer to your question from the current Administration, which is our question. We have not received a detailed strategy.

**Mr. Brady.** And you have made that request?

**Mr. Silvers.** We have made that request.

Now in fairness to the Administration, they are—the Treasury Department is clearly enormously challenged both in terms of the people they have in place, in terms of the events that they are trying to manage in the larger markets and internationally.

The panel is not in my view, of the view that the Treasury Department is remiss in not having communicated with us to date.

But I would like to make an observation about strategic considerations here, and I think it goes to what you said about things are—conditions appear to be deteriorating. Now from day to day all sorts of different things happen and stock markets—I think to a certain extent stock markets are over—there is an over-reliance on stock markets as the measure of what is going on here. Credit markets are probably much, much more important. It is just harder to get good data on many of the credit markets.

But here is my strategic observation: I believe it is hard not to look at what occurred in the initial months of TARP and not conclude that the strategic thinking at that time was that we faced fundamentally a liquidity problem and a problem of market irrationality, and that——

**Mr. Brady.** Sure. And, Mr. Silvers, I agree with you on all that, and I am sort of running out of time and I still have another question for the panel. I think the point is that things are changing; it is difficult to stay ahead of it, as it has been from day one; but my point is still every day it gets worse. Every day it is more confusing. A clear, detailed, workable plan both for the markets and for panels like you I think would be very helpful.

Can I ask this very quickly, because I have 33 seconds left—30, 29— [Laughter.]

**Mr. Brady** [continuing]. TARP I, first half, $300 billion, second half another $350 billion. The President's budget has the equivalent of $700 billion for another TARP effort. Do you think that will be the cap? Does anyone on the panel believe that that will be the cap of more investment in this effort? Or will it likely go beyond that? And I will yield.

**Mr. Silvers.** Sir, Nouriel Roubini, who has done what most people acknowledge to be the deepest empirical academic work in this area, estimates that the hole in U.S. bank equity is $1.8 trillion, and the hole in U.S. non-bank financial equity is $1.8 trillion. There is no way I think to look at those numbers and not conclude that there is a reasonable chance more money will be needed.

**Mr. Brady.** Mr. Pollock.

**Mr. Pollock.** I think whatever the number is, Congressman, that Congress should not be about approving a budget until a good estimate of the TARP number going forward is delivered to you all.

**Mr. Brady.**

Okay. Thank you very much.

**Chair Maloney.** Senator Klobuchar.

**Senator Klobuchar.** Thank you very much, Madam Chairman. Thank you all.

I have five minutes, Mr. Silvers, so I will let you finish your point. You were talking—I found it very helpful as you looked at this historically, and you were making a point about when you look back at the original TARP funds that were directed at this liquidity problem, and why don't you complete that thought.

**Mr. Silvers.** Thank you, Senator.

What I was saying was it is hard not to look at what happened in the fall and winter and not conclude that the strategy was to buy time to allow liquidity to return and rationality to return to the markets.

**Senator Klobuchar.** Right.

**Mr. Silvers.** The fundamental assumption was that financial institutions really were healthy, and that the purpose of the capital infusions was to provide sort of a semi-federal guarantee, mostly for psychological purposes, and I think if you go back and look at statements made during that period during September and October by the Bush Administration you would I think pick up that thread.

**Senator Klobuchar.** Um-hmm.

**Mr. Silvers.** While that may be true of some institutions, I believe that there is no way to conclude at this point anything other than that time is not on our side in respect to this problem; that the phenomenon of undercapitalized and crippled financial institutions in a financial sector which is now extraordinarily concentrated, there are more than 50 percent of the deposits are in four institutions in this country, that that is exerting a profound downward pressure on our economy; and that if we allow that to continue that it will not right itself automatically.

And I am very interested in, and intend to read, both Chairman Hoenig's speech and at least something about Jesse Jones, because I think that the notion that we need decisive action here to reverse a downward cycle seems to me to be hard to deny at this point.

**Senator Klobuchar.** So what do you think needs to be done, then, Mr. Silvers? I mean, you can see that the Administration now is looking at these institutions. They're giving these stress tests to try to figure out which ones need the help, which ones don't. I believe that there are some banks and credit unions, and I know that they don't have that 50 percent of the market you're talking about, but on the other 50 percent side there are some that are healthier than others.

And one of my concerns is that the longer this goes on without a clear definition of how we are going to help those institutions that are clearly having issues and we know what we are doing with some of them now, that it is bringing down some of these other institutions in the market.

And that balance I find very hard. Because I know even a few months ago some of them were doing better than they are now, and not necessarily because of the bad deals they made but because of the way the stock market is doing.

**Mr. Silvers.** I think that—and here again I emphasize this is just me; I am not speaking for the Panel—I believe that the basic outline that my co-panelist Alex Pollock referred to historically, which is to determine what the true health of the balance sheets of financial institutions are, which is not the same thing as what the mark-to-market is, and it is also not the same thing as what the par value is, right? It tends to be something in between, to (a) determine that.

And then (b) to determine—and I think it would not be a bad idea, to the extent we are investing the kind of capital—public money we are investing in many of these institutions—to make some assessment of the management. And then to figure out what a plan is for bringing the institutions we need to bring back to life, and to do so at the least cost to the taxpayer. The key issue is bringing institutions back to life.

With respect to smaller institutions, it must be—let me just observe that it must be enormously frustrating to be the CEO, or the director, or a stockholder of a smaller financial institution and to have an application pending before the capital purchase program in which your health, your survivability is going to be passed on by regulators. And to look in your newspaper and read about the rather extraordinary series of circumstances in which clearly unhealthy institutions receive money under the same terms. That must really get you.

**Senator Klobuchar.** Yes. I know some of them. It is frustrating.

**Mr. Silvers.** And—anyway.

**Senator Klobuchar.** And again, I thank you for your testimony here. I guess my other piece I wanted to ask both of you is just what more information you need to do your oversight, because that is what you are supposed to be doing, and we want that piece to work. Because as Senator Casey was saying, I think this trust that you get out of having the oversight, I don't think the American people are unsophisticated here. I think they know that some of this is not going well, and they know that some of the institutions are hanging in there and that they want to get that lending going.

So what do you need to do your job?

**Mr. Neiman.** I would like to respond to that, and also to just pick up on one of the comments that Damon talked about. We can never lose sight of the fact, with all the focus on the balance sheets and the capital of our institutions in this country, we cannot lose sight of another critical factor: and that is restoring confidence in the securitization market that has shut down, and that has played such a critical role in funding consumer and other lending in this country.

And until that market is restored, banks will never be able to make up for the lending that has been withdrawn as a result of that market.

So back to your question on what else can we do? Data. Being able to assess both the use of those funds, how those funds were used, as well as the impact that those funds are having both on that institution, both on the financial industry as a whole, and then on the economy and the capital markets.

I do not think we have at this stage the proper metrics to be able to evaluate the effectiveness of the plan. I know the Treasury has talked about both transparency and accountability. They just started issuing their monthly snapshot with quantitative and qualitative analysis, which we are now assessing that I think will be very helpful. And we also will be in a position to assess whether there should be more information.

I commend Chairwoman Maloney on her bill that is going to create more debate and discussion as to what else is needed. Are there more technological means for banks and government and the Oversight Panel to gather data in order to assess the effectiveness of the program?

**Mr. Pollock.** Madam Chairman, could I just make a quick comment——

**Chair Maloney.** Sure.

**Mr. Pollock.**—on what to do? I would recommend three points:

One, get rid of so-called "fair value" or "mark-to-market" accounting for banks, which is driving the banking system in a downward, negative spiral.

Two——

**Chair Maloney.** We have a hearing on that tomorrow, and we are looking at flexibility in that program.

**Mr. Pollock.** I have submitted written testimony for that hearing, and I hope you will take a look at it.

**Chair Maloney.** I will.

**Mr. Pollock.** Two, get rid of toxic assets. What is the definition of a "toxic asset"? It is an asset whose price you do not like. Every asset is a good asset at some——

**Chair Maloney.** But the question is how do you get rid of it?

**Mr. Pollock.** You get rid of it by getting it to the right price. And then you can do the Jesse Jones plan.

And three, I believe the Government of the United States should be systematically encouraging the creation of new banks to engage the new capital, which is on the sideline, to provide new credit. These would be banks which are not burdened down, weighed down by the mistakes of the past. The opposite is happening: the regulatory bodies are discouraging the creation of new banks. We need

to turn that completely around and have a national program for bringing new banks and new private capital into the market.

Thank you.

**Senator Klobuchar.** Thank you.

**Chair Maloney.** But couldn't we just use our regional banks and our community banks that are healthy and don't have the toxics? Is there really a need to create a new bank when there are many healthy banks that are out there that could provide the services?

**Mr. Pollock.** They should do whatever they can. But in my view, we should have investors willing to put new capital—and some of these might be quite large—into banks coming into the market at a time when spreads on credit spreads are wide, and credit standards are high. It is the ideal time to start anew and we ought to be encouraging that.

**Chair Maloney.** Thank you.

Mr. Campbell for five minutes.

**Mr. Campbell.** Thank you, Madam Chair.

Mr. Silvers, I first want to ask, you said something that was news to me, and maybe I just have not been listening, but you said 50 percent of all deposits? Are you talking about all deposits in all regulated institutions, thrifts, credit unions, whatever, are in four institutions? No?

**Mr. Silvers.** It's FDIC-insured deposits.

**Mr. Campbell.** So 50 percent of all FDIC-insured deposits are in four institutions?

**Mr. Silvers.** Yes.

**Mr. Campbell.** So in other words, if there is a deposit which is greater than the FDIC insurance, then it is not included in that?

**Mr. Silvers.** No, I believe that number covers all deposits, not insured deposits, but in FDIC-insured institutions.

**Mr. Campbell.** In FDIC-insured institutions. And those four institutions are?

**Mr. Silvers.** They are J.P. Morgan Chase, Citigroup, Bank of America, and Wells Fargo.

**Mr. Campbell.** Okay. The next question I have, which is for all of you, is something Mr. Silvers brought up that I think is a good point, and you said three. I'll say there's basically kind of two different pools of money here within the TARP.

One has been to those, call them healthy banks, or call them institutions which are not insolvent, or not currently insolvent, or not expected to be significantly insolvent, or whatever, from which I think there is at least an expectation, if not a likelihood, that the money will eventually be repaid to the taxpayer perhaps with some investment earnings.

Then there is this money that has been put essentially for system risk, that has been put in an institution not necessarily—to an insolvent institution, not necessarily to invest in that institution as much as it is to cover that institution's obligations to other institutions that create a systemic risk.

It would seem to me that the expectation for the taxpayer to get that money back has to be very low. If you even take the healthy parts of let's say an AIG, the traditional insurance, for them to earn that kind of money back, same with a Fannie or a Freddie,

or whatever, over time would take a tremendous amount. Am I wrong on that?

And this is a question to anybody on the panel. Am I wrong on that? And if I am not wrong, then should we be treating these two things in terms of disclosure completely differently?

**Mr. Pollock.** I would say your comments are very much on target, Congressman.

**Mr. Neiman.** I think it raises the issue as to what the public benefit is with respect to those systemic investments. And it is broader than just a return on those individual investments.

The impact it has on our financial system is so critical to the overall economy—and I think when we talk about the valuation report, the value at the time of those investments, we cannot lose sight of the fact that there was a specific strategy not to distinguish the risk factors in those nine institutions in which those original nine CPP investments were made.

It was so critical at the time. We talk about going back in history to the 1930s, so I do not think we can forget what the time was like in October the crisis that we feared and the need to get this money in quickly to stabilize the market. The big question that so many economists are struggling with is what would have happened had we not made those investments on those standardized terms? Recognizing that some of those banks were healthier than other banks.

**Mr. Campbell.** You know what, Mr. Neiman, at this point I am not trying to argue whether it is the right thing to do, was the right thing to do, or will be the right thing to do again in the future. We are looking at oversight here today, and we will have other times for that.

So what I am trying to figure is, if we have a different expectation for that money, what is it? I mean, if we do not necessarily expect to get a return, what do we expect? And how do we measure whether we are getting the expectation out of that?

**Mr. Silvers.** May I respond?

**Mr. Campbell.** Please.

**Mr. Silvers.** I think that, (a), any time you talk about spending government money to prevent a systemic crisis, as my colleague, Richard Neiman says, you are seeking to achieve a broader public good.

I think we as a Panel are trying to figure out a method for trying to assess whether that was done. It is very difficult. It is very difficult to assess that question because there are so many different factors in play.

However, I think there are a couple of metrics one can use—a couple of questions one can pose about those types of expenditures. And I say "expenditures" acknowledging that we are getting something for them, right? We are getting in the case of AIG, we have some of the Fed's money in the form of a loan; some of that is still a loan. There is preferred stock that the TARP received. There are warrants. It is not that we are getting nothing.

But the question that we need to ask is: One, is the strategy an effective strategy for achieving the goal of systemic stabilization?

Two, to the extent that we are talking about institutions that we believe, one of the goals in relation to is to bring them back to

life—not necessarily clear whether that is the case with AIG, but it would appear to be the case with the very large banks that we were just discussing a moment ago—is the strategy we are adopting going to bring them back to life? Or is it going to lead them to be perpetually under-capitalized?

The third question is the question of whether we are doing so in a cost-effective manner? Is the way in which we are doing the intervention effectively the cheapest way of doing it from the taxpayer's perspective?

Those questions seem to me to be the questions to pose about the AIG matter, which is the only TARP expenditure that has explicitly been justified as a systemic-risk intervention.

**Mr. Campbell.** So far.

**Mr. Silvers.** So far. It is also I believe the way to think about plans going forward, and proposals for dealing with the zombie bank problem. Because there clearly today are two kinds of risks in play.

One is the risk, the continuing risk of a systemic freeze, which was very much present in October and September.

The other risk is the risk of sort of frozen financial institutions that are now very large and macro economically significant pulling our economy downward. And I think all of us, certainly in my day job I hear about this all the time, all of us are hearing out in the real economy that that's what's happened.

**Chair Maloney.** Thank you. The gentleman's time has expired. Congressman Burgess.

**Mr. Burgess.** Thank you. Thank you, Madam Chairwoman.

Mr. Silvers, let me if I could just continue on what you were discussing about plans going forward, and I realize that your role is oversight on the Oversight Board, but are you satisfied that the Administration is doing everything that it can do? Are you satisfied the United States Congress is doing everything it can do to get us through this crisis?

**Mr. Silvers.** My, Congressman, that is some question.

**Mr. Burgess.** Well then I can just narrow it down. And you heard my complaint at the beginning. President Clinton—and I was no great admirer of President Clinton, I will stipulate that up front—but he came to office at a time of perhaps more modest economic crisis, and said: "I am going to focus like a laser beam on the economy."

**Mr. Silvers.** Yes.

**Mr. Burgess.** Do we need that kind of focus on our economic recovery? We are facing a crisis perhaps as great as Pearl Harbor—Warren Buffett made that analogy—certainly as great as 9/11 that President Bush faced early in his office—do we need to be focusing on that greater? And our former colleague Rahm Emanuel, the White House Chief of Staff, who says, "you don't want a good crisis to go to waste." Are they seeing this as an opportunity to be doing other aspects of social evolution, societal evolution in health care, and carbon tax, and all of these things that they want to do, are they taking their eye off the ball and trying to do too much? And should we just get back to basics and try to fix the economy?

**Mr. Silvers.** Congressman, it is very helpful for you to clarify where the focus of your question is. I believe that, (a) from what

I can tell in both this Administration and in the last Administration, and in Congress, that an awful lot of people are working extremely hard and are trying their very best to have a laser-like focus, as you describe.

I have great respect both for the current team in the Administration and for the prior Administration's team that worked on this.

I think that when you talk about a laser-like focus on the economy, I think we have to recognize that the financial sector, which is of course the focus of this hearing, is not the economy. It is extremely important. And if it does not function properly, it makes it very hard for the real economy to function, but it is not the whole picture.

And that some of the issues that you mentioned, that I understand that you may feel are extraneous, are—in my view at least—are fundamental to whether we will be able to have a healthy long-term economy.

**Mr. Burgess.** Let me just—I do not want to interrupt there, but "extraneous" was probably not a word that I would use—but still, we are pushing full-speed ahead in my other Committee on Energy and Commerce for the carbon tax, we call it Cap and Trade, but it is in its simplest form going to be a carbon tax; we are pushing full-speed ahead with creating what is going to be called a Public Option Plan in health insurance. The reality is, it is a vast expansion of Medicare and Medicaid-type structure.

And is it appropriate to be doing those things this spring while so many American families are hurting and our job losses are mounting? And even in a State like Texas where we have been blessed with a fairly stable economy, we are feeling it significantly back home, is it appropriate to be doing those things?

Or is it more like Mr. Emanuel said, look, everything is in crisis so no one is going to notice that we tax carbon, that we socialize medicine, that we do all of these other things that we have wanted to do for some time?

**Mr. Silvers.** Congressman, I do not believe it will be possible, say, to revive the banking system unless the stimulus effort works. From what I can see, the stimulus effort, despite what everyone says about it, is underpowered; that in relation to the downward force on our economy, there is not enough Keynesian stimulus being applied.

In relation to issues like energy and health care, they seem, to me at least, to be fundamental to whether or not we get the long-term future of our economy correct; and that the problems in those areas have contributed substantially to why we are in the mess we are in today.

**Mr. Burgess.** But those are long-term issues, and we have got a serious short-term crisis in the months and weeks ahead.

**Mr. Silvers.** Congressman, my view is that they are intertwined.

**Mr. Burgess.** Let me just—yes, sir. Please.

**Mr. Neiman.** I was going to comment on long-term versus short-term in the financial sector. Because of the singular focus on solving the banking crisis, we have to address the regulatory reform and restructuring at the same time.

To the extent that that is viewed as long-term, it is critical. It does present challenges. It is like putting out the fire at the same time you are rebuilding the fire department——

**Mr. Burgess.** Right, or the front porch. Let me just ask, before I lose my time, Ms. Tichon, are you satisfied with the level of oversight that your—is your group satisfied with the caliber and level of oversight that is being provided currently on the TARP funding?

**Mr. Neiman.** Well, the——

**Mr. Burgess.** I was asking Ms. Tichon.

**Mr. Neiman.** Oh, I'm sorry.

**Ms. Tichon.** Well as we said in our testimony, there are a number of improvements that we would like to see with respect to the program.

I think that, you know, thinking about what is going to restore some of the confidence back into the American people that we know—well not "we," but that the government knows what it is doing, I think opening up the process from beginning to end so that we know exactly what is the criteria, and why are certain banks and institutions getting this money, what is their strategy, what is their business plan going forward, how are they going to achieve the goals that were set by the original EESA?

So from our perspective, we have a list of specific reports and specific line items that we would like to see reported on from anyone who is receiving these funds that we are not seeing so far.

So we have been promised, or we have seen, you know, some guidelines and some recommendations around a monthly report for the top 20 recipients. We have seen reporting going forward. However, I think we need to look at it from the beginning to the end, where we are looking at transparency on the financial health of the banks or the institutions straight through the execution of their program.

**Mr. Burgess.** Are you going to make those available to the Committee?

**Ms. Tichon.** Yes. We have, actually. Within my written testimony we have created a list of not only recommendations that we would like to see within any sort of TARP reform legislation going forward; we will be publishing a quarterly report card that will say: Here are the list of reforms. And then rating for a consistency, completeness, useability standpoint where we fall on those particular items.

So we are very interested in this, and very interested in communicating it back to the American people.

**Mr. Burgess.** Thank you. Thank you for your involvement.

**Chair Maloney.** Thank you so much. Votes have been called, so the last question will be asked by Congressman Snyder from Arkansas. It really has been very instructive. You have given us a number of really constructive recommendations.

**Mr. Snyder.** Thank you, Madam Chair. I am sorry I missed the discussion. I was actually at our Armed Services Committee hearing in which we were having a discussion about how the world financial crisis affects our national security, which is going on simultaneously.

I am new to this Committee, so I take advantage of it to try to figure out things I don't understand, and this is not exactly related

to the topic of the hearing today, but two questions, and then you can comment on them any way you want, and then we have to go.

When we talk about toxic assets, I have a banker back home who says whether you are dealing with accounting rules, or whatever you are doing, what you are terming toxic assets, I have some things that would probably fall in that category but they are performing. The people are going to continue to pay on those. They don't want to be messed with. I don't want to be messed with. They are performing loans.

Where do those fit into this discussion?

My second question is on executive pay. I wasn't very excited about the executive pay limitation that was put onto the stimulus bill. I don't think there was enough discussion about it. But again, if we have small banks that are doing reasonably well around the country, and their traditional way of doing business has been they'll have employees that have a base pay of $130,000, $150,000, you know, $160,000 with some kind of an incentive, if a bank, even if it participates in one of these programs, continues to make a profit, are we making a mistake by not allowing some kind of incentive pay perhaps up to 5 or 10 percent of whatever the profit is for that year of a bank?

Otherwise, it changes the way a bank executive is given pay. Any comments you have on those two questions, and I'm done.

**Mr. Pollock.** Congressman, I would say on your first point, the fundamental question is what principal and interest are we going to collect?

If we are going to collect all the interest and all the principal, then that is a good asset. We are trapped, I said a little bit before you got here, unfortunately in a so-called fair value or mark-to-market accounting system——

**Mr. Snyder.** Well that is the essence of the question, because if it is a performing loan to the end of time then it does not matter what it is valued at today, does it?

**Mr. Pollock.** No. And one of the recommendations I made previously was we need to get rid of this so-called fair-value accounting and replace it with something based on the money we are actually going to collect as valuation.

On your comments on compensation, I fully agree with them. There are about 7,000 banks and 1,000 thrifts in the country. Some people project 400 or 500 may fail over this cycle, but that means 7,500 will not fail.

**Mr. Snyder.** Right.

**Mr. Pollock.** And they need to keep managing their business. Any investors, including the government as investors, should be looking at the business as to what will make it successful, including compensation.

**Mr. Neiman.** I think you have raised a topic that probably deserves a panel all to itself. The issue of the impact that fair-value accounting has on bank capital where you have performing loans I think this is one that is hard to explain and really deserves much thorough revisiting by all, both at the accounting side, but particularly at the bank regulatory side.

**Chair Maloney.** Mr. Silvers.

**Mr. Silvers.** Just two points in relation to your question from our Panel's reports. In our Regulatory Reform Panel when we looked at executive compensation and financial institutions, the points that we made were that, more than the amounts involved, what mattered was the structure and the incentives created.

Were they short term, or long term?

Was there an equal exposure to the down side as to the up side?

In relation to accounting, as I said earlier, perhaps before you came in, I think that the appropriate accounting here is to look not at par value, and not perhaps at markets that have liquidity problems and are in other ways maybe not representative of fair value, but to have a really thoughtful kind of auditing, an independent auditing of the assets of troubled banks.

But there are a couple of caveats here:

One of them is that a loan may be performing today. That may describe say an Alt A mortgage, right, that has not reset, but it may be extremely clear that in some very short period of time it will not be, or at least as a body it will not be.

Secondly, I am convinced personally that the way our banks are accounting for mortgage assets has created a set of incentives not to restructure the loans; that there are circumstances in which banks are able to carry the loans at par or close to par, including not holding—not making them available for sale, that enable them to carry them at a value which is actually above their foreclosure value, even as the loan is not performing. And that if they were to restructure—but that that loan is headed for foreclosure. And if they were to restructure it, they would have to mark it down.

Now I am not expert enough to be able to do this at a more precise level than I just did, but we ought to be creating incentives for rational behavior, meaning for restructuring mortgage loans rather than foreclosing on them.

**Chair Maloney.** We are——

**Mr. Snyder.** Thank you, Madam Chair.

**Chair Maloney** [continuing]. Thank you so much. You have given us so much to think about. We are having a hearing literally tomorrow on mark-to-market, and looking at ways to make it more flexible and to reflect the value.

Senator Risch, we welcome you. He has indicated he does not have a question. We have been called for a vote, so this is adjourned so we can vote.

Thank you very much for coming. It was very informative. Thank you.

[Whereupon, at 12:19 p.m., Wednesday, March 11, 2009, the hearing was adjourned.]

# SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY, CHAIR

The focus of this hearing is on the need for better information on the use and beneficiaries of TARP funds. As has become alarmingly clear, we have very little idea where the money has gone or what good it has done. Not knowing is not acceptable. The efforts of the Panel and of independent advocates such as PIRG to get this information are critically important to the ability of this Congress to ensure that taxpayer money is used as intended—to restore financial stability so that our economy can recover.

Last week, I wrote to Fed Reserve Chairman Bernanke, reiterating a request I had made in November 2008 for a full accounting of the Fed's purchase of assets on which AIG had written credit default swaps insuring the performance of those assets as part of the bailout of AIG. I requested information on who the Fed purchased the assets from, how much each of them received, and how the prices for the assets—collateralized debt obligations, credit default swaps, and residential mortgage backed securities—were determined in a frozen market. I attached a letter I had just received from Nobel laureate and noted economist Joseph Stiglitz, also requesting release of this information. As he said, the provision of this information is essential to informed discussion of how the TARP is doing in achieving its goals of restoring stability to our financial system, getting credit flowing, and reducing foreclosure rates.

So far I have not received an answer.

However, the Wall Street Journal seems to have gotten some of the information I asked for from a confidential source. On Saturday they published a list of some of the banks that have reportedly received the money and some information about how much they have received. Now we have a situation where elected representatives of the taxpayers are denied this information even when it is leaked by confidential insiders to the Wall Street press. It raises serious questions about how decisions on the use of TARP funds are being made and who exactly is accountable to the American people.

The reports done by the Congressional Oversight Panel to date—including the most recent report on foreclosure mitigation and the report on valuation of Treasury's purchases of preferred stock—show that, due to poor design and execution by the Bush administration, we have almost no information about where the TARP funds have gone and whether they are making any difference. The two GAO reports likewise note that the TARP lacks adequate systems of tracking and accounting for expenses. Advocates from PIRG to Mr. Pollock seem to agree. We are in desperate need of data.

Last week, I introduced a bill that will take one step in the direction of getting more data. H.R. 1242 would create a central government data base for the use of the TARP oversight entities with real time financial information on TARP recipients from the multiple government entities to which these financial institutions presently report such data. My bill would require this data to be translated into a standard format that would enable compilation and comparison of the information so that trends or totals can be easily seen. The fact that this data would be available in real time would enable the oversight bodies to spot misdirection of the program before it is irreversible, so that preventive action could be taken. We would not be here months after the fact asking how much the government paid who for what. We would have known right away and been able to decide whether to let other similar purchases go forward or not.

There are other legislative proposals as well that call for greater accountability and transparency, such as the bill that passed the House in January, H.R. 384. These bills lay down in no uncertain terms the marker: this Congress expects better use of the second tranche of TARP funds than was made of the first.

We have to find a better balance between how the TARP is being administered and the public's right to know how their money is being spent. Transparency and accountability must be transformed from slogans to achievable actions.

I look forward to the testimony.

# In Letter To Bernanke, JEC Chair Maloney Renews Request For AIG Transparency

March 4, 2009

**IN LETTER TO BERNANKE JEC CHAIR MALONEY RENEWS REQUEST FOR AIG TRANSPARENCY**

**Washington, D.C.** – Today **Congresswoman Carolyn B. Maloney, Chair of the Joint Economic Committee, sent the following letter to Federal Reserve Chairman Ben Bernanke.** Chair Maloney is renewing her request for information pertaining to the Federal Reserve's purchase of collateralized debt obligations and residential mortgage backed securities from AIG.

The letter, as sent to Chairman Bernanke, is below. The letter from noted economist and Nobel laureate Joseph Stiglitz, referenced below, is attached.

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BY ELECTRONIC MAIL AND MAIL DELIVERY

March 4, 2009

Hon. Ben Bernanke
Chairman
Board of Governors of the Federal Reserve

Dear Chairman Bernanke:

As you may recall, late last year, when you were testifying before the House Financial Services Committee, you agreed, in response to my request, to provide me and the Committee with information about the counterparty transactions in which the Federal Reserve (or entities set up and funded by the Federal Reserve) purchased from certain counterparties multi-sector collateralized debt obligations (CDOs) on which AIG had written credit default swap (CDS) contracts. In connection with the purchase of these CDOs, counterparties unwound related CDS transactions. Also, the Federal Reserve funded the purchase of residential mortgage backed securities (RMBS) from AIG. I requested information on the identities of the counterparties from whom the CDOs and CDS were purchased, the price paid by the Fed for the CDOs, CDS and RMBS, and a description of how the prices were determined.

However, to date, your office has not provided that information to me nor, as far as I am aware, to the Financial Services Committee. This letter is to reiterate that request and to ask that the information be provided to me at the Joint Economic Committee and to the Financial Services Committee as soon as possible. As the New York Times editorial said on March 3, 2009 about these very transactions: "The AIG bailouts fail the basic test of transparency: Who ends up with the money?" I agree with the Times that "not knowing is not acceptable."

In further support of my request, I attach a letter from a fellow New Yorker, the noted economist and Nobel laureate Joseph Stiglitz, separately requesting release of this information on his own behalf and explaining how the Fed's providing this information is essential to informed debate over, and efficient development of solutions to, our current economic crisis, as well as to Congress' ability to oversee the

use of taxpayers' money with respect to the AIG bailout or similar efforts. This is the letter I put into the record at the Financial Services hearing at which you testified on February 25, 2009.

Thank you very much for your prompt response to this request.

Sincerely,

Carolyn B. Maloney
Chair, Joint Economic Committee

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Joseph E. Stiglitz
University Professor

February 24, 2008

Dear Representative Maloney,

I have been trying to study the impact on the American economy of the bail-outs to AIG and to banks. One of the critical questions is where did the money that we gave them go? It is important to know this for several reasons. First, the claim was made that it was necessary to bail-out AIG in order to prevent systemic risk to the American economy. In order to evaluate this claim, we must know who the ultimate beneficiaries were of the money provided to AIG. If, for instance, the money went abroad, then it was unlikely that AIG's failure would have represented systemic risk to the US. If the money went to a large investment bank, then we can assess the impact on that bank. Perhaps without the bail-out the bank would have survived, though admittedly its shareholders would have been worse off.

Secondly, going forward, we have to devise clear rules about when we will bail-out institutions and when we will not. With our growing national debt, it is imperative that we spend taxpayer dollars wisely. If only a small percentage of the AIG money went to banks which were systemically important, it would have been far more efficient to assist directly those firms. The AIG bail-out provides a good case study within which to frame this important policy debate.

Unfortunately, the public does not seem to have access to this information. I realize that some claims may be made that releasing such information at the time of the bail-out might have exacerbated market turmoil. I am, however, a strong believer in market transparency. Many of our current problems can be traced to inadequate transparency. Whatever one's views on this, sufficient time has elapsed that these concerns are no longer relevant. American taxpayers have a right to know where their money is going, and it is imperative that Congress has this information in order to frame appropriate legislative responses.

Firms should play by the rules. The basic rule of capitalism is that firms should bear the consequences of their mistakes. If there are exceptions, they should be narrow and well defined. I am requesting that you make publicly available information about who received the money given by the Fed and the U.S. Government to AIG and about the derivative contracts under which this money was delivered. The information I am requesting should be of immense help in assisting Congress to undertake the essential analyses I have described.

It would also be useful to know the analyses that the Federal Reserve and Treasury undertook prior to the bail-out, which led them to the conclusion that the failure of AIG would lead to systemic risk, as well as the analyses that they undertook prior to the decision not to bail-out Lehman Brothers which led them to the conclusion that the failure of Lehman Brothers would not lead to systemic consequences. It is important that the government have appropriate analytic frameworks for addressing these questions, and it is apparent that, at least in the case of Lehman Brothers, the existing frameworks are deficient.

As the current crisis continues to grow, it is important to have this information as quickly as possible.

I look forward to your response.

Sincerely,

Joseph E. Stiglitz
University Professor
Columbia University

PREPARED STATEMENT OF SENATOR SAM BROWNBACK, RANKING MINORITY

I wish to thank Chairwoman Maloney for arranging today's hearing and thank members of the panel for their testimonies.

Today's hearing looks at achieving transparency and accountability in the Troubled Asset Relief Program, known as TARP. TARP was created as a $700 billion program under the Emergency Economic Stabilization Act of 2008.

My understanding of the oversight panel's reports thus far is that Treasury has been less than forthcoming in its explanations of what it has accomplished with an allocation of up to $700 billion of taxpayer dollars. This is unfortunate, because ordinary taxpayers would like to know that the taxes that are financing Treasury's efforts are being used effectively. Taxpayers and financial markets worldwide would also like to know that there is a definitive plan to address our ongoing financial crisis.

When I try to understand the difficulties presented by our current financial circumstances, I look to experts from my constituency. Fortunately, I can tap into the wisdom of the President and CEO of the Federal Reserve Bank of Kansas City, Mr. Thomas Hoenig.

In a recent speech about our financial system and efforts to deal with the financial crisis, delivered on March 6 of this year, President Hoenig identified that: "We have been quick to provide liquidity and public capital, but we have not defined a consistent plan . . ." I agree with President Hoenig, and believe that there is a large amount of uncertainty about how we will deal with the pressing problems in our financial system. This uncertainty is preventing us from moving forward. Until there is resolution of uncertainty about how we are going to shore up our financial system, there is little reason to expect private capital to flow into our financial system. Private money is simply waiting on the sidelines until there is a resolute signal about who will absorb losses, and how the banking system will be structured moving forward.

President Hoenig identified that, while we would prefer not to "nationalize" our major financial institutions, we are "nevertheless drifting into a situation where institutions are being nationalized piecemeal with no resolution of the crisis."

The term "nationalization" is not well defined. We have, by some definitions, already effectively nationalized some major financial institutions, such as AIG. It seems to me that it would be prudent to avoid fascination with the term nationalization and move to definitive steps to address the difficulties in our Nation's financial institutions and the resulting "credit crunch," which involves severely interrupted credit flows and the negative consequences such as businesses' inability to finance payrolls and expansion, and households' inability to weather our current severe economic downturn.

Rather than arriving at definitive steps to address our financial problems, it seems that the Treasury, under past and current administrations, has chosen to adopt half-measures and incomplete plans. Financial markets are certainly not buying it. Judging by stock prices generally, and stock prices of potentially troubled financial institutions in particular, there is little to no confidence in the plans of Treasury and the Administration to move us out of our financial malaise.

Today's hearing is useful in helping to identify both what has been done with massive amounts of taxpayer money to address our challenges in financial markets and what is planned by Treasury and the Administration as we move forward.

My hope is that Treasury and the Administration will come forward with a resolute plan to face up to the difficulties in our financial markets. We need a plan that offers hope to markets, and not a plan that raises more questions and more uncertainty. We also, as Kansas City Fed President Hoenig has clearly articulated, need to move definitively away from a system of finance subject to the threat of "too big to fail." In President Hoenig's insightful words, "Too Big Has Failed."

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TOO BIG HAS FAILED

(By Thomas M. Hoenig, President and Chief Executive Officer, Federal Reserve Bank of Kansas City)

Two years ago, we started seeing a problem in a specialized area of financial markets that many people had never heard of, known as the subprime mortgage market. At that time, most policymakers thought the problems would be self-contained and have limited impact on the broader economy. Today, we know differently. We are in the midst of a very serious financial crisis, and our economy is under significant stress.

Over the past year, the Federal government and financial policy makers have enacted numerous programs and committed trillions of dollars of public funds to ad-

dress the crisis. And still the problems remain. We have yet to restore confidence and transparency to the financial markets, leaving lenders and investors wary of making new commitments.

The outcome so far, while disappointing, is perhaps not surprising.

We have been slow to face up to the fundamental problems in our financial system and reluctant to take decisive action with respect to failing institutions. We are slowly beginning to deal with the overhang of problem assets and management weaknesses in some of our largest firms that this crisis is revealing. We have been quick to provide liquidity and public capital, but we have not defined a consistent plan and not addressed basic shortcomings and, in some cases, the insolvent position of these institutions.

We understandably would prefer not to "nationalize" these businesses, but in reacting as we are, we nevertheless are drifting into a situation where institutions are being nationalized piecemeal with no resolution of the crisis.

With conditions deteriorating around us, I will offer my views on how we might yet deal with the current state of affairs. I'll start with a brief overview of the policy actions we have been pursuing, but I will also provide perspective on the actions we have taken and the outcomes we have experienced in previous financial crises. Finally, I will suggest what lessons we might take from these previous crises and apply to working our way out of the current crisis.

In suggesting alternative solutions, I acknowledge it is no simple matter to solve. People say "it can't be done" when speaking of allowing large institutions to fail. But I don't think that those who managed the Reconstruction Finance Corporation, the Resolution Trust Corporation, the Swedish financial crisis or any other financial crisis were handed a blueprint that carried a guarantee of success. I don't accept that we have lost our ability to solve a new problem, especially when it looks like a familiar problem.

## CURRENT POLICY ACTIONS AND PROBLEMS

Much has been written about how we got into our current situation, most notably the breakdowns in our mortgage finance system, weak or neglected risk management practices, and highly leveraged and interconnected firms and financial markets. Because this has been well-documented, today I will focus on the policy responses we have tried so far and where they appear to be falling short.

A wide range of policy steps has been taken to support financial institutions and improve the flow of credit to businesses and households. In the interest of time, I will go over the list quickly.

As a means of providing liquidity to the financial system and the economy, the Federal Reserve has reduced the targeted federal funds rate in a series of steps from 5.25 percent at mid-year 2007 to the present 0 to 25 basis-point range. In addition, the Federal Reserve has instituted a wide range of new lending programs and, through its emergency lending powers, has extended this lending beyond depository institutions.

The Treasury Department, the Federal Reserve and other regulators have also arranged bailouts and mergers for large struggling or insolvent institutions, including Fannie Mae and Freddie Mac, Bear Stearns, WaMu, Wachovia, AIG, Countrywide, and Merrill Lynch. But other firms, such as Lehman Brothers, have been allowed to fail.

The Treasury has invested public funds, buying preferred stock in more than 400 financial institutions through the TARP program. TARP money has also been used to fund government guarantees of more than $400 billion of securities held by major financial institutions, such as CitiGroup and Bank of America. In addition, the Federal Reserve and the Treasury Department have committed more than $170 billion to bail out the troubled insurance company AIG.

Other actions have included increased deposit insurance limits and guarantees for bank debt instruments and money market mutual funds.

The most recent step is the Treasury financial stability plan, which provides for a new round of TARP spending and controls, assistance for struggling homeowners, and a plan for a government/private sector partnership to buy up bad assets held by financial institutions and others.

The sequence of these actions, unfortunately, has added to market uncertainty. Investors are understandably watching to see which institutions will receive public money and survive as wards of the state.

Any financial crisis leaves a stream of losses embedded among the various participants, and these losses must ultimately be borne by someone. To start the resolution process, management responsible for the problems must be replaced and the losses identified and taken. Until these kinds of actions are taken, there is little

chance to restore market confidence and get credit markets flowing. It is not a question of avoiding these losses, but one of how soon we will take them and get on to the process of recovery. Economist Allan Meltzer may have expressed this point best when he said that "capitalism without failure is like religion without sin."

WHAT MIGHT WE LEARN FROM PREVIOUS FINANCIAL CRISES?

Many of the policy actions I just described provide support to the largest financial institutions, those that are frequently referred to as "too big to fail." A rationale for such actions is that the failure of a large institution would have a systemic impact on the economy. It is emphasized that markets have become more complex, and institutions—both bank and nonbank entities—are now larger and connected more closely through a complicated set of relationships. Often, they point to the negative impact on the economy caused by last year's failure of Lehman Brothers.

History, however, may show us another experience. When examining previous financial crises, in other countries as well as in the United States, large institutions have been allowed to fail. Banking authorities have been successful in placing new and more responsible managers and directors in charge and then reprivatizing them. There is also evidence suggesting that countries that have tried to avoid taking such steps have been much slower to recover, and the ultimate cost to taxpayers has been larger.

There are several examples that illustrate these points and show what has worked in previous crises and what hasn't. A comparison that many are starting to draw now is with what happened in Japan and Sweden.

Japan took a very gradual and delayed approach in addressing the problems in its banks. A series of limited steps spread out over a number of years were taken to slowly remove bad assets from the banks, and Japan put off efforts to address an even more fundamental problem—a critical shortage of capital in these banks. As a result, the banks were left in the position of having to focus on past problems with little resources available to help finance any economic recovery.

In contrast, Sweden took decisive steps to identify losses in its major financial institutions and insisted that solvent institutions restore capital and clean up their balance sheets. The Swedish government did provide loans to solvent institutions, but only if they also raised private capital.

Sweden dealt firmly with insolvent institutions, including operating two of the largest banks under governmental oversight with the goal of bringing in private capital within a reasonable amount of time. To deal with the bad assets in these banks, Sweden created well-capitalized asset management corporations or what we might call "bad banks." This step allowed the problem assets to be dealt with separately and systematically, while other banking operations continued under a transparent and focused framework.

The end result of this approach was to restore confidence in the Swedish banking system in a timely manner and limit the amount of taxpayer losses. Sweden, which experienced a real estate decline more severe than that in the United States, was able to resolve its banking problems at a long term net cost of less than 2 percent of GDP.

We can also learn a great deal from how the United States has dealt with previous crises. There has been a lot written attempting to draw parallels with the Great Depression. The main way that we dealt with struggling banks at that time was through the Reconstruction Finance Corporation.

Without going into great detail about the RFC, I will note the four principles that Jesse Jones, the head of the RFC, employed in restructuring banks. The first step was to write down a bank's bad assets to realistic economic values. Next, the RFC would judge the character and capacity of bank management and make any needed and appropriate changes. The third step was to inject equity in the form of preferred stock, but this step did not occur until realistic asset values and capable management were in place. The final step was receiving the dividends and eventually recovering the par value of the stock as a bank returned to profitability and full private ownership.

At one point in 1933, the RFC held capital in more than 40 percent of all banks, representing one-third of total bank capital according to some estimates, but because of the four principles of Jesse Jones, this was all carried out without any net cost to the government or to taxpayers.

If we compare the TARP program to the RFC, TARP began without a clear set of principles and has proceeded with what seems to be an ad hoc and less-than-transparent approach in the case of banks judged "too big to fail." In both the RFC and Swedish experiences, triage was first used to set priorities and determine what institutions should be addressed immediately. TARP treated the largest institutions

as one. As we move forward from here, therefore, we would be wise to have a systematic set of principles and a detailed plan to guide us.

Another example we need to be aware of relates to the thrift problems of the 1980s. Because the thrift insurance fund was inadequate to avoid the losses embedded in thrift balance sheets, an attempt was made to cover over the losses with net worth certificates and expanded powers that were supposed to allow thrifts to grow out of their problems. A notable fraction of the thrift industry was insolvent, but continued to operate as so-called "zombie" or "living dead" thrifts. As you may recall, this attempt to postpone closing insolvent thrifts did not end well, but instead added greatly to the eventual losses and led to greater real estate problems.

A final example—our approach to large bank problems in the 1980s and early 1990s—shows that we have taken some steps to deal with banking organizations that are considered "too big to fail" or very important on a regional level.

The most prominent example is Continental Illinois' failure in 1984. Continental was the seventh-largest bank in the country, the largest domestic commercial and industrial lender, and the bank that popularized the phrase "too big to fail." Questions about Continental's soundness led to a run by large foreign depositors in May of 1984.

But looking back, Continental actually was allowed to fail. Although the FDIC put together an open bank assistance plan and injected capital in the form of preferred stock, it also brought in new management at the top level, and shareholders, who were the bank's owners, lost their entire investment. The FDIC also separated the problem assets from the bank, which left a clean bank to be restructured and eventually sold. To liquidate the bad assets, the FDIC hired specialists to oversee the different categories of loans and entered into a service agreement with Continental that provided incentive compensation for its staff to help with the liquidation process.

A lesson to be drawn from Continental is that even large banks can be dealt with in a manner that imposes market discipline on management and stockholders, while controlling taxpayer losses. The FDIC's asset disposition model in Continental, which used incentive fees and contracts with outside specialists, also proved to be an effective and workable model. This model was employed again in the failure of Bank of New England in 1991, the failures of nearly all of the large banking organizations in Texas in the 1980s, and also for the Resolution Trust Corporation, which was set up to liquidate failed thrifts.

RESOLVING THE CURRENT CRISIS

Turning to the current crisis, there are several lessons we can draw from these past experiences.

- First, the losses in the financial system won't go away—they will only fester and increase while impeding our chances for a recovery.
- Second, we must take a consistent, timely, and specific approach to major institutions and their problems if we are to reduce market uncertainty and bring in private investors and market funding.
- Third, if institutions—no matter what their size—have lost market confidenceand can't survive on their own, we must be willing to write down their losses, bring in capable management, sell off and reorganize misaligned activities and businesses, and begin the process of restoring them to private ownership.

How can we do this today in an era where we have to deal with systemic issues rising not only from very large banks, but also from many other segments of the marketplace? I would be the first to acknowledge that some things have changed in our financial markets, but financial crises continue to occur for the same reasons as always—over-optimism, excessive debt and leverage ratios, and misguided incentives and perspectives—and our solutions must continue to address these basic problems.

The process we use for failing banks—albeit far from perfect in dealing with "too big to fail" banks—provides some first insight into the principles we should establish in dealing with financial institutions of any type.

Our bank resolution framework focuses on timely action to protect depositors and other claimants, while limiting spillover effects to the economy. Insured depositors at failed banks typically gain full and immediate access to their friends, while uninsured depositors often receive quick, partial payouts based on expected recoveries.

To provide for a continuation of essential banking services, the FDIC may choose from a variety of options, including purchase and assumption transactions, deposit transfers or payouts, bridge banks, conservatorships, and open bank assistance.

These options focus on transferring important banking functions over to sound banking organizations with capable management, while putting shareholders at failed banks first in line to absorb losses.

Other important features in resolving failing banks include an established priority for handling claimants, prompt corrective action, and least-cost resolution provisions to protect the deposit insurance fund and, ultimately, taxpayers and to also bring as much market discipline to the process as possible.

I would argue for constructing a defined resolution program for "too big to fail" banks and bank holding companies, and nonbank financial institutions. It is especially necessary in cases where the normal bankruptcy process may be too slow or disruptive to financial market activities and relationships. The program and resolution process should be implemented on a consistent, transparent and equitable basis whether we are resolving small banks, large banks or other complex financial entities.

How should we structure this resolution process? While a number of details would need to be worked out, let me provide a broad outline of how it might be done.

First, public authorities would be directed to declare any financial institution insolvent whenever its capital level falls too low to support its ongoing operations and the claims against it, or whenever the market loses confidence in the fine and refuses to provide funding and capital. This directive should be clearly stated and consistently adhered to for all financial institutions that are part of the intermediation process or payments system. We must also recognize up front that the FDIC's resources and other financial industry support funds may not always be sufficient for this task and that Treasury money may also be needed.

Next, public authorities should use receivership, conservatorship or "bridge bank" powers to take over the failing institution and continue its operations under new management. Following what we have done with banks, a receiver would then take out all or a portion of the bad assets and either sell the remaining operations to one or more sound financial institutions or arrange for the operations to continue on a bridge basis under new management and professional oversight. In the case of larger institutions with complex operations, such bridge operations would need to continue until a plan can be carried out for cleaning up and restructuring the firm and then reprivatizing it.

Shareholders would be forced to bear the full risk of the positions they have taken and suffer the resulting losses. The newly restructured institution would continue the essential services and operations of the failing firm.

All existing obligations would be addressed and dealt with according to whatever priority is set up for handling claims. This could go so far as providing 100 percent guarantees to all liabilities, or, alternatively, it could include resolving short-term claims expeditiously and, in the case of uninsured claims, giving access to maturing funds with the potential for haircuts depending on expected recoveries, any collateral protection and likely market impact.

There is legitimate concern for addressing these issues when institutions have significant foreign operations. However, if all liabilities are guaranteed, for example, and the institution is in receivership, such international complexities could be addressed satisfactorily.

One other point in resolving "too big to fail" institutions is that public authorities should take care not to worsen our exposure to such institutions going forward. In fact, for failed institutions that have proven to be too big or too complex to manage well, steps must be taken to break up their operations and sell them off in more manageable pieces. We must also look for other ways to limit the creation and growth of firms that might be considered "too big to fail."

In this regard, our recent experience with ad hoc solutions to large failing firms has led to even more concentrated financial markets as only the largest institutions are likely to have the available resources for the type of hasty takeovers that have occurred. Another drawback is that these organizations do not have the time for necessary "due diligence" assessments and, as we have seen, may encounter serious acquisition problems. Under a more orderly resolution process, public authorities would have the time to be more selective and bring in a wider group of bidders, and they would be able to offer all or portions of institutions that have been restored to sound conditions.

## CONCLUDING THOUGHTS

While hardly painless and with much complexity itself, this approach to addressing "too big to fail" strikes me as constructive and as having a proven track record. Moreover, the current path is beset by ad hoc decision making and the potential for much political interference, including efforts to force problem institutions to lend if

they accept public funds; operate under other imposed controls; and limit management pay, bonuses and severance.

If an institution's management has failed the test of the marketplace, these managers should be replaced. They should not be given public funds and then micromanaged, as we are now doing under TARP, with a set of political strings attached.

Many are now beginning to criticize the idea of public authorities taking over large institutions on the grounds that we would be "nationalizing" our financial system. I believe that this is a misnomer, as we are taking a temporary step that is aimed at cleaning up a limited number of failed institutions and returning them to private ownership as soon as possible. This is something that the banking agencies have done many times before with smaller institutions and, in selected cases, with very large institutions. In many ways, it is also similar to what is typically done in a bankruptcy court, but with an emphasis on ensuring a continuity of services. In contrast, what we have been doing so far is every bit a process that results in a protracted nationalization of "too big to fail" institutions.

The issue that we should be most concerned about is what approach will produce consistent and equitable outcomes and will get us back on the path to recovery in the quickest manner and at reasonable cost. While it may take us some time to clean up and reprivatize a large institution in today's environment—and I do not intend to underestimate the difficulties that would be encountered—the alternative of leaving an institution to continue its operations with a failed management team in place is certain to be more costly and far less likely to produce a desirable outcome.

In a similar fashion, some are now claiming that public authorities do not have the expertise and capacity to take over and run a "too big to fail" institution. They contend that such takeovers would destroy a firm's inherent value, give talented employees a reason to leave, cause further financial panic and require many years for the restructuring process. We should ask, though, why would anyone assume we are better off leaving an institution under the control of failing managers, dealing with the large volume of "toxic" assets they created and coping with a raft of politically imposed controls that would be placed on their operations?

In contrast, a firm resolution process could be placed under the oversight of independent regulatory agencies whenever possible and ideally would be funded through a combination of Treasury and financial industry funds.

Furthermore, the experience of the banking agencies in dealing with significant failures indicates that financial regulators are capable of bringing in qualified management and specialized expertise to restore failing institutions to sound health. This rebuilding process thus provides a means of restoring value to an institution, while creating the type of stable environment necessary to maintain and attract talented employees. Regulatory agencies also have a proven track record in handling large volumes of problem assets—a record that helps to ensure that resolutions are handled in a way that best protects public funds.

Finally, I would argue that creating a framework that can handle the failure of institutions of any size will restore an important element of market discipline to our financial system, limit moral hazard concerns, and assure the fairness of treatment from the smallest to the largest organizations that that is the hallmark of our economic system.

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## PREPARED STATEMENT OF KEVIN BRADY, SR. HOUSE REPUBLICAN

### BANKING SECTOR CLEANUP MUST BE TOP PRIORITY

I'm pleased to welcome the panel of witnesses before us today. TARP certainly raises a number of very troubling issues, but the central one is why we still do not have a credible, effective, and transparent financial rescue plan in place.

Economists and financial experts agree that nothing else we do will matter much until the issue of how to dispose of toxic bank assets is resolved. The Treasury proposal unveiled last February 10th has not been well received because it did not clearly address this issue. *The Economist* magazine, for example, characterized it as "timid, incomplete, and short on detail."

Over the last several weeks the financial press has daily noted how the lack of specifics undermines confidence and contributes to more uncertainty and financial market instability. As observed by *Business Week*, following the announcement of the Treasury plan, "the stock market [was] down on sketchy details." Last week the *Financial Times* noted that since the Treasury plan was unveiled, the S&P had declined 20 percent.

Despite the fact that a timely economic recovery is entirely dependent on an effective and credible plan for dealing with banks' toxic assets, the administration has failed to provide one. The lack of a clear policy framework raises fears about undue political influence and meddling and is deterring new private investment in banks. Financial decisions regarding bank lending, investment, and capital structure should not be politicized. Policymakers do have an important role to play in setting appropriate ground rules, but this should not include micromanaging the banks.

There is much to criticize in the TARP as well as other financial bailouts. But the key question facing the country is government policy regarding the toxic assets of the banking system. The administration seems to be focused on other priorities instead of the critical and pressing need for a clear resolution of the banking crisis. While the administration devotes its attention to pushing its budget with huge increases in deficit spending and federal debt, the financial markets and the economy sink into greater distress. However, a financial recovery plan may cost the Treasury up to a trillion dollars more. This means that Congress should not enact costly new deficit spending measures that the country cannot afford.

The misplaced priorities in the budget are one aspect of this problem, while the optimistic economic assumptions underlying the budget policies are another. Last week Secretary Geithner responded to my questions about the latter by assuring me that the economic assumptions were realistic, but they are not. For example, the new Blue Chip Consensus forecasts a 2009 GDP decline of 2.6 percent, relative to the 1.2 percent decline in the President's budget. The unemployment rate has already reached the level projected by the administration for the entire year. The unrealistic assumptions in the budget mean that deficit spending will be closer to $2 trillion in 2009. No wonder *The Economist* called the assumptions in the administration's budget "deeply flawed" in an article entitled, "Wishful, and dangerous, thinking." The Congress should not carelessly enact policies based on such an unsound foundation.

The administration needs to focus on the resolution of the banking crisis as the best way to reestablish a reasonable prospect for economic growth. This is the key issue in economic policy right now. The longer the administration fiddles with half-measures, the longer the economy will burn.

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PREPARED STATEMENT OF MICHAEL C. BURGESS, M.D.

Anxiety is a simple word to describe what Americans are feeling when we hear about the situation our banks are in today, but frustration and anger are more appropriate words to describe the way American's feel about the government's lack of response to the banking crisis.

The first Congressional Oversight Panel report came out in December 2008 and started with the question, "what is Treasury's strategy?" Unfortunately, the fifth Panel report, due in early April, could plausibly start out with the same exact question. We need a significant and clear plan to come out of the Troubled Asset Relief Program, and we need it now.

I am glad we have members of the Congressional Oversight Panel here today because I want to tell them that serious damage continues to occur in our banks with the word "insolvency" lurking throughout each firm. Since January 16, 2009, Bank of America is down 56%; Citigroup down 70%; PNC 51%; Suntrust 53%; and US Bank down 52%, this year alone. These are losses that have occurred with TARP money, yet, I have not heard any tough questions about these losses coming out of the Congressional Oversight Panel. The January report talked about accountability, the February report talked about evaluating acquisitions, the March report focused on home foreclosures. Right now we need the TARP to operate like emergency financial trauma specialists in order to address the banking crisis but they cannot operate without a focused and clear plan. Where's the plan?

Everyone is talking about confidence, confidence, confidence in our banks and between our banks, but clearly our banking institutions are not buying what the government is selling them. They are not willing to free the credit markets because they are either insolvent themselves or they are operating under a fiduciary responsibility to respect the money invested by their shareholders and cannot risk losing money by making more bad investments. They don't see a bottom to this economic trough and until they see a bottom, or see a plan to turn this around, we will not begin to see a freeing up of the credit markets.

According to Committee Memos, $197 billion has been used to purchase preferred stock in 496 banks under the TARP Capital Purchase Program as of March 5th. I would like to ask the panel members here today, "How much more money is Treasury going to invest in these banks without asking for some control? Do we know?

Do we even have the ability to find out? Is there a limit, or a ballpark window, say between one and two trillion dollars?"

With that, I yield back the balance of my time.

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PREPARED STATEMENT OF DAMON A. SILVERS

Good morning. I am Damon Silvers, and I am the Deputy Chair of the Congressional Oversight Panel. I am also Associate General Counsel of the AFL-CIO. I would like to express my thanks to the Chair, Representative Maloney, for inviting me to appear today before the Committee. I should note at the outset that my testimony today is mine alone, and does not necessarily reflect the views of the Congressional Oversight Panel as a whole, its staff, or its Chair, Professor Elizabeth Warren.

I am going to speak briefly about the general role of the Congressional Oversight Panel, and then address the Panel's work in valuing the preferred stock purchased by the Treasury Department under the TARP. My fellow Panel member Richard Neiman will focus his testimony on our most recent report on the mortgage crisis.

The Congressional Oversight Panel was created as part of the TARP in last year's Emergency Economic Stabilization Act ("EESA"). The job of the Panel is to "review the current state of the financial markets and the financial regulatory system" and report to Congress every 30 days. The Panel has submitted reports to Congress on December 10, January 9, and February 6, and March 6, and is beginning now to prepare its fifth report for early April. The Panel also submitted a special report on regulatory reform to Congress, as required by the legislation, at the end of January.

The Oversight Panel is one of three organizations to which the TARP legislation gives oversight responsibilities: the Panel, the Special Inspector General, and the GAO. The Special Inspector General for the TARP has a broad responsibility, and matching authority, to audit and investigate any part of the Program. GAO is given an even more detailed set of instructions for "ongoing oversight of the activities and performance of the TARP," as well as responsibility for an annual audit of the TARP's financial statements. Panel staff meets regularly with IG staff and with GAO staff assigned to TARP in an effort to see that we are coordinated and that the results of our efforts are more than the sum of our parts. The Oversight Panel sees our role in this landscape as oriented toward broad policy considerations. In the Emergency Economic Stabilization Act, Congress specifically asked that the Oversight Panel conduct oversight on: the use of Treasury authority under the TARP; the Program's effect on the financial markets, financial institutions, and market transparency; the effectiveness of foreclosure mitigation efforts; and the TARP's effectiveness in minimizing long-term costs and maximizing long-term benefits for the nation's taxpayers. Our ultimate question is whether the TARP is operating to benefit the American family and the American economy.

The Panel began our work in our first report issued in December by asking ten basic questions about TARP—starting with the question, "what is Treasury's strategy?," and including the question, "(i)s the public receiving a fair deal?" This first report had one substantive recommendation—that "the public has a right to know how financial institutions that have received public money are using that money" and "that Treasury should be responsible for holding individual institutions accountable for how they use the public's money." While the Treasury Department has committed to the concept of tracking the use of TARP money in principle, the specific plans for doing so have not been released.

In asking these questions, we were influenced by statements by then Treasury Secretary Henry Paulsen at the time of the first nine major TARP transactions that "(t)his is an investment, not an expenditure, and there is no reason to expect this program will cost taxpayers anything."[1]

The Panel recognized in asking these questions that they raised complex issues, and that the answers would be multilayered. However, we thought it was not possible to begin to answer questions like "did the public get a fair deal," without understanding exactly what deal the public did get in the transactions completed under TARP last year.

The Panel sought the advice of leading valuation experts, and concluded that the way to ask the question "what did the public get" was to ask what was the value of the preferred stock purchased by the Treasury on the date it was purchased, based on the prices of related securities and based on transactions undertaken by

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[1] U.S. Department of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Capital Purchase Program (Oct. 20, 2008) (online at www.treas.gov/press/releases/hp1223.htm).

the TARP recipient institutions with private parties. The Panel did a search for valuation firms that had minimal conflicts and the requisite expertise and resources to undertake this task, and we retained Duff and Phelps, the world's largest specialty valuation firm. Duff and Phelps were supervised by a team of experts consisting of Adam M. Blumenthal, Managing Partner in Blue Wolf Capital Management and the former Deputy Comptroller of New York City, William N. Goetzmann, the Edwin J. Beinecke Professor of Finance and Management Studies and the Director of the International Center for Finance at the Yale School of Management, and Deborah J. Lucas, Donald C. Clarke HSBC Professor of Consumer Finance at the Kellogg School of Management at Northwestern University and the former Chief Economist of the Congressional Budget Office.

In parallel, the Panel engaged a legal team with experience in both bank rescues and preferred stock transactions to review the legal terms of the TARP transactions. The Panel sought to compare those terms with the terms obtained by private parties during the same period, the terms typically obtained by private parties making preferred stock investments, and the terms obtained by the British government during its parallel efforts to support its banking system during the last quarter of 2008. The legal effort was led by Catherina Celosse, an attorney formerly with the firm of Davis Polk and Wardwell, with experience representing the Indonesian government during the Indonesian bank crisis, and Timothy Massad, a senior partner at Cravath, Swaine and Moore who took a leave to assist the Panel on a pro bono basis.

The valuation and legal analysis had a limited purpose—to understand and place before the public the extent to which the TARP transactions had been investments that obtained fair value for the taxpayer, and the extent to which they were subsidies to the recipient banks and their shareholders. We did not attempt to answer the question of whether subsidies were a good idea or a bad idea—whether the TARP transactions created public benefit that made them worthwhile, or whether that same public benefit could have been created without the subsidy. The Panel continues to do work in the area of trying to formulate ways of answering these much more complicated and vitally important questions.

Duff and Phelps used three methods of valuing the preferred stock—(1) a discounted cash flow methods, where the likely payments over time are discounted at a rate reflecting the risks of not receiving those payments derived from market yields, (2) a discounted cash flow analysis where the likely payments over time are discounted based on survival probabilities derived from Credit Default Swap spreads, and (3) a contingent claims method, that treated the preferred stock as a claim against the assets of the TARP firms, a claim whose value is determined by the volatility of those assets, much as the price of an option does. Duff and Phelps then looked for the convergence of the values derived from each method to set a valuation range for each security.

Duff and Phelps looked at each of the ten initial major TARP investments separately, and the 700 plus page report they provided the Panel contains a detailed analysis of the market conditions associated with each major recipient bank at the time of the transaction. Duff and Phelps also examined each feature of the preferred stock designed by Treasury, including the impact of several options embedded within the terms of the security.

Duff and Phelps found that the 2008 TARP transactions ranged from preferred stock purchases that delivered close to full value to the government in the case of the strongest banks at the time (5% and 7% discounts in the case of U.S. Bancorp and Wells Fargo), to purchases that at the time they were made delivered less than 50% or less of their face value to the government in the case of the purchase of AIG preferred stock and the second purchase of Citigroup preferred stock in November 2008.

I should emphasize here that the Panel's findings reflected the value of the preferred stock Treasury purchased on the date the transactions were announced. We have not attempted to value these securities on an ongoing basis, but it seems very likely that they have declined in value since then, and in the case of Citigroup and Bank of America, declined precipitously.

Duff and Phelps found that by comparison, private parties received somewhat better deals. Mitsubishi obtained essentially 88–94% of face value for its investment in Morgan Stanley, compared to 58% for the Treasury Department's investment in the same firm. Warren Buffett, not surprisingly, was able to get above market value (108–112%) for his investment in Goldman Sachs, while Treasury's investment in Goldman Sachs was worth 75% of what Treasury paid for it on the transaction date.

The Panel found that the key structural reason for the failure to obtain securities that were worth their purchase price on a market value basis was the decision to offer the same price to all the banks in the initial purchase, and the apparent deci-

sion to only vary the terms of the second Citigroup investment to a small degree from the terms of the investments in "healthy banks" made under the Capital Purchase Program. Once the decision was made to offer all banks the same terms, in order to attract the participation of relatively healthy banks, those terms had to be ones that would be attractive to healthy banks. Offering the same terms to much weaker institutions like Citigroup and AIG ensured that those firms would receive a substantial subsidy.

Duff and Phelps extrapolated from its findings with respect to the nine largest transactions, and extended the same total subsidy rate to the smaller transactions under the Capital Purchase Program. Using this methodology, the Panel estimated that in total through the end of December the TARP program had involved an $78 billion subsidy to all 311 Capital Purchase Program recipient banks at the time of the report. However, Duff and Phelps found that more than half of the subsidy in the program as a whole went to two institutions—AIG and Citigroup.

This analysis has clear implications for future TARP transactions with weak financial institutions. Currently, the preferred stock of weak banks like Citigroup is trading at prices that imply a market interest rate in excess of 20%. Since the purpose of TARP is to strengthen financial institutions, and not to drain cash from them, there is no way to protect value for taxpayers by charging interest in the form of preferred dividends adequate to compensate taxpayers for the very real risk of further losses in the preferred. The only way to do so is to take a larger percentage of the upside in the form of common stock, warrants for common stock or other equity linked instruments. In the case of the weakest banks, it appears to me that even if the government took 100% of the future upside we would still not be able to receive securities worth the value of the funds we would infuse into such weak banks. It may still be in the public interest to do such transactions, but we should not fool ourselves or the public that we are receiving in the form of securities full value for the public's money. And the less we ask in terms of common equity, the greater the subsidy will be.

The legal review found that Treasury modeled its term sheet for Capital Purchase Plan transactions on the deal documents used by Warren Buffett in his investment in Goldman Sachs. We found that the terms were consistent across the Capital Purchase Plan transactions. However, the Panel's legal analysis found that the terms obtained by the Treasury were in places both more and less advantageous than the Buffett terms, and than the terms typically found in preferred stock deals. There were however a number of major areas where the terms obtained by the Treasury were not as favorable to the government as terms obtained by the British government in the course of their bank rescue efforts.

Our valuation report relied entirely on publicly available data. The Panel did make a broad document request of the Treasury Department pursuant to our authority under Section 125 of the EESA on December 17, 2008. Our purpose was to obtain any non-public information that Treasury possessed that would go to issues of valuation, in addition to contributing to our general ability to oversee the TARP program. In a letter dated December 24, 2008, the Treasury Department declined to provide the material we requested, and raised concerns about our newly formed Panel's internal controls over confidential documents. Despite extensive discussions between our staff and the Treasury Department, Treasury has only produced a small number of the documents the Panel requested. The Panel ultimately concluded it was unlikely, in view of TARP recipients' legal obligations to disclose material financial information to the public, that the accuracy of the valuation report would be affected by the Treasury Department's failure to produce the requested documents.

This matter relates to a matter of concern to this Committee. Although it was not the primary purpose of our document request, I had expected that the request would result in the Panel being informed as to the identities of the counterparties to derivative transactions who were made whole as a result of the funds provided both by the Federal Reserve Bank of New York and the TARP to AIG. The Panel currently does not know the identity of those counterparties or the amounts they received. We are aware of press accounts of this matter, which have not been consistent with respect to issues such as how much money Goldman, Sachs, a direct recipient under TARP's Capital Purchase Program, received indirectly through the AIG TARP transaction.

The Congressional Oversight Panel is seeking to expand the scope of its analysis of the larger impact of TARP and related programs. The Panel is particularly interested in looking at transactions under the Term Asset Backed Securities Loan Facility (TALF) and potential transactions involving public-private partnerships. The Panel is also working to define its role in relation to activities undertaken by the

Board of Governors of the Federal Reserve that are linked to actions undertaken by the Treasury Department pursuant to the EESA. Thank you.

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SUPPLEMENTAL STATEMENT ON TWO FACTUAL MATTERS:

In the Hearing, Chairwoman Carolyn Maloney asked if TARP funds were used to purchase collateralized debt obligations (CDO's) insured by AIG credit default swaps. I have confirmed my tentative statement in the hearing that these purchases were funded by the Federal Reserve System, and were not directly funded by TARP.

Secondly, there was some discussion in the hearing about the percentage of U.S. bank deposits held by the four largest banks. During the hearing, I stated that "4 banks that hold more than 50% of insured deposits." The information I was referencing was actually the portion of the deposits at Citigroup, Bank of America, Wells Fargo and JP Morgan compared to the total deposits at the top 50 largest U.S. commercial banks. It did not include insured deposits at institutions that were not commercial banks, such as savings and loans, or smaller commercial banks.

It is very difficult to determine what the actual percent of U.S. deposits that are held at these four banks. Looking at the banking profile from the FDIC, the total domestic deposits of FDIC insured institutions at the end of December 2008 was $7,505,354,000,000 of which $3,991,272,000,000 was in insured commercial banks. The $7,505,354,000,000 includes commercial banks and savings institutions as well as thrifts and FDIC-insured state banks. The total insured deposits at the end of December was $4,759,995.

On 12/31/08, the 4 largest BHCs had the following domestic deposits:

| Institution | Deposits* ($) | % of deposits at insured institutions |
|---|---|---|
| BofA: | 792,272,230 | 10.56 |
| Citi: | 289,818,000 | 3.86 |
| JPM: | 721,976,000 | 9.62 |
| Wells: | 742,900,000 | 9.90 |
| TOTAL | 2,546,966,230 | 33.94 |

*In thousands

This is about 1/3 of domestic deposits.

However, these four institutions appear to have more than 50 percent of the assets of U.S. banks. Martin Wolf had a piece in the *Financial Times* on March 3, 2009 citing Fed data that showed that Bank of American, Citi, JP Morgan and Wells Fargo have more than 60% of U.S. Commercial Bank Assets (http://www.ft.com/cms/s/0/f24fc392-082a-11de-8a33-0000779fd2ac.html).

In terms of the discussion we had at the hearing, the data quoted by Martin Wolf would be the best measure of the relative importance of the four largest banks to the U.S. banking system.

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PREPARED STATEMENT OF RICHARD H. NEIMAN

Chairwoman Maloney, Vice Chairman Schumer, and distinguished members of the Committee: I am Richard H. Neiman, the Superintendent of Banks for the State of New York. I am also a member of the Congressional Oversight Panel, and I appreciate this opportunity to comment on the ongoing evaluation of the Treasury Department's implementation of the Emergency Economic Stability Act (EESA). I should note that the views expressed in this testimony are my own, and do not necessarily reflect the opinion of the Panel or any other members.

OVERVIEW OF PANEL REPORTS

The Panel is charged by statute to provide monthly reports to Congress assessing the effectiveness of the Treasury's implementation of the Troubled Asset Relief Program (TARP), including foreclosure mitigation efforts.

The Panel's first report was issued in December, and set out a framework for future inquiry through a set of ten tough but fair questions. These questions cover fundamental issues, including: is the strategy working to stabilize markets and reduce foreclosures? What have banks done with the money? And is the public receiv-

ing a fair deal? The regular monthly reports have explored these issues in more depth, in addition to a Special Report on regulatory reform issued in January.

Given the limited time for prepared remarks, I will focus on the Panel's most recent report on foreclosure mitigation which I took a lead role in preparing. As the only bank regulator on the Panel and as one who has led his state's foreclosure prevention efforts, I believe I bring a unique perspective to this critical issue. I look forward, however, to questions from the Committee on the full range of the Panel's responsibilities.

PANEL REPORT ON FORECLOSURE MITIGATION

The Panel's March report highlights the symptoms that gave rise to the housing crisis, as well as major impediments to a solution. The report provides a roadmap for successful foreclosure prevention going forward. Let me summarize the major impediments.

1. *Affordability.* The key to any sustainable modification program is whether the borrower can afford the monthly payments. A problem that began with exploding mortgage products that may have been inappropriate at inception has now expanded to borrowers who are falling behind for many reasons, such as illness, divorce, or job loss in the economic downturn. Existing modification plans have not adequately addressed this critical impediment of affordability, leading to high rates of re-default. Voluntary modification efforts often leave the borrower with the same or higher monthly payments through repayment plans or the capitalization of amounts past due. The Panel is concerned that the commonly used housing payment ratio of 38% of the borrower's gross income remains too high to be affordable, and is encouraged that the President's Homeowner Affordability and Stability Plan targets a 31% housing ratio.

2. *Negative equity.* Negative equity can occur when property values decline or if appraisals were inflated. Borrowers in this situation are unable to refinance, and cannot sell the home unless the lender agrees to a reduced payoff in a short sale. Panel data shows a strong correlation between high negative equity and default; however, this is not necessarily evidence of a causal relationship. Further, the survey data received from the federal banking regulators was limited by the lack of current borrower income information which may under-estimate the importance of affordability in this result.

3. *Securitization contracts.* Mortgages that have been securitized are subject to the terms of pooling and servicing agreements (PSAs) that may present obstacles to loan modifications. These PSAs often contain restrictions on the number of loans within the pool that may be modified and the circumstances in which modification is permissible. As modification and other loss mitigation outcomes may impact the various tranches of investors differently, litigation risk may be a disincentive for servicers to engage in modification. A safe harbor from litigation for servicers that modify loans, as outlined in the Helping Families Save Their Homes Act of 2009, would help to overcome this impediment.

4. *Servicer incentives.* The fee arrangements for servicers can also create misaligned incentives. In particular, servicers need incentives to engage in intervention while borrowers are still current but when default is imminent, to preserve the borrower's credit history and retain a fuller range of workout options. The President's Homeowner Affordability and Stability Plan does address this issue by providing incentive payments to servicer for early outreach, as well as "pay for success" incentives to both servicers and borrowers based on performance of the modified loan.

5. *Borrower outreach and servicer capacity.* The Panel's report documents the lack of servicer capacity to reach borrowers at-risk. There is a clear distinction between the regular work of servicers in payment processing and collections, which is largely automated, and loan modification efforts, which are labor-intensive and involve highly trained staff. Servicing firms are set up for payment processing, but many are not as well-equipped to handle the volume of individual modification cases.

6. *Junior mortgages.* Multiple mortgages on the same property also complicate the foreclosure prevention effort. In the case of a refinance or of a modification that involves an increase in the loan amount, the second lien holder must consent to subordination or the first lien holder loses priority. Some junior lien holders are charging high fees to subordinate or extinguish their liens. The President's Plan provides fee incentives to first lien holders to extinguish subordinate liens in the course of modifying the primary

mortgage, but more needs to be done to ensure all mortgage payments are stabilized.

These are the principal impediments to successful avoidance of foreclosure. The President's Plan addresses many of these critical elements, particularly affordability and servicer incentives, and is estimated to help 7 to 9 million homeowners at risk.

While these projections are encouraging, the Panel has additional areas of concern that are not fully addressed. In particular, the Plan does not include a safe harbor for servicers operating under pooling and servicing agreements to address the potential litigation risk. And while the modification aspects of the Plan will be mandatory for banks receiving TARP funds going forward, the level of broader industry acceptance remains unclear.

The more detailed guidelines on the President's Plan were just released on March 4, and the Panel will continue to monitor implementation and advise Congress and the American people accordingly.

NEED FOR EXPANDED DATA ON FORECLOSURE AND DELINQUENCIES

One important recommendation to Congress in the report goes to the adequacy of mortgage loan performance data. Access to complete information on foreclosures and loans in default is unavailable and the reason is simple: there is no mortgage loan performance data reporting requirement for the industry. Congress and the regulators need to have much better data available so they can ensure the smooth and efficient functioning of the national housing finance market and prevent future crises.

That is why the Panel believes that Congress should create a national mortgage loan performance reporting requirement applicable to banking institutions and others who service mortgage loans, to provide a source of comprehensive intelligence about loan performance, loss mitigation efforts and foreclosure. Federal banking or housing regulators should be mandated to analyze such data and share the results with the public. A similar reporting requirement exists for new mortgage loan originations under the Home Mortgage Disclosure Act. Because lenders already report delinquency and foreclosure data to credit reporting bureaus, it would be feasible to create a tailored performance data standard that could be put into operation swiftly.

CONCLUSION

We cannot solve the financial crisis without dealing with the root of the problem: the millions of American families who are at risk of losing their homes to foreclosure. I appreciate the opportunity to share my views, and hope that dialogue between the Panel and this Committee becomes a regular occurrence. Events are developing rapidly, and many of the tools needed to respond are best accomplished with the support of progressive legislation. I would be pleased to provide more details on the Panel's work to date or answer any questions. Thank you.

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PREPARED STATEMENT OF NICOLE TICHON

Madam Chair Maloney, Vice Chair Schumer, Committee Members and distinguished panelists.

Good morning. My name is Nicole Tichon and I am the Tax and Budget Reform Advocate for the U.S. Public Interest Research Group. We serve as the federation of state PIRGs, which are non-profit, non-partisan public interest advocacy groups that take on powerful interests on behalf of our members.

We are pleased to be part of this critical conversation. We look forward to the Committee and other interested parties to restore confidence to the taxpayers who have already invested so much in what is now collectively known as the Financial Stability Plan, which we've been referring to as TARP, and the public thinks of as "the Wall Street bailout."

SUMMARY AND RECOMMENDATIONS

In February, U.S. PIRG released its first Report Card on the transparency and accountability of the TARP program. The implementation at that point was failing by most measures. U.S. PIRG's position is that TARP accountability, oversight and transparency should be addressed and mandated by law. Congress should give the Administration as many tools as possible to manage TARP and related programs. U.S. PIRG calls for more specific, consistently applied and frequent reporting. This reporting should account for the use of the funds and how the activities associated with their use meet the goals and objectives of the program. This information should

be made public and easily accessed. These requirements should be retroactive, including a full accounting for the first disbursement of funds. In addition, provisions to protect the taxpayer and subject recipients to the same operational requirements as those imposed in the auto industry bailout should also be instituted to make banks more accountable to their investors.

DISCUSSION

Leading economists and my fellow panelists have offered many policy recommendations on how to restore stability to the economy and provided potential strategies for assisting banks and financial companies. We'll respectfully yield that territory to them. U.S. PIRG seeks a consistent, transparent and accountable implementation of the Financial Stability Plan from the standpoint of taxpayers who have watched billions of dollars poured into what appears to be a failing and flailing system.

Taxpayers have lost their own investments - their pensions, retirement savings and education savings. And in their first mass investment into the banks that failed them, they were undersold by $78 billion according to the Congressional Oversight Panel, and so far would get approximately 67 cents on each dollar invested.[1] That gap is likely to get larger as we learn more about the truth of the financial health of these companies. This hardly inspires confidence that taxpayers will be seeing much of a return on their investment. Our goal is to make sure that any program—especially one of this magnitude—has a clear strategy and is transparent to those paying for it.

One of the questions posed by the Congressional Oversight Panel to both the former and current Treasury Secretary gets to the heart of this matter: "What is Treasury doing to help the American family?" Taxpayers—real people who are feeling the impact of the stalled economy—deserve answers. We hope that the new Administration will provide them.

THE REPORT CARD

U.S. PIRG released a report in February, "Failed Bailout: Lessons for Obama from Bush's Failures on TARP" (attached) to try to piece together what little was known about the then misnamed Troubled Asset Relief Program (TARP), recommend changes to make the program more accountable and transparent, and then develop a simple set of benchmarks to assess progress. The information used to make the assessment was based on a wide range of reports and accounts. In the absence of reporting the only information available about the TARP spending or recipients were from news stories. The U.S. PIRG report told the story of just how little we knew about the first disbursement of funds. For the first quarter of fiscal year 2009 (the fourth quarter of calendar 2008), the Report Card revealed failing grades on transparency, oversight and accountability.

Our aim is to continue to publish a very simple quarterly Report Card to show progress on the reforms we've recommended. The Report Card assesses the implementation of the reform in terms of completeness, consistent application across programs and its usability or accessibility.

Since issuing our first Report Card last month, there have been varying degrees of progress on several line items. We will provide a full assessment in our next Report Card at the end of the quarter. Some of the reforms where progress has been made include:

- Posting the fund recipients, amounts and contracts on the Treasury website is a good first step. U.S. PIRG would like this information to be made more accessible as the files are large and difficult to navigate. The summary tables are in the form of static pdfs, which is not as useful as a dynamic searchable online database would be. In this era of Google, people rightly expect that government will provide navigation tools to find needles in a haystack of data.
- Treasury has begun process of sending monthly surveys to the 20 largest fund recipients. U.S. PIRG agrees with the Government Accounting Office that this request for information should be program-wide, not limited to the largest recipients only.
- The Special Inspector General has sent a request to all TARP recipients asking what was done with the first disbursement. U.S. PIRG is anxious to see the results.

[1] http://www.guardian.co.uk/commentisfree/2009/mar/06/useconomy-useconomicgrowth

- The Financial Stability Plan (FSP)[2] proposes increased transparency and disclosure around bank balance sheets. U.S. PIRG is interested in additional details as to how this process will work across financial regulators and the agencies.
- The FSP proposes specific reporting requirements around plans for the use of funds and monthly reports on lending. It is not clear to U.S. PIRG whether or not these requirements only apply to those who receive "exceptional assistance" and how "exceptional assistance" is defined.
- The FSP established a website (*FinancialStabilitv.gov*) that posts information about the new programs and promises to also post any reports from the recipients of capital assistance.
- The FSP proposes "strong oversight requirements" and "robust data" to evaluate the success of the Administration's foreclosure mitigation program.[3]
- The *American Recovery and Reinvestment Act of 2009* (Pub. Law No. 111-5) includes the strongest language we've seen on limiting executive incentive pay. U.S. PIRG would like to know how this will be reconciled in conjunction with the FSP's previously-announced executive compensation language and what the Treasury Secretary's plan is for implementing the new law.

In addition, PIRG recommends that the following requirements be included in any new accountability and transparency efforts:

- In general, the new conditions around reporting, transparency and executive compensation should be retroactive.
- Monthly reports should not just focus on lending—but on ALL activities associated with the use of the funds, and should extend to all participants, not just the top 20.
- Reporting requirements should be extended to the Federal Reserve disbursements—which are projected to be $3.8 trillion.[4]
- In terms of a clear strategy, PIRG is still unclear as to the reasons for the initial ad hoc programs created after the first $350 billion disbursement and would like the public provided with a more detailed explanation for the most recent shifts described in the FSP. The restructuring of the agreements with Citigroup and A.I.G. demonstrates another change in strategy, and one that may put taxpayers at additional risk.[5]
- The information currently offered around the contracts is hard to access.[6] It is hard to find pertinent information. Again, establishment of a publicly available online, searchable database would be much more useful.
- Additional governance guidance around internal operations, accountability, leadership, and strategic planning would make the banks more accountable for achieving success.
- Metrics should be communicated by Treasury to Congress and the public to demonstrate that the stated goals or strategies (once clearly ' established) are working and that the programs contribute to stabilizing the economy.

It is our hope that in the coming weeks, the reports requested by Special Inspector General requested will shed light on what so far has been a very murky and expensive program.

WHAT'S NEXT

U.S. PIRG's position is very straightforward. We support the enactment of reform legislation. A strong law providing for oversight, accountability and transparency is the best tool that Congress can offer as help to the Administration—and to the program participants. If we have clarity, then everyone starts with the same information and expectations. Our Report Card includes these recommendations for reform.

Several bills have been introduced that address some of U.S. PIRG's recommendations. While U.S. PIRG does not necessarily endorse all of these bills in their entirety, there are provisions within them that reflect the recommendations of our Report.

For example, the House of Representatives passed a comprehensive TARP Reform and Accountability Act of 2009 reform bill (HR 384), earlier this year. We urge the Senate to pass a similar comprehensive package.

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[2] http:/lfinancialstability.gov/docs/fact-sheet.pdf
[3] http://financialstabilitv.gov/docs/fact-sheet.pdf
[4] http://www.washingtonpost.com/wp-dyn/content/graphic/2009/02/24/GR2009022401373.html
[5] http://online.wsj.com/article./SB123629999083146775.html#articleTabs=article
[6] http://www.treas.gov/initiatives/eesa/agreements/02272009/1st%20Enterprise%20Bank.pdf (example)

Key provisions of this and other legislation to provide for greater transparency, such as two bills introduced by Chair Maloney (HR 1095, on reporting and governance, and HR 1242, to set up an electronic database), include:

- Quarterly reporting that is accessible to the public for all TARP recipients (HR 384, Rep. Frank)
- Reporting on all activities—with specific requirements around relating activities to the original goals of the EESA (stabilization of economy, lending, consumer credit) (HR 1095, Rep. Maloney; S 195, Sen. Dorgan)
- Retroactive reporting on the first disbursement (HR 384)
- An online, searchable database of reports provided by recipients (HR 1242, Rep. Maloney)
- An online aggregation of data from other agencies to get the most holistic picture of the impact of TARP funds (HR 1242, Rep. Maloney)
- Governance guidelines (HR 1095, Rep. Maloney)
- Additional reporting/collection of data with a full description of collateral or other interests to ensure that taxpayers are repaid to the maximum extent possible (S 195, Sen. Dorgan)
- Subjecting all firms receiving assistance to the same conditions as the automotive industry; failure to comply resulting in a return of the funds (S 195, Sen. Dorgan)
- Requiring the Federal Reserve to report on its financial assistance (S 513, Sen. Sanders)

A number of other bills and amendments have surfaced in the House and Senate with respect to TARP, many directly responding to the public concern over certain corporate expenditures, such as Rep. Cummings' bill (HR 846). All of these TARP-related bills and amendments reflect the fact that your constituents want to be heard.

U.S. PIRG encourages Congress to take specific action in making reporting, transparency and accountability requirements law so that Congress, taxpayers, researchers and the public can see who is getting bailout money, where it is going and whether the programs are working. We urge Congress to give the Treasury Secretary and the Administration a comprehensive tool set to help them manage these programs. And make sure that the oversight of these activities ensures that they are applied completely and consistently across all of the institutions benefiting from this enormous taxpayer investment. Thank you and I am happy to answer any questions.

# Failed Bailout: Lessons for Obama From Bush's Failures on TARP

**A Report of the Securing America's Financial Future program of**

**The U.S. Public Interest Research Group Education Fund**
**February 2009**

By Nicole Tichon, Federal Tax and Budget Reform Advocate
with Edmund Mierzwinski, Consumer Program Director

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## Failed Bailout: Lessons for Obama From Bush's Failures on TARP

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## Failed Bailout: Lessons for Obama From Bush's Failures on TARP

### 1. Summary and Conclusions

*"If the taxpayers are helping you, then you've got certain responsibilities to not be living high on the hog,"*

-- President Barack Obama to the Associated Press on Feb. 4, 2009.

Following the collapse of major financial institutions Congress enacted a sweeping $700 billion taxpayer-financed bailout of the financial sector. However, months into the program and billions of dollars later, no one knows how the money was spent and no one is convinced that it's achieved any of the intended results. The U.S Public Interest Research Group Education Fund (U.S. PIRG) believes it is critical for Congress to demand and the Department of Treasury to implement mechanisms and metrics to make sure that the actions of the TARP recipients reflect the original goals and objectives of the Emergency Economic Stabilization Act (EESA). Those mechanisms must be based on the sound public policy principles of oversight and accountability.

The report first establishes that what *is* known about how the TARP recipients' behavior before, during and after the bailout paints a dire picture of how the TARP funds were spent. It then presents a clear opportunity for lawmakers to regain some of the withering faith of the American people through widely supported execution tactics and simple communication practices with respect to TARP.

#### 1.1 Key Findings:

- Without specific, proactive oversight, the TARP program will continue to fail. TARP fund recipients are not going to voluntarily comply with the intent of the EESA law or provide reports on their actions.
- The Congressional Oversight Panel (COP), the Special Inspector General, the Government Accountability Office and two bills currently active in Congress all provide actionable recommendations and pose tough questions to the Department of Treasury for reforming TARP. Treasury should consider the provisions and recommendations to reform TARP.
- Taxpayers deserve to know, in a clear and concise way, which reforms have occurred, to restore some level of confidence that the next $350 billion will be allocated and implemented fairly, strategically and with upfront sign-off on accountability measures.

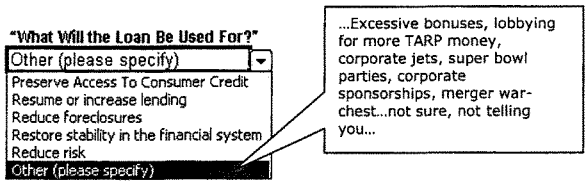
To help achieve these ends, U.S. PIRG Education Fund created a set of metrics and proposes the use of a TARP Report Card. The metrics are based on reports from leading government watchdogs, including the Government Accountability Office (GAO), the COP on the TARP and the TARP Special Inspector General. This report describes why that report card is needed. Based on the lack of any information about where the first $350 billion went, and the real possibility that Treasury never asked or required any information, the first report card, attached, gives the Bush Administration an F in almost every oversight category for its fourth quarter 2008 actions.

We will continue to issue quarterly report cards to track efforts by the fledgling Obama administration. Some early efforts are promising, such as its restrictions on lobbying by firms receiving TARP funds, its efforts to increase transparency and its actions on excessive executive pay and bonuses. We recommend that the Obama administration consider use of the report card to keep American taxpayers and lawmakers aware of the progress made in reforming the program.

## 2. Background

When a consumer applies for a personal loan, he or she fills out a form that asks a basic question: "What will the loan be used for?" If the consumer chooses "other" the bank may conduct additional underwriting and due diligence. After all, the bank needs to make sure that the loan terms make sense from a risk standpoint. Based on our analysis of the findings of government watchdog agencies, on news media reports and on Congressional testimony on the TARP program, it appears that not only did the Treasury Department encourage banks to choose "other," it did not require or conduct additional due diligence when they did.

**Figure 1: Sample (Hypothetical) Financial Institution "TARP Loan" Application**




Last fall, following the collapse of many of the nation's leading financial institutions, Congress enacted a sweeping government bailout of the financial sector. The centerpiece of the emergency law was a $700 billion taxpayer-financed bailout. Originally, the law countenanced using the funds – of which $350 billion was made immediately available to Treasury – to purchase troubled assets, hence the Troubled Assets Relief Program (TARP) was born. Immediately, Treasury decided that buying assets that could not be valued wouldn't work. It shifted the goals of the program to recapitalize the financial sector. The $350 billion was dumped into the financial system under several TARP programs using a variety of "strategies;" in some cases, some of the nation's largest banks received money under several different TARP programs.[1]

Nothing worked. The U.S. and world economies continue to crash. As 2008 came to a close, layoffs and foreclosures continue, as bank assets, home prices and 401-k values tumble. To make matters worse, while the original purpose of the Emergency Economic Stabilization Act was to jump-start consumer and business lending,[2] the Bush Administration's Treasury Department did little to ensure this would occur. Treasury placed minimal or no controls or reporting on the money's use. Although Congress added approximately 100 pages of controls and transparency measures to former Treasury Secretary Paulson's original 3-page proposed bill, no one knows what banks did with the money.

The publicly available information about TARP recipient activities leave the President, Congress and the American people with the only information they *do* have: that banks are spending taxpayer money on Super Bowl parties and Vegas junkets, lobbying for more bailout funds and for mergers and acquisitions, instead of making loans. The problem is worse than the optics of the lobbying and bonuses.

Although provisions providing for clarification of its intent and additional terms and conditions for the Troubled Asset Relief Program (TARP) funds were hastily worked into the final legislation passed last fall, so as not to issue a blank check to banks from an unchecked agency, our findings indicate that those transparency and accountability goals have not been achieved. Given the lack of proactive monitoring of the recipient selection and fund execution process, the TARP Congressional Oversight Panel agrees and

says it "still does not know what the banks are doing with taxpayer money." Neither does the TARP Special Inspector General.

With hundreds of billions of taxpayer dollars and the future of the global economy already at stake, Treasury and financial institutions need to do a lot better than recommend and select "other," on their "loan application." In the last four months, banks have received $350 billion of taxpayer dollars without accountability. The bill to the American people, so far, is roughly $4,500 per worker,[3] or $2,300 for every single person in the United States.[4] An additional $350 billion may soon be distributed and more will likely be needed. Experts believe as much as 3 times as much – or $2 trillion - may ultimately be the total cost of stabilizing the financial markets. Worse, homeowners have seen no relief from the threat of foreclosure that keeps the economy in a slide. Meanwhile, taxpayer anger continues to grow over the waves of revelations of the program's poor implementation.

President Obama recently called it "shameful" for failed executives to collect exorbitant bonuses as their taxpayer-subsidized firms continue to fail. He said that they are essentially being "rewarded for failure."[5] Yet, according to media reports, TARP recipients remain indignant when asked how and why the money was spent.[6] It is clearly time to mandate action and to put mechanisms in place to make sure that the next $350 billion and more is allocated, spent and monitored in an objective, sensible and transparent way.

## 3. Reports on TARP Recipients Paint Ugly Picture

Reports of the activities of TARP recipients continue to paint a picture of an industry "running wild" even as it keeps asking for more and more taxpayer dollars. Some of the more egregious actions included those by firms who continued practices that contributed heavily to the meltdown as they were being saved. Merrill Lynch, for example, continued to buy troubled mortgage assets even as it was being bought out by the *bailed* out Bank of America in a government-assisted merger. Their massive losses amounted to billions of dollars and resulted in a second bailout for a distressed Bank of America.[7] The available examples of what is known about the activities of TARP recipients describe a corporate and regulatory culture unable to focus on the reality that they are no longer accountable only to shareholders, but also to the American taxpayer.

Completing a picture that is blurry at best and infuriating at worst are the widespread reports that bailed-out companies may be using TARP money on lobbying, bonuses and corporate perks. These actions fan the flames of taxpayer bailout fatigue. Encouragingly, the Obama Administration has already announced restrictions on lobbying and executive bonuses by TARP recipients.

### 3.1 Problem: Lack of Use for Either Lending or Foreclosure Relief

> *"Make more loans? We're not going to change our business model or our credit policies to accommodate the needs of the public sector as they see it to have us make more loans[8]."*
> *- John C. Hope III, Chairman, Whitney National Bank, in New York Times*

The primary outcomes anticipated or expected by the implementation of the TARP were to give banks more flexibility to make personal and business loans and to prevent a tidal wave of foreclosures. To date, there is scant evidence that the banks are using the TARP funds as a means to that end.

**Lending.** One of the original policy goals of the TARP program was increasing loans to both individuals and businesses. However as the program evolved and its intent apparently became both broader and less accountable, some banks looked at the infusion of capital as almost as a slush fund, using it for a variety of purposes, including to pad their balance sheets and put themselves in a better position financially without increasing lending.[9] Many of the smaller banks receiving TARP funds available to non-distressed firms are simply holding on to the funds in case things get worse, as often predicted, before they get better. In fact, ten of the large recipients of TARP funds and several smaller banks reported a decrease in lending by a total of $46 billion between the third and fourth quarters of 2008.[10]

Some banks blame the economy and cite fewer opportunities to originate a lot of new loans. Others claimed a small increase in lending, such as BB&T's reported two percent increase in lending, but most maintained that the bulk of the TARP money was simply "invested" without providing clarification.[11] Some banks apparently consider it unfair to be told to make loans and claim that they don't want to risk making bad loans.[12] The lack of increased lending highlights just one of the outcomes that has been inconsistent with the intent of the implementation of TARP.

**Foreclosure Prevention.** With respect to curbing foreclosures, the second report published by the Congressional Oversight Panel could find "no evidence" that the TARP funds were in any way being used to "maximize assistance for homeowners" by helping to prevent further foreclosures.[13]

The FDIC estimates that over the next two years, an estimated 4 to 5 million mortgage loans will enter foreclosure if nothing is done.[14] The vacant and often vandalized homes are prone to criminal activity and their boarded-up windows generally drive down the value of neighboring homes. Entire communities feel these effects. Nobel laureate and Columbia professor Joseph Stiglitz testified to the Congressional Oversight Panel that "The start of our economic problem...was in the mortgage market...banks made loans based on inflated housing prices; the mortgages were beyond many individuals' ability to pay...Matters have only grown worse, as we gradually discover the depth of their incompetencies in managing risk and allocating capital." While Citibank, a major recipient from several TARP programs, has recently announced its tentative support (with weakening amendments) for the priority reform of allowing bankruptcy judges to renegotiate loan terms to keep families in their homes paying their loans instead of out of their homes and in foreclosure, strident and vehement opposition from other TARP recipients has kept the bills locked up in House and Senate committees since the last Congress.[15]

### 3.2 Problem: Use for Lobbying and Corporate Perks

*"JUST PLANE DESPICABLE."*

- Headline of New York Post (following the revelation of the size of the corporate jet fleet still held by taxpayer-subsidized banks.)

**Living High on the Hog.** Joe Cassano, head of A.I.G. Financial Products, earned $280 million the year he was essentially blamed for the company's rapid demise. In addition, he received a $34 million bonus and was kept on a $1 million per month retainer even after he was let go. As the government pumped money to the tune of $150 billion into A.I.G. because it was deemed systemically significant and therefore "too big to fail," its executives and top sales representatives enjoyed a California beach spa and golf retreat at a cost totaling $440,000.[16] Meanwhile former Merrill Lynch CEO John Thain demanded a $10 million bonus even as his company was acquired at a fire sale price -- due to its poor returns -- by Bank of America in a government-assisted acquisition. Despite an outcry, he still managed a $750,000 salary and a $4 million

bonus after all was said and done. Another example is Citigroup. As the company received $25 billion from the government, it managed to designate $25.9 billion for compensation and bonuses.[17] Money is fungible. While the bank can say that the bonuses came from a different account, that account could have been empty before the TARP money came in.

**Sponsored By.** At the Super Bowl earlier this month, Bank of America sponsored the multi-million dollar "NFL Experience," as ABC News reported, which featured 850,000 square feet of a fan fest including interactive entertainment attractions.[18] Congressman Elijah Cummings, (D-MD), said, "They should know better, but obviously they don't."

**Lobbying.** It's now been widely reported, and finally acted upon by Treasury, that the same firms receiving billions of bailout dollars continue to lobby Congress not only for more money, but also to maintain the current toxic environment of deregulation that helped lead us to where we are today. According to the Associated Press (AP), these companies would not segregate dollar amounts by subject of the lobbying activity.[19] For example, the Capitol Hill newspaper The Hill reports that in light of the absence of any restrictions, (as were applied to Fannie Mae and Freddie Mac), Citigroup spent $1.28 million in the final quarter of 2008, Bank of America spent $820,000, Morgan Stanley spent $520,000.[20] The financial industry, which is largely not unionized, has also been reported to use TARP funds against major legislation sought by the labor movement to improve workers' rights to organize (the Employee Free Choice Act).

### 3.3 Problem: Deceptive Accounting and Reporting

*"Americans were told you have to pony up some money to help these companies. And it's rather infuriating for them to find out now that those companies, when they were profitable, didn't want to pay taxes and found clever ways to hide their money overseas."*

*- Senator Byron Dorgan, Washington Post*

Part of what makes the bailout hard to stomach for many Americans is how these companies behaved when things were going well for them. Fueled by a decade of deregulation and overzealous housing price projections, several of the largest recipients, who were first in line for TARP money, had a history of using questionable, unethical and even illegal business practices that gave them unfair competitive advantages while harming consumers. In January of this year, Senator Carl Levin (D-MI), chairman of the Permanent Subcommittee on Investigations, stated his findings before the Homeland Security and Governmental Affairs Committee:[21]

- Leading U.S. financial institutions such as Citigroup, JPMorgan Chase, and Merrill Lynch willingly participated in deceptive transactions to help Enron inflate its earnings [before its collapse].
- U.S. corporations engaged in misleading accounting, offshore tax abuses, excessive stock option payments, and other disturbing practices.
- Lehman Brothers, Morgan Stanley, and others helped offshore hedge funds dodge payment of U.S. taxes on U.S. stock dividends by facilitating complex swap agreements and stock loan transactions.
- Countrywide and others sold abusive mortgages, overcharged borrowers, and offloaded defective mortgage-based securities onto the market.

According to the Government Accountability Office (GAO), a number of the biggest (both in their size and their bailout fund receipts) financial institutions maintain revenues in offshore "tax haven" countries, where there are no or nominal taxes and minimal, if any, reporting. According to Department of Treasury reports, the U.S. government loses $100 billion a year in tax revenue from these tax dodges from all sources, including these firms.[22] For instance, Citigroup claims 427 different overseas locations or tax jurisdictions – 90 in the Cayman Islands alone; Morgan Stanley has 273 locations, of which 158, or well more than half, are in those notorious Cayman Islands.[23]

The most dangerous behavior, though, has to do with how banks assess their assets versus how the market does. The banks essentially value their assets at a price at which investors would not be willing to pay. If the Treasury has to end up selling these assets at a lower price, it would, and so the taxpayers would, endure massive losses.[24]

> "As a group, these [bailed out companies] are very risky companies. Unfortunately, the odds are that a number of these companies will fail at some level in the future, which raises the concern that the Federal Government is throwing good money at bad. At a minimum... we should demand a more thorough review of their accounting and corporate governance practices," surmised the CEO of Audit Integrity.[25]

In the end, the financial institutions in the TARP programs are likely in worse shape than their records would indicate, and taxpayer dollars are now at risk because no one has controlled the risks for years, even as firms increased their use of even riskier practices and acquisition of riskier assets.

## 4. Treasury Dropped the Ball: What We Know About TARP Execution

*"Basically we dropped a huge amount of money...and we have nothing to show for what we actually wanted to happen."*

- Campbell Harvey, Finance Professor Duke University[26]

*"They didn't tell me that I had to do anything particular with it."*

- Alan B. White, Chairman, PlainsCapital Bank[27]

### 4.1 Problem: Deceptive Accounting and Reporting

The TARP recipients mentioned previously weren't the only forces at work to make such a "mess" as described by Eric M. Thorson, the former inspector general in Bush's Treasury Department. In its January 9, 2009 report, the Congressional Oversight Panel bluntly criticized Treasury for having no strategy or even a solid set of guiding principles for how and why it expects the TARP to work.[28] And if Treasury isn't sure why it is doing what it is doing, it's hard to blame the banks alone for the lack of transparency on their part or the possibility that they spent money on lobbying, parties or bonuses. Senate Banking Chair Senator Chris Dodd (D-CT) referred to TARP implementation as mere "lurching interventions" with no clear direction or purpose.[29]

**Strategy (?) Shifts.** The trouble began at the outset when the former Administration changed the fundamentals of TARP from buying up bad mortgages, bad mortgage-backed securities and other "toxic assets" to instead buying preferred stock and warrants[30] in the nine largest American Banks and hundreds of smaller banks.[31] Treasury injected capital into "healthy" banks (the Capital Purchase Program), made loans to the automotive industry (the Automotive Industry Financing Program), made a direct investment in American International Group (the Systemically Significant Failing Institution program) and created a similar program for Citigroup and Bank of America (Targeted Investment Program). This confusion bled into every step of the bailout process, starting with choosing participants.

**Arbitrary Choices.** Although Treasury lays out the fields of its application process on its website, it provides no insight as to why certain institutions were chosen. Because the strategy continues to shift again along the way – from buying troubled assets to helping healthy banks and those "too big to fail," many engaged participants and overseers – including Members of Congress, the Congressional Oversight Panel and even the recipients themselves – have no idea what the criteria were and are for choosing participants. Further, Treasury did not evaluate the participants based on risk. It paid a uniform price across healthy and unhealthy financial institutions, which caused the Congressional Oversight Panel to issue a thousand-page report based on an expert consultant's analysis that found that the American taxpayer ended up overpaying for these assets by $78 billion.[32]

Citi, for example, received funds as a "healthy" bank, and then shortly thereafter, qualified as a failing bank. Bank of America received funds from three different programs under TARP, and even the Special Inspector General for TARP is not aware of the criteria for qualifying for each. [33] "Shifting criteria," as Senator Grassley testified in the Senate Banking Committee, "makes it easier for regulators to pick winners and losers."[34]

"It's totally arbitrary," said Republican Governor Mark Sanford of South Carolina to the Wall Street Journal last month. "If you've got the right lobbyists and the right representative connected to Washington or the right ties to Washington, you get the golden tap on the shoulder."[35]

**Where's the Money?** The Treasury failed to mandate any reporting from recipients of the massive Capital Purchase Program (CPP). Even those recipients who do not plead ignorance have been unapologetic and have no fear of repercussions for using the funds for things other than what the bill originally intended. The Treasury Department did not put forth any initial controls, plans or requirements for CPP recipients to agree to prior to receiving the money.[36] There are currently no enforcement mechanisms in place that have any meaning to TARP CPP recipients.

At the time of the release of this report, only Citigroup has provided a report on TARP fund uses and loan and foreclosure prevention activities for the last quarter of 2008. And this is likely because Citi agreed[37] as a result of its second TARP contract, for its specially-created Targeted Investment Program funds, to report on a quarterly basis. While this is a start, this practice needs to be standardized and required across ALL TARP programs, all participants, and complete with comparative data from previous quarters.

## 5. Not This Time: An Opportunity for Congress and The President

> *" Where you've got federal money involved, taxpayers' money involved, TARP money involved, and the way they have spent it, with no accountability, is getting close to being criminal."*
> - Sen. Richard Shelby (R-AL), to Associated Press

The new Congress and the Obama Administration have an immediate, specific and unparalleled opportunity to provide those bankrolling the banks – the American taxpayer – with a full disclosure of how their money was spent and with a clear, mandated plan to make sure that the recipients' actions are in line with the EESA goals.

There's an emerging philosophy among the industry and its supporters that government "interference" or participation is just fine when government wants to provide banks with a capital infusion, but that when the government moves toward attaching restrictions on compensation or operations, all of the sudden it's deemed an undue influence. Many lawmakers believe that hypocrisy needs to end now. As Senator Claire McCaskill, (D-MO) stated to the Associated Press, it's not enough to simply ask, or say "Please," if we want bailout recipients to spend the money as it was intended.[38]

### 5.1 Goal: Restoring Confidence

Results of a survey conducted in December by Luigi Zingales, a professor at the University of Chicago's Booth School of Business, and Paola Sapienza, a professor at Northwestern's Kellogg School of Management, demonstrate the degree to which people have little to no confidence in the financial system and the government's response to the meltdown.[39] Approximately 60% of respondents said they "believe the financial system is unfair" and 80% said the "government's methods made them less confident in the market." Also, a new poll from Celinda Lake finds strong support for greater transparency in both the use of economic recovery and bailout funds.[40]

The Obama administration has acknowledged that TARP requires a heavy overhaul and has begun to indicate ways in which it plans to change the program. For example, Treasury requested that TARP recipients submit lending data to the Treasury Department by the end of January. However, it has been reported that the disclosures won't disclose anything new.[41] This is just the beginning, we hope, of a series of announced reforms. The new Treasury officials need to essentially turn this program upside down, shake it and start over – from strategic planning to monitoring and maintenance.

A critical first step is for the Special Inspector General for TARP (SIGTARP), Neil Barofsky, to execute his inquiry to TARP recipients as to how the money was spent and how they plan to spend any remaining funds. After his extraordinary testimony that he had no idea what TARP recipients were spending money on, Barofsky reported to the Senate Banking Committee that TARP recipients now have 30 days to answer his straightforward questions, including how they spent the TARP funds. In a letter to the Senate Finance Committee's ranking Republican, Sen. Charles Grassley, SIGTARP Barofsky said, "If the American taxpayer is expected to fund this extraordinary effort to stabilize the financial system, it not unreasonable that the public...and Congress have some understanding as to how those funds have been used by the recipients." Barofsky has broader authority, including subpoena power, and a larger staff, than the Congressional Oversight Panel, to carry out this process.

Another step that Treasury recently took was to post TARP transactions and contracts on its websites. However, the contracts posted are, first, enormously large (8-10 mB) scanned files and, second, consist largely of boilerplate legalese with little specific information about an individual institution that would be useful in analyzing their effect. The goal here was laudable, but the execution lacking.

### 5.2 Goal: Reforming the TARP Program

Public outrage has continued to increase. Fortunately, there is now a great deal of consensus across outside watchdog groups, the Government Accounting Office (GAO), the TARP Congressional Oversight Panel (COP), the FDIC, Administration officials, Members of Congress and the general public about the specific steps that must be taken to ensure that this program is reformed. At time of publication, the COP and GAO have agreed that there is still no clear strategy or vision for what the TARP program aims to accomplish.[42] On January 28, the COP sent the same set of common sense questions regarding TARP transparency and accountability that it had sent to Secretary Paulson (and went mostly unanswered or answered poorly) to the new Treasury Secretary, Timothy Geithner.

Implementing stringent requirements has the potential to deter possible applicants who may not need the funds, and who will assume it's a free infusion of cash. It has been reported that even before any of these recommendations or additional requirements have been implemented, that the perception of new requirements and restrictions prompted many banks who were initially accepted into the program to withdraw.[43]

An even more powerful message to the current participants – and to the bail-out fatigued American taxpayers – would be to make these requirements retroactive. And if firms were unable or unwilling to meet the new strict reporting requirements and adherence to the original principles of the legislation, then they could be required to pay back their loans.

## 6. Conclusion

Based on the findings of this report, U.S. PIRG Education Fund recommends that reforms described to improve transparency and accountability under the TARP program be implemented immediately by Treasury or Congress as appropriate. In addition, U.S. PIRG recommends that policymakers use the metrics and Report Card described here as a way to identify and compare the status of the implementation of TARP reform programs in a way that can be easily communicated. Improving transparency and accountability within the program is an obvious goal to protect the taxpayer; improving transparency about the program will better inform both the taxpayer and policymakers. Of course, improving the TARP program is only a short term solution to our financial regulation problems. In a pending report of the Securing America's Financial Future program of the U.S. PIRG Education Fund, we intend to discuss why that long-term solution should be based on the findings of the Congressional Oversight Panel's Special Report on Regulatory Reform.

**Attachments Follow:**

Appendix A: 111th Congressional and Obama Administration Actions to date
Appendix B: TARP Implementation Quarterly Report Card
Appendix C: Additional Available TARP Resources

## 7. Appendix A: 111th Congress and Obama Administration Actions to Date

This appendix tracks the reform actions (including proposals) taken so far by both Congress and the new Obama Administration. Representative Barney Frank (D-MA) introduced the TARP Reform and Accountability Act, H.R. 384, which was passed by the full House of Representatives. Senator Byron Dorgan (D-ND) has introduced a bill, The Taxpayer Protection Act, S. 195, to increase the oversight, transparency and accountability of the EESA. Progress has been made in the effort to make real reforms with real meaning and real enforcement mechanisms happen – but there's still much to be done. And as we learned with the first disbursement, unless someone is watching, asking and mandating things in writing – it's not going to happen.

**Appendix 1: TARP Reform Actions (including proposals) to date**
(The actions are categorized under Recommendations prioritized by U.S. PIRG Education Fund based on reports of the Congressional Oversight Panel, the Special Inspector General for TARP, the GAO and other sources.)

| Recommendation | Action from Congress | Action from Administration |
|---|---|---|
| Provide a detailed disclosure of how the first $350 billion was spent for all TARP fund recipients. | Both the House and Senate have held a number of hearings on TARP transparency. For example, on 5 Feb, Senate Banking heard from Gene Dodaro, Acting Comptroller General at GAO, Elizabeth Warren, Chair of the Congressional Oversight Panel on TARP and Neil Barofsky, Special Inspector General for TARP (SIGTARP). At that hearing, Senate Banking Committee members indicated strong support for SIGTARP enforcing the original intent of the EESA through rigorous reporting and auditing. Upcoming hearings scheduled include testimony from Bank of America.<br><br>Financial Services Chairman, Rep. Barney Frank, sent a letter dated 1/27/09 to the Special Inspector General for TARP (SIGTARP) Neil Barofsky thanking him for his efforts and requesting an update as soon as available.[44] | Treasury's agreements with Bank of America and Citi require these entities to report on their use of funds.<br><br>Treasury has begun the process of sending monthly surveys to 20 of the largest institutions and plans to implement a quarterly report from other institutions.<br><br>A letter 1/22/09 from the SIGTARP to indicated that SIGTARP plans to send a request to all TARP recipients to account for their use of funds and their implementation of executive compensation restrictions. |
| Establish clear and unambiguous terms by which recipients of TARP funds are chosen | | GAO reports that the Department of Treasury relies on regulator's recommendations (and banks choose their regulators) for approving applications to the Capital Purchase Program (CPP). There's also a lack of consistency as to the extent of information provided by these regulators.[45] |
| Establish specific terms and a mechanism to repay the American taxpayer (TARP purchases are guaranteed in some cases with non-voting preferred stock (which could change in value) or in warrants to re-purchase at fixed prices. However, the lack of accuracy around the value of these assets "puts" diminishes returns. | S. 195, the Taxpayer Protection Act, (Dorgan (D-ND) requires Treasury to collect data with a full description of the collateral or other interests granted to Treasury to ensure that taxpayers are repaid, to the maximum extent possible.[46] It essentially makes sure that taxpayers are beneficiaries to any upside of this investment.<br><br>S. 195 also creates a Taxpayer Protection Prosecution Tax Force that would prosecute any person or entity found to benefit from financial wrongdoing. | |

**Appendix 1: TARP Reform Actions (including proposals) to date**
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| Recommendation | Action from Congress | Action from Administration |
|---|---|---|
| Establish controls, operational checkpoints and specific reporting requirements to which ALLTARP recipients must comply to receive funding (and retroactively for the first round recipients). Provide continuous and frequent reports on the alignment with the goals and objectives of the EESA (retroactively for the first round recipients), including foreclosure mitigation and increase in lending | HR 384, (Frank, D-MA), the TARP Reform and Accountability Act, passed by the House of Representatives, on a roll call vote of 260-166 (1/29/09). The bill requires the Secretary to incorporate within the TARP assistance agreement how the funds are to be used and the benchmarks an institution must meet in using such funds.<br><br>S. 195 requires entities to provide, in writing, an agreement to provide a detailed monthly report to Congress about how emergency assistance provided is being used to meet the intended objectives and goals of the program.<br><br>S. 195 requires all firms receiving assistance to be subject to the same conditions as the automotive industry: prohibit executive bonuses, prohibit repayment of dividends, make operational changes to prevent reckless behavior. Failure to comply would require firms to repay their loans immediately. | Treasury has developed a survey for 20 of the largest recipients (which leaves out the majority of recipients) to report monthly on loan balances, new loan originations and purchases of asset-backed and mortgage-backed securities.<br><br>The FDIC requires the banks that it regulates (state non-members of the Federal Reserve) to report on banks' use of TARP CPP funds and how their capital subscription was used to promote lending and encourage foreclosure prevention efforts. To be effective, this should be extended to the remaining, and much larger, participants.[47]<br><br>The Administration has called for using the funds for foreclosure mitigation (reported from $50 - $100 billion).[48]<br><br>Citigroup released a required quarterly report on 2/3 providing Quarter 4 2008 figures with respect to expenditures of the TARP funding. Citigroup is also the only entity for which a mortgage modification program is required. [49] |
| Limits on executive compensation, bonuses and dividends | S.195 limits executive compensation and annual executive compensation tax deductions. It also prohibits bonuses or incentive compensation awards to the 25 most highly compensated employees of the TARP recipient. | On 2/4/09 the Administration announced a new cap regarding executive compensation that would apply to institutions that negotiate agreements with the Treasury Department for "exceptional assistance" in the future. This new rule would not apply to previous recipients – including American International Group (A.I.G.), Bank of America and Citigroup.[50] |

## 8. Appendix B: TARP Implementation Quarterly Report Card

There have been attempts from several different organizations, as well as from the Department of Treasury itself, to report out progress on reforming the program and demonstrating transparency. U.S PIRG Education Fund's financial, tax and budget staff have drawn from metrics proposed by the U.S. Government Accounting Office (GAO) TARP report (1/30), the TARP Congressional Oversight Panel findings in its 2nd report (1/9), and from the report by the Special Inspector General for TARP (2/6) to come up with a simple report card to show the Department of Treasury's progress against meeting accountability and transparency metrics. We will release the TARP Report Card at the close of each quarter going forward.

Government agencies, technology firms, consumer organizations and universities have systems established to provide product or service reports so that their stakeholders can make informed decisions. The TARP Report Card draws from both the detail of technical criteria[51] *and* the simplicity of consumer-focused reports.[52]

Based on the lack of any information about where the first $350 billion went, and the real possibility that Treasury never asked or required any information, the first report card, on the next page, gives the Bush Administration an F in almost every oversight category for its fourth quarter 2008 actions.

We recommend that the Obama administration consider use of metrics and the report card. We will continue to issue quarterly report cards to track efforts by the Obama administration. Some early efforts by the fledgling Obama administration are promising, such as its restrictions on lobbying by firms receiving TARP funds, its efforts to increase transparency and its actions on excessive executive pay and bonuses

This TARP report card for the initial implementation of the TARP program in the first quarter of FY 2009 (fourth quarter of calendar 2008) gives an overall F grade on all but one line item.

| U.S. PIRG Education Fund's TARP Report Card | Quarter 1 of FY 2009 FINAL | | | |
|---|---|---|---|---|
| **TARP Reforms Should Include:** | Complete | Consistent | Usable | **Overall Grade** |
| **A clear strategy for all TARP programs** | ○ | ○ | ○ | F |
| **Contingency or alternative plans should the program fail** | ○ | ○ | ○ | F |
| **Provision of clear and objective criteria for establishing eligibility for TARP assistance** | ○ | ○ | ○ | F |
| **Accessible information regarding the terms of receipt of TARP funds** | ○ | ○ | ○ | F |
| **Metrics to make sure that the TARP recipient is using the funds to forward the objectives of the EESA, including:** | ○ | ○ | ○ | F |
| -- Reporting on lending | ○ | ○ | ○ | F |
| -- Reporting on foreclosure assistance/loan or rate modification | ○ | ○ | ○ | F |
| -- Reporting on consumer credit access | ○ | ○ | ○ | F |
| -- Clear consumer and taxpayer protection provisions | ○ | ○ | ○ | F |
| -- Reporting on all activities that do not directly support the goals | ○ | ○ | ○ | F |
| **Prohibition for using funds for mergers and acquisitions** | ○ | ○ | ○ | F |
| **Organizational/operational reforms established for recipients** | ◐ | ○ | ○ | D |
| **A plan to make sure assets are accurately evaluated to give a holistic picture of recipients and the taxpayer investment** | ○ | ○ | ○ | F |
| **Limits and restrictions on executive pay, bonuses and payment of dividends** | ○ | ○ | ○ | F |

| Criteria Definitions | |
|---|---|
| Complete | Item has been addressed and implemented. |
| Consistent | Consistent implementation of item/program across all TARP recipients. |
| Usable | Information provided to the recipient and the public is clear and accessible. |

Legend for Ratings

● High ◐ Medium ○ Low

## 9. Appendix C: Additional Available TARP Resources

Program Descriptions and Participants (all directly from Department of Treasury Website):

**Capital Purchase Program:** Under the program, Treasury will purchase up to $250 billion of senior preferred shares on standardized terms as described in the program's term sheet. The program will be available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged only in financial activities that elect to. Treasury will determine eligibility and allocations for interested parties after consultation with the appropriate federal banking agency. Application guidelines and deadlines are available at http://www.treasury.gov/initiatives/eesa/application-documents.shtml.

**Participants:**
Bank of America
The Goldman Sachs Group
Morgan Stanley
Citigroup
JPMorgan Chase
Wells Fargo & Co.
Bank of New York Mellon
State Street
Merrill Lynch
+ other smaller banks: Transactions Report on Department of Treasury Website:
http://www.treas.gov/initiatives/eesa/transactions.shtml.

**Systemically Significant Failing Institutions Program:** The primary objective of this program is to provide stability and prevent disruption to financial markets in order to limit the impact on the economy and protect American jobs, savings, and retirement security from the failure of a systemically significant institution. In an environment of substantially reduced confidence, severe strains, and high volatility in financial markets, the disorderly failure of a systemically significant institution could impose significant losses on creditors and counterparties, call into question the financial strength of other similarly situated financial institutions, disrupt financial markets, raise borrowing costs for households and businesses, and reduce household wealth.

**Participants:**
American International Group (A.I.G.)

**Targeted Investment Program:** The objective of this program is to foster financial market stability and thereby to strengthen the economy and protect American jobs, savings, and retirement security. In an environment of high volatility and severe financial market strains, the loss of confidence in a financial institution could result in significant market disruptions that threaten the financial strength of similarly situated financial institutions and thus impair broader financial markets and pose a threat to the overall economy.

**Participants:**
Citigroup

**Automotive Industry Financing Program:** The objective of this program is to prevent a significant disruption of the American automotive industry that poses a systemic risk to financial market stability and will have a negative effect on the real economy of the United States. The program will require steps be taken by participating firms to implement plans that achieve long-term viability.

**Participants:**
GM
GMAC
Chrysler

**Other online resources:**

Congressional Oversight Panel:
http://cop.senate.gov/index.cfm

Senate Finance Committee:
http://finance.senate.gov/index.html

Special Inspector General:
http://www.sigtarp.gov/

Government Accountability Office:
http://www.gao.gov/

## 10. Endnotes

[1] See Appendix C

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PREPARED STATEMENT OF ALEX J. POLLOCK

Madam Chairman, Ranking Member Brownback, Vice Chairman Schumer, Senior House Republican Member Brady, and members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago. I am a director of three financial services companies.

My testimony considers the context in which to understand banking bailouts, the clear accounting for them we should demand, and relevant lessons from Jesse Jones and the Reconstruction Finance Corporation.

THE CONTEXT OF BANKING BAILOUTS

The United States and many other countries once again demonstrate the dilemmas of the recurring historical experience of using public money to offset the losses of banks in the name of economic and social stability. Debates about this go back at least to 1802, when Henry Thornton (in *The Nature and Effects of the Paper Credit of Great Britain*) clearly discussed the "moral hazard" and the "systemic risk," as we now call them, involved in financial rescues.

At the end of the last big U.S. depository institution bust, in 1989–1992, Americans seemed relieved to have the government present the bill for the cost of its deposit guarantees to the taxpayers. As the RTC liquidated the failed thrifts, and helped investors and commercial banks by selling them cheap assets, the thrift depositors were protected with funds from the Resolution Funding Corporation (Refcorp). Refcorp sold 30- and 40-year non-callable bonds on the Treasury's credit, with some coupons of over 9%, to raise money. These borrowings are still outstanding, so we are still paying on the bailout of 20 years ago.

The Japanese in the 1990s, and many other countries before and since, have had similar bailouts. Why should this keep happening?

Because there is an unresolvable conflict in financial systems between the political desire to have deposits for the public which are riskless, combined with a banking business which is inherently risky. Anything levered 12 or 15 or more to 1 is very risky. So we observe that banking is subject to recurring losses of capital which turn out to be much greater than anyone imagined possible—just like now.

The combination of riskless funding with a risky business is in fact impossible: the risk simply moves to the government guarantor. Governments are periodically put in the position of transferring losses from the banks to the public, and money from the public to the banks—as once again today.

CLEAR ACCOUNTING FOR THE FINANCIAL RESULTS OF BAILOUT OPERATIONS

Government bailout operations make the 60% of households who actually pay federal income taxes into involuntary investors: either investors in bank equity, investors in distressed assets, or both. How can we, the involuntary investors and their Congressional representatives, figure out what is happening with the money?

First, all the activities of the TARP program should be isolated in a separate accounting entity, preferably a Treasury-guaranteed government corporation. This entity should have to borrow on its own balance sheet to finance its investments or expenses in excess of income.

All investments and other assets, all related borrowings and other liabilities, all expenses, and all income should be clearly measured as if TARP were a corporation. This would be most straightforward if it were in fact a corporation—like the Reconstruction Finance Corporation was.

An audited balance sheet and income statement should be regularly produced. This would allow the operators of the bailout program, the administration, the Congress in its oversight responsibilities, and most importantly, the taxpayers as investors, to judge its performance over time. Its retained earnings or accumulated losses would show its results life to date.

In my view, the Congress should require such a regular and disciplined accounting.

Looking forward, as well as measuring backwards, should be businesslike, with regular budgets and forecasts. For as long as TARP represents such large outlays, the Congress should certainly demand a clear forecast of the next year's TARP activity and results before it approves any federal budget.

The investments the taxpayers are involuntarily making might have an overall positive return in the long run, when asset prices recover. With yield on the pre-

ferred stock investments being made, and the possible future upside of warrants and common stock, the TARP program might in the end make a profit. Or it might break even, or make a loss, or a big loss—we need to know which one it is.

It is my view that if there is a profit in the end, 100% of any such profit should be earmarked as explicit dividends to the taxpayer-investors. These dividends might be in the form of cash or specific tax credits. This would be a well-deserved recompense to the majority of citizens who bought houses they could afford, paid their mortgage loans on time, did not engage in leveraged speculations, paid their taxes, and then paid for and took all the risk of the bailout efforts.

Prudence, moderation and virtue are their own reward, yes, but if the bailout should make money in the end, let's declare dividends for the investors.

LESSONS FROM THE RFC

A fruitful historical comparison might be made between TARP and the Reconstruction Finance Corporation (RFC)—specifically the RFC of the 1930s financial crisis (not the war finance RFC of the 1940s). The RFC was one of the most important and powerful agencies created to cope with the greatest U.S. financial crisis ever; it made investments in more than 6,000 banks in its day.

Set up under President Hoover, and expanded by President Roosevelt, the RFC was run for most of the time by a forceful and very experienced character named Jesse Jones, a successful entrepreneur from Texas (a Democrat by definition in those days), whose formal schooling had ended in the eighth grade.

The basic pattern of RFC bailout equity investing was described by Jones in his instructive memoirs, Fifty Billion Dollars: My Thirteen Years With the RFC. There were, he wrote, four principal steps:

1. Write down the bad assets to realistic economic values, and consequently write off book equity.
2. Make a judgment about the character and capacity of management and make any appropriate management changes.
3. Based on realistic asset values and capable management, have the RFC buy new equity in the bank in the form of redeemable, dividend-paying preferred stock.
4. Receive dividends and ultimately the par value of the preferred stock back, as the bank returns to profitability and recapitalizes in the private market over time.

This summarizes a sensible and tough-minded program, easier said than done well, but a logical crisis model. Note a key difference between the equity investments of TARP and Jones' rule #1: first the write-downs, only then the recapitalization. This strikes me as the right order.

As the President of the Kansas City Federal Reserve Bank, Tom Hoenig, pointed out in a recent speech, "Too Big Has Failed," the RFC at one point held capital in about 40% of all banks, but in the end had no net cost to the taxpayers.

A final thought: organizations are important, but more important is who is running them. In addition to making sure TARP has disciplined accounting, we need to find another Jesse Jones to run the bailout operation.

Thank you again for the opportunity to share these views.

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